U.S. Regulation of the International Securities and Derivatives Markets

Twelfth Edition | 2017

SECURITIES MARKETS

Edward F. Greene
Leslie N. Silverman
Daniel A. Braverman
Sebastian R. Sperber
Nicolas Grabar
Adam E. Fleisher

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U.S. Regulation of the International Securities and Derivatives Markets, HIGHLIGHTS

U.S. Regulation of the International Securities and Derivatives Markets
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U.S. Regulation of the International Securities and Derivatives Markets

Twelfth Edition

Securities Markets

by Edward F. Greene, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar and Adam E. Fleisher

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U.S. Regulation of the International Securities and Derivatives Markets, Twelfth Edition, Securities Markets provides the only available comprehensive analysis of the application of U.S. securities laws to participants and transactions in securities in the international capital and financial markets. The book provides in-depth analysis of the legal framework for all types of securities offerings—from registered IPOs to Rule 144A offerings, including the principal issues a foreign company should consider when deciding whether and how to offer securities in the United States (*i.e.*, publicly or privately). It also offers guidance on U.S. regulations governing brokers and dealers, investment companies and investment advisers.

Prior editions of this treatise covered both U.S. regulation of the international securities markets and U.S. regulation of the international derivatives markets. With this Twelfth Edition, we have divided the topics into two separate volumes. For a detailed description of the U.S. regulatory regime governing international financial transactions involving derivatives, as well as the U.S. regulatory regime governing futures commission merchants, dealers in swaps and security-based swaps, major participants in swaps and security-based swaps, commodity pool operators and commodity trading advisors, please refer to *U.S. Regulation of the International Securities and Derivatives Markets, Twelfth Edition, Derivatives Markets*, forthcoming.

This treatise was authored by a team of attorneys at Cleary Gottlieb Steen & Hamilton LLP, renowned as one of the foremost law firms in international capital markets and financial transactions.

The book is divided into 16 chapters:

Chapter 1: **Statutory and Regulatory Framework** introduces the key pieces of legislation that are discussed in more detail in subsequent chapters and discusses the principal ways in which this legislation is evolving.

Chapter 2: **Key Considerations for a Foreign Company Accessing the U.S. Capital Markets for the First Time** is an entirely new chapter that presents the key issues for a foreign company considering offering securities in the United States for the first time, including whether to do so as a public offering or private placement.

Chapter 3: **The U.S. Public Offering Process for Foreign Issuers** discusses in detail the U.S. public offering process and the considerations that will affect how a foreign company approaches the U.S. public market.

Chapter 4: **Foreign Issuer Disclosure in the U.S. Public Securities Market** details the disclosure required of foreign issuers under the SEC's rules for public offerings and reporting companies, and it explores the major issues foreign issuers often encounter in attempting to meet these disclosure requirements.

Chapter 5: **Corporate Governance and Similar Requirements Applicable to Reporting Foreign Private Issuers** now consolidates in one chapter a detailed discussion of the corporate governance requirements applicable to a foreign company that is public in the United States.

Chapter 6: **Certain Requirements Relating to Directors, Officers and Major Shareholders of Foreign Private Issuers that Are Public Companies in the United States** analyzes the reporting obligations under the U.S. securities laws applicable to senior officers, directors and significant shareholders of foreign companies whose securities are publicly traded in the United States.

Chapter 7: **Private Offerings in the United States by Foreign Issuers** deals with Rule 144A offerings and other private placements exempt from Securities Act registration.

Chapter 8: **Financings Outside the United States** discusses the requirements of the safe harbor provisions of Regulation S that afford an exemption from Securities Act registration for securities offerings outside the United States.

Chapter 9: **Tender Offers, Repurchases of Equity Securities, Liability Management, Business Combinations** describes the rules governing tender and exchange offers, liability management transactions, business combinations and other issues relating to the acquisition—whether by the company or third parties—of significant interests in companies whose securities trade in the United States or that conduct business in the United States.

Chapter 10: **Selected Practical Issues in Cross-Border Offerings** discusses various practical issues related to international offerings as well as certain types of nontraditional offerings, such as continuous offerings, block trades, rights offerings, spin-offs and offerings of tracking stock and contingent value rights.

Chapter 11: **Enforcement of the U.S. Securities Laws** addresses governmental and private remedies, including class actions, relating to violations of the U.S. securities laws.

Chapter 12: **Categorization and Regulation of Securities** analyzes the continuing evolution of the jurisprudence governing the legal status of certain financial instruments, including derivatives, under the U.S. securities laws.

Chapter 13: **The U.S.-Canadian Multijurisdictional Disclosure System** analyzes the MJDS, which provides for complex reciprocal arrangements intended to facilitate certain U.S.-Canadian cross-border securities offerings and tender offers.

Chapter 14: **Foreign and Foreign-Owned Broker-Dealers** discusses the regulatory frameworks applicable to broker-dealers, focusing on jurisdictional issues, registration requirements and applicable exemptive provisions, and summarizing the regulatory regime applicable to registered entities.

Chapter 15: **Foreign Investment Companies** describes the regulatory framework applicable to investment companies, focusing on jurisdictional issues, registration requirements and applicable exemptive provisions.

Chapter 16: **Foreign and Foreign-Owned Investment Advisers** discusses the regulatory frameworks applicable to investment advisers, focusing on jurisdictional issues, registration requirements and applicable exemptive provisions.

The *Guide to Locating Relevant Forms, Statutes, Rules and Regulations*, which is now part of the front matter of this book, guides readers to the location of electronic copies of a wide variety of the authorities cited in the book, including statutory provisions, rules, regulations, forms, cases and administrative decisions.

Highlights of the Twelfth Edition

This Twelfth Edition covers a number of topics not previously discussed in the book and has been reorganized and streamlined. New Chapter 2 presents the key issues for a foreign company considering offering securities in the United States for the first time, including whether to do so in a public offering or private placement. This new chapter functions as an executive summary of issues that are discussed in detail later in the book, and includes a roadmap to these subsequent discussions. In addition, this Twelfth Edition now covers pre-deal communications such as pilot fishing and the role of anchor and cornerstone investors (discussed in Chapter 3) and liability management (discussed in Chapter 9). Chapter 10 includes a new discussion of contingent value rights. We have also reorganized the book to consolidate the discussion of corporate governance requirements applicable to foreign issuers in one chapter (new Chapter 5) and to present in one chapter the discussion of requirements applicable to senior officers, directors and significant shareholders of U.S. public companies (new Chapter 6).

This Twelfth Edition also discusses recent developments in a number of areas. Continuing its emphasis on facilitating access to the capital markets for issuers previously evidenced by the passage of the Jumpstart Our Business Startups Act (the “JOBS Act”) in 2012, in late 2015 Congress passed the Fixing America's Surface Transportation Act (the “FAST Act”), which, among other legislation, included several bills designed to facilitate the offer and sale of securities by providing accommodations related to the SEC registration process for “emerging growth companies” beyond those that had been provided by the JOBS Act. We discuss those additional accommodations in Chapter 4. In 2016, the SEC staff published several Compliance and Disclosure Interpretations aimed at curbing what it perceived to be increased misuse of non-GAAP measures; Chapter 4 discusses those interpretations as well as the SEC staff's subsequent posture with respect to non-GAAP measures in several comment letters to issuers. In Chapter 9, we discuss the *Marblegate Asset Management v. Education Management Corp.* line of cases interpreting § 316(b) of the Trust Indenture Act with respect to the meaning of “impairment” of the rights of debt holders to receive principal and interest when due in the context of restructuring transactions. Lastly, Chapter 11 discusses the courts' evolving interpretation of what constitutes a “personal benefit” for purposes of insider trading liability, which culminated in the Supreme Court's unanimous decision in *Salman v. United States* in late 2016.

This book covers, among other topics, rules and requirements applicable to public companies in the United States that were adopted pursuant to the Dodd-Frank Act, including certain disclosure-related rules that were intended to achieve social or political goals. The Trump administration has moved quickly to reverse certain of these Dodd-Frank related rules, as discussed in detail in Chapter 4 with respect to conflict minerals and resource extraction payments. The administration has also moved to reverse a Dodd-Frank mandated rule recently promulgated by the Department of Labor regarding the fiduciary duty of financial advisors under certain circumstances, which is discussed in Chapter 14. More generally, President Trump has stated publicly he intends to undertake a thorough reexamination of the Dodd-Frank Act, and it remains to be seen whether he will achieve a significant scaling back of Dodd-Frank, in the form of modification or repeal of existing rules, enforcement priorities or otherwise, during the course of his administration. It also remains to be seen whether the SEC under the new administration and new Chair nominee Jay Clayton will make liberalizing rule changes, including adoption of pending rule proposals with respect to, among other things, streamlining disclosure requirements.

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U.S. Regulation of the International Securities and Derivatives Markets, ABOUT THE AUTHORS

U.S. Regulation of the International Securities and Derivatives Markets
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Edward F. Greene

Edward F. Greene is senior counsel at Cleary Gottlieb. His practice focuses on securities, corporate governance, regulatory and financial services reform and other corporate law matters.

Mr. Greene served as General Counsel of the Securities and Exchange Commission from 1981 to 1982 and as Director of the Division of Corporation Finance from 1979 to 1981. From 2004 to 2008, he served as General Counsel of Citigroup's Institutional Clients Group.

Mr. Greene is the author of several books and law review articles, including *The Sarbanes-Oxley Act: Analysis and Practice*, which was co-authored with Cleary partners and is widely used as an essential source of practical advice. Mr. Greene has been recognized as one of the best capital markets lawyers by *Chambers Global*.

Mr. Greene originally joined the firm in 1982 and returned in 2009. During his more than 20-year tenure at Cleary Gottlieb, Mr. Greene was also resident in the firm's Washington, Tokyo and London offices, and was the first licensed foreign lawyer to be admitted to practice law in Japan in 1987. He is a member of the Bar in New York.

Mr. Greene received an LL.B. from Harvard Law School in 1966 and an undergraduate degree from Amherst College in 1963. He is currently a Senior Research Scholar and Lecturer-in-Law at Columbia Law School and has been a Lecturer at Harvard Law School and an Adjunct Professor of Law at the University of Pennsylvania and Georgetown University Law Center. He was appointed to the Nomura Chair of International Securities Regulation (a part-time position) by the law faculty of the University of Tokyo for the 1989-1990 academic year, was Chairman of the Legal Advisory Board of the New York Stock Exchange from 1995 until 2001 and was a member of the SEC's Advisory Committee on Capital Formation and Regulatory Processes and a Trustee and member of the Executive Committee of the Practicing Law Institute (“PLI”). Mr. Greene is on the Board of Advisors of the *Capital Markets Law Journal*, published by Oxford University Press.

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Leslie N. Silverman

Leslie N. Silverman is a partner at Cleary Gottlieb, and his practice focuses on the domestic and international capital markets, representing both issuers and underwriters. Mr. Silverman has extensive experience, in particular, in cross-border offerings and the development of new financial products. He regularly counsels companies on compliance with the Jumpstart Our Business Startups Act, Dodd-Frank and Sarbanes-Oxley Acts, the SEC's implementing regulations and related corporate governance matters.

Mr. Silverman is widely published and is one of the authors of *PLI’s Guide to the Securities Offering Reforms* (Practising Law Institute, 2005) and *The Sarbanes-Oxley Act of 2002: Analysis and Practice* (Aspen Publishers, 2003). He also co-authored “Private Offerings: SEC Liberalizes the Rules but also Proposes New Requirements,” in *VC Experts* (October 23, 2013), “SEC's Silent Opposition to Arbitration Bylaws Is Speaking Volumes,” in *The National Law Journal* (August 12, 2013), and “Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes,” in the *Harvard Journal of Law & Public Policy* (Summer 2013). He is currently serving as a member of, and counsel to, the Committee on Capital Markets Regulation. He is distinguished as one of the world's best lawyers by *Chambers Global*, *Chambers USA*, *Chambers Latin America*, *IFLR 1000: The Guide to the World’s Leading Law Firms*, *The International Who’s Who of Business Lawyers*, *The Legal Media Group Guide to the World's Leading Capital Markets Lawyers*, *The Best Lawyers in America*, *The Legal 500 U.S.* and *PLC Which Lawyer? Yearbook*.

Mr. Silverman joined the firm in 1974 and became a partner in 1982. From 1985 to 1989, he was resident in the London office. He received a J.D. from Yale Law School in 1973, where he was an editor of the *Law Journal*, and an undergraduate degree, *summa cum laude*, from the Wharton School of the University of Pennsylvania. He also served as law clerk to Chief Judge Irving R. Kaufman of the U.S. Court of Appeals for the Second Circuit.

Mr. Silverman is a member of the Bars in New York and the District of Columbia, and is admitted to practice before the U.S. Court of Appeals, Second Circuit, and the U.S. District Court for the Southern District of New York.

Daniel A. Braverman

Daniel A. Braverman retired as a partner of Cleary Gottlieb at the end of 2013 and is now a senior counsel at the firm.

While a partner, Mr. Braverman not only focused on international finance, but he also worked in the mergers and acquisitions, joint venture and restructuring areas, and he assumed responsibility for a significant part of the firm's practice in Russia. Mr. Braverman joined the firm as an associate in 1985, became a partner in 1994 and a senior counsel in 2014.

Mr. Braverman is distinguished as a "Senior Statesman" and leading lawyer for capital markets by *Chambers UK*, *Chambers Global*, *Chambers Europe* and *The Legal 500 UK.* He was ranked as a "Star Individual" by *Chambers Global* 2012 for Russia Capital Markets, Overseas Counsel, the only lawyer in this category to be so ranked. He is also ranked as a "Senior Statesman" in *Chambers Global* as a leading Foreign Expert for Russia Restructuring/Insolvency and Russia Corporate/M&A.

Mr. Braverman received a J.D. in 1985 from Yale Law School, an M.Sc. in Politics (with reference to China) in 1982 from the School of Oriental and African Studies of the University of London while on a Marshall Scholarship, and a B.A., *summa cum laude*, in East Asian Studies from Harvard College in 1980.

Mr. Braverman is a member of the Bar in New York, and he has qualified as a Canadian Ski Instructors' Alliance ("CSIA") Level 2 ski instructor. He spends part of the year in Argentière, France.

Sebastian R. Sperber

Sebastian R. Sperber is a partner at Cleary Gottlieb Steen & Hamilton LLP based in the London office. Mr. Sperber's practice focuses on international capital markets transactions and merger and acquisition transactions. He regularly counsels companies on compliance with U.S. securities law requirements and related corporate governance matters.

Mr. Sperber has devoted a substantial amount of time to working on global equity offerings, including privatization transactions in several countries. His M&A experience includes both public and private transactions in various industries in Europe and Asia. His practice also includes derivative products, and he has assisted a number of clients in structuring "over-the-counter" ("OTC") and listed instruments.

Mr. Sperber has been recognized by *Chambers Global*, *Chambers UK*, *The Legal 500* and *IFLR 1000: Guide to the World's Leading Law Firms* for his work in the debt and equity capital markets, and by *IFLR 1000: Guide to the World's Leading Law Firms* in the M&A: Premium Deals, £250m+ category.

Mr. Sperber is widely published on topics in the capital markets, and frequently speaks on such topics at professional conferences. Publications co-authored by him include the firm's treatise on *The Sarbanes-Oxley Act: Analysis and Practice* (2003).

Mr. Sperber received a J.D. in 1988 from Columbia Law School, where he was a Harlan Fiske Stone Scholar and Editor-in-Chief of the *Columbia Journal of Transnational Law*, and a B.A., *cum laude*, in 1985 from Columbia College. Mr. Sperber serves on the board of advisors of the *Columbia Journal of Transnational Law Association,* *Inc.*

Mr. Sperber joined the firm in its New York office in 1988 and became a partner in 1997. From 1990 to 2000 (except for a stint in Hong Kong in 1998), he was resident in the London office. He spent 2001 to early 2004 in Hong Kong and then returned to London. He is a member of the Bar in New York.

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Nicolas Grabar

Nicolas Grabar is a partner at Cleary Gottlieb, and his practice focuses on international capital markets and securities regulation and on the representation of large reporting companies. He plays a primary role in the firm's work for *Fortune 100* companies, leading Mexican and Brazilian businesses, sovereigns and global investment banks.

Mr. Grabar has extensive experience in international financings in public and private markets, in U.S. securities law and regulations applicable to foreign issuers and in the regulation of financial reporting. He has also specialized in the telecommunications and natural resources sectors and has advised on acquisitions, joint ventures, privatizations and debt restructuring. Mr. Grabar has been repeatedly recognized for his work on behalf of clients, including by the *American Lawyer*, which named him a “Dealmaker of the Year” in 2011, and by *Latin Lawyer*, which named him its “International Lawyer of the Year” in 2016. The publication described him as “an elite dealmaker with a reputation for assisting on novel financing structures that set precedents for others to follow.”

Mr. Grabar received a J.D., *cum laude*, from Harvard Law School in 1982 and a B.A., *magna cum laude*, from Harvard College in 1978. He served as law clerk to the Honorable Pierre N. Leval of the U.S. District Court for the Southern District of New York.

Mr. Grabar is frequently published in publications such as *Harvard Law School Forum on Corporate Governance and Financial Regulation* and authors memoranda on SEC reporting matters.

Mr. Grabar is a member of the Board of Directors at the Council of the Americas. From 2002 to 2010, he served as chair of the annual program on global capital markets at the Practicing Law Institute. He is also a former Chair of the Financial Reporting Committee of the New York City Bar Association. He is a member of TriBar Committee on Legal Opinions and a member of the Board of Trustees at Brooklyn Youth Chorus Association.

Mr. Grabar joined the firm in 1984 and became a partner in 1991. From 1985 to 1989, he was resident in the Paris office.

Adam E. Fleisher

Adam E. Fleisher is a partner at Cleary Gottlieb based in the New York Office and his practice focuses on a wide range of corporate finance transactions and securities regulatory matters, including, in particular, in the asset management space.

Mr. Fleisher is a Visiting Clinical Lecturer (co-teacher, “Advanced Issues in Capital Markets: Role of Counsel for Issuers and Underwriters in an Initial Public Offering”) at Yale Law School, U.S. Advisory Board Member at Practical Law Company and former Secretary of the Financial Reporting Committee at the Association of the Bar of the City of New York.

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Mr. Fleisher received a J.D. from Yale Law School in 2000 and an A.B. from Harvard University in 1997, and he is a member of the Bar in New York.

Mr. Fleisher is a frequent speaker on legal topics and an author of numerous articles, including: “United States,” *Getting the Deal Through: Debt Capital Markets*, contributing eds., David C. Lopez, Adam E. Fleisher, Dase Kim (2014, 2015 and 2016 editions); “Going Public: A Guide to U.S. IPOs for Founders, Officers, Directors and Other Market Participants,” Adam E. Fleisher, Rebecca Tabb and Andra Troy, republished as “The Registered

Offering," in *Financial Product Fundamentals* treatise (2nd ed. 2015); "The Mechanics of A/B Exchange Offers," *Practical Law, The Journal*, Adam E. Fleisher, David E. Webb and Angela K. Chen (2015); "Regulation M: What the Deal Team Needs to Know," *Practical Law Company Practice Note*, Adam E. Fleisher and Jung W. Ju (2012 and 2015); "Alternatives to Traditional Securities Offerings," *Financial Product Fundamentals* treatise; Adam Fleisher, Joon Hur and Jesse Brush (2013); "Communication with Financial Analysts and Related Disclosure Issues," The Columbia Law School Blue Sky Blog on Corporations and The Capital Markets, Leslie N. Silverman, Adam E. Fleisher, Brian T. Sandstrom and Daseul Kim; (2013); "Selling Shares in a Newly Public Company," *Butterworths Journal of International Banking and Financial Law*, Adam Fleisher and Dase Kim (2013); "Regulation S Selling and Transfer Restrictions: A Basic User's Guide," *Insights, The Corporate & Securities Law Advisor*, Adam Fleisher and Peter Castellon (2012); "The Deal Team's Guide to Regulation M," *Practical Law, The Journal*, Adam E. Fleisher and Jung W. Ju (2013); "Recent Cases Address Important Section 16 Short-Swing Issues," *Insights, The Corporate & Securities Law Advisor*, Arthur H. Kohn, Adam E. Fleisher and Paris Nathaniel Nicholls (2012); "Revised Rule 144 and Registration Rights: Market Practice Two Years On," *Practical Law, The Journal*, Adam E. Fleisher and Jung W. Ju (2010).

Mr. Fleisher joined the firm in the New York office in 2000 and became a partner in 2008. He was resident in the firm's London office from 2001 to 2005.

U.S. Regulation of the International Securities and Derivatives Markets, PREFACE

U.S. Regulation of the International Securities and Derivatives Markets
11th and 12th Editions

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U.S. Regulation of the International Securities and Derivatives Markets, Twelfth Edition, Securities Markets, describes in detail the U.S. regulatory regime applicable to foreign companies entering the U.S. capital markets, including the principal issues a foreign company should consider when deciding whether, and if so, how, to offer securities in the United States (*i.e.*, publicly or privately). It also analyzes how the U.S. regulatory regime applies to securities brokers and dealers, investment companies and investment advisers. Except where otherwise noted, this edition speaks as of January 1, 2017.

Prior editions of this treatise covered both U.S. regulation of the international securities markets and U.S. regulation of the international derivatives markets. With this Twelfth Edition, we have divided the topics into two separate volumes. For a detailed description of the U.S. regulatory regime governing international financial transactions involving derivatives, as well as the U.S. regulatory regime governing futures commission merchants, dealers in swaps and security-based swaps, major participants in swaps and security-based swaps, commodity pool operators and commodity trading advisors, please refer to *U.S. Regulation of the International Securities and Derivatives Markets, Twelfth Edition, Derivatives Markets*, forthcoming.

This book is divided into 16 chapters. In Chapter 1, we provide an overview of the U.S. securities statutory and regulatory framework, introducing the key pieces of legislation discussed in detail throughout the book. We then, in an entirely new Chapter 2, present the key issues for a foreign company considering offering securities in the United States for the first time, including whether to do so as a public offering or private placement. Chapters 3 through 6 discuss the U.S. legal considerations involved in conducting a public offering of securities in the United States and becoming a U.S. public company, reorganized to more clearly divide the subject matter into the public offering process (Chapter 3), the ongoing reporting requirements of a public company (Chapter 4), the corporate governance requirements applicable to a public company (Chapter 5) and the requirements applicable to senior officers, directors and significant shareholders of U.S. public companies (Chapter 6). In Chapter 7, we discuss private offerings, and in Chapter 8 we discuss offerings outside the United States. Chapter 9 describes the rules governing liability management transactions, tender and exchange offers, business combinations and other issues relating to the acquisition of significant interests in companies whose securities trade in the

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United States or that conduct business in the United States. Chapter 10 discusses various practical issues related to global offerings as well as certain types of nontraditional offerings, such as continuous offerings, block trades, rights offerings, spin-offs and offerings of tracking stock. Chapter 11 describes the risks and remedies for violations of the U.S. securities laws, and we analyze in Chapter 12 whether particular instruments, including derivatives, are “securities” for the purposes of the U.S. securities laws. Chapter 13 discusses the Multijurisdictional Disclosure System, or “MJDS,” which is applicable to certain U.S.-Canadian cross-border securities offerings and tender offers. The remaining three chapters of the book focus on the U.S. laws that apply to particular kinds of foreign financial institutions conducting operations in the United States directly or through U.S. affiliates—broker-dealers, investment companies and investment advisers.

A book covering the regulation of such a wide range of activities as this treatise must omit certain topics. As we prepared this Twelfth Edition we reconsidered our focus. As a result, we eliminated the chapter on the U.S. regulation of the securities activities of banks, a topic covered more thoroughly than we could in Guide to Bank

UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (Robert L. Tortoriello, Derek M. Bush & Hugh C. Conroy eds., 21st Ed. Thompson, 2016), which is also published by our firm. We also refocused on specifically U.S. regulation of the securities markets, eliminating the chapter on EU regulation. Readers interested in EU regulation of the securities markets may wish to refer to another publication of our firm, EUROPEAN SECURITIES LAW (Raj Panasar & Philip Boechman eds., 2nd Ed., 2014). As in prior editions, we do not discuss in this edition the detail of U.S. state laws, many of which not only deal with the sale of securities to their residents but also regulate broker-dealers, investment advisers and corporate takeovers. We do, however, touch on these areas where they are most relevant.

In the *Guide to Locating Relevant Forms, Statutes, Rules and Regulations* that is now part of the front matter of the treatise, we describe where readers may locate electronic copies of a wide variety of the authorities cited in this book, including statutory provisions, rules, regulations, forms, cases and administrative decisions.

This book is the result of the efforts of many lawyers in the international law firm of Cleary Gottlieb Steen & Hamilton LLP, which has its principal office in New York and other offices in Washington, Paris, Brussels, London, Frankfurt, Cologne, Rome, Milan, Moscow, Hong Kong, Beijing, Buenos Aires, São Paulo, Abu Dhabi and Seoul. The firm owes a very special thanks to Andrea M. Basham, a senior attorney who revised several chapters in this Twelfth Edition and coordinated the revision and review of all chapters in this Twelfth Edition. The firm thanks paralegals Barbara Gaffney, Heidi Rasciner and Karen Simpson, without whose organizational and myriad other skills this book would not have been completed. The firm further thanks partners Robin M. Bergen, Craig B.

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Brod, Daniel P. Culley, Michael D. Dayan, Sandra L. Flow, Jared Gerber, Simon Jay, Richard S. Lincer, Paul D. Marquardt, Aaron J. Meyers and Raj Panasar; counsels Mary E. Alcock, Helena K. Grannis and Emmanuel Ronco; senior attorneys Elizabeth A. Chang, James Corsiglia, Meghan Irmler, David Parish and Christopher F. Smith; associates Nina E. Bell, Elizabeth K. Bieber, Nathan Brownback, Angela K. Chen, Kimberly Brunelle, Katherine M. Clemens, Sarah Crandall, Izukanne Emeagwali, Jocelyn Greer, Matthew Hamilton-Foyn, Daseul (Dase) Kim, Igor Kleyman, Erin E. Langley, Evan J. Leitch, Daniel Rainer, Chrishan Raja, Aslam A. Rawoof, Sam Raymond, Marc Rotter, Manual Silva and Nicholas C. Steer; and former associate Laura K. Palmer for their assistance in drafting this Twelfth Edition. The firm also thanks Kenneth Ottenbreit and Gordon Cameron of Stikeman Elliot for their assistance with certain Canadian securities law matters discussed in Chapter 13, and David Aman for his assistance with Chapter 14. While we gladly acknowledge the efforts and insights of all these persons, responsibility for shortcomings in the book is of course ours alone.

U.S. Regulation of the International Securities and Derivatives Markets, GUIDE TO LOCATING RELEVANT FORMS, STATUTES, RULES AND REGULATIONS

U.S. Regulation of the International Securities and Derivatives Markets
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This book discusses and cites a wide variety of authorities, including statutory provisions, rules, regulations, forms, judicial cases, administrative decisions and a wealth of other sources. Instead of appending, as we have in prior editions, a small subset of these materials for reference, we have prepared a guide, set forth below, directing readers to websites where many of the sources may be accessed. Referring readers to websites instead of reproducing selected materials in their entirety allows us to provide a more comprehensive resource and reflects the prevailing practice among practitioners of retrieving online the current version of an item they need.

Most of the websites set forth below are the official websites of the relevant regulatory agency (*e.g.*, the SEC). We list a freely available third-party website when the third-party website offers a more user-friendly version of a particular item. Many practitioners prefer to use such third-party websites more generally for access to the text of key securities laws and SEC rules. Practitioners may also consult a number of subscription services that offer ready access to an array of primary and secondary materials and often have sophisticated search capabilities.

Regulatory agencies may post only current or relatively recent materials. The guide below therefore describes, where possible, how to obtain older materials in paper format.

The URLs included in the list below are current as of ***October 27, 2016***. While they are subject to change, it should be possible and relatively easy to navigate to the new location of a particular authority from the relevant agency's home page.

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Category of Authority		Where It or a Link to It May Be Found
SEC Materials		
Key Statutes:		
	Securities Act (as amended)	http://www.sec.gov/about/laws.shtml
	Exchange Act (as amended)	http://www.sec.gov/about/laws.shtml
	Investment Company Act (as amended)	http://www.sec.gov/about/laws.shtml
	Investment Advisers Act (as amended)	http://www.sec.gov/about/laws.shtml
	Trust Indenture Act of 1939 (as amended)	http://www.sec.gov/about/laws.shtml
	Sarbanes-Oxley Act	http://taft.law.uc.edu/CCL/Soact/toc.html

	Dodd-Frank Act	http://www.gpo.gov/fdsys/pkg/PLAW-IIIpub1203/pdf/PLAW-IIIpub1203.pdf
	Jumpstart Our Business Startups Act of 2012	http://www.sec.gov/about/laws.shtml
Rules and Regulations:		
	Under the Securities Act	http://www.sec.gov/about/laws/secrulesregs.htm
	Under the Exchange Act (including Regulation M, Regulation FD and Regulation G)	http://www.sec.gov/about/laws/secrulesregs.htm
	Under the Investment Company Act	http://www.sec.gov/about/laws/secrulesregs.htm
	Under the Investment Advisers Act	http://www.sec.gov/about/laws/secrulesregs.htm
	Under the Trust Indenture Act of 1939	http://www.sec.gov/about/laws/secrulesregs.htm
	Regulation S-K	http://www.sec.gov/about/laws/secrulesregs.htm
	Regulation S-X	http://www.sec.gov/about/laws/secrulesregs.htm
Forms:		
	Under the Securities Act	http://www.sec.gov/about/forms/secforms.htm
	Under the Exchange Act:	
	Generally	http://www.sec.gov/about/forms/secforms.htm
	Under the Investment Company Act	http://www.sec.gov/about/forms/secforms.htm
	Under the Investment Advisers Act	http://www.sec.gov/about/forms/secforms.htm
	Under the Trust Indenture Act of 1939	http://www.sec.gov/about/forms/secforms.htm
Industry Guides		http://www.sec.gov/about/forms/industryguides.pdf
SEC Regulatory Actions:		
	Releases Proposing Rules	http://www.sec.gov/rules/proposed.shtml
	Releases Adopting Rules	http://www.sec.gov/rules/final.shtml
	Releases Adopting Interim Final Rules	http://www.sec.gov/rules/interim-final-temp.shtml
	Concept Releases	http://www.sec.gov/rules/concept.shtml
	Interpretive Releases	http://www.sec.gov/rules/interp.shtml

	Policy Statements		http://www.sec.gov/rules/policy.shtml
	SRO Rulemaking		http://www.sec.gov/rules/sro.shtml
	Other Regulatory Actions		http://www.sec.gov/rules.shtml
Staff No-Action, Interpretive and Exemptive Letters:			
	Division of Corporation Finance:		
		For Letters Dated After Jan. 15, 2002	https://www.sec.gov/divisions/corpfin/cf-noaction.shtml
		For Letters Dated Before Jan. 15, 2002	*See* "SEC Materials—How To Retrieve Print Materials" below
	Division of Investment Management:		
		For Letters Dated After Jan. 1, 1995	http://www.sec.gov/divisions/investment/im-noaction.shtml
		For Letters Dated Before Jan. 1, 1995	*See* "SEC Materials—How To Retrieve Print Materials" below
	Division of Trading and Markets (formerly Division of Market Regulation):		
		For Letters Dated After Jan. 1, 2002	http://www.sec.gov/divisions/marketreg/mr-noaction.shtml
		For Letters Dated Before Jan. 1, 2002	*See* "SEC Materials—How To Retrieve Print Materials" below
Staff Accounting Bulletins ("SABs"):			
	SABs 94 through 114		http://www.sec.gov/interps/account.shtml
	SABs 1 through 93		*See* "SEC Materials—How To Retrieve Print Materials" below
Staff Legal Bulletins			http://www.sec.gov/interps/legal.shtml
Other Division of Corporation Finance Interpretive Sources:			
	Compliance and Disclosure Interpretations		http://www.sec.gov/divisions/corpfin/cfguidance.shtml
	Manual of Publicly Available Telephone Interpretations		http://www.sec.gov/interps/telephone.shtml
	Financial Reporting Manual		http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.shtml
	"FAQs" on Various Topics		http://www.sec.gov/divisions/corpfin/cfguidance.s

			html
	"Dear CFO" Letters		http://sec.gov/divisions/corpfin/cfdisclosure.shtml
Enforcement Actions:			
	Litigation Releases:		
		Litigation Releases Dated After Sept. 28, 1995	http://www.sec.gov/litigation/litreleases.shtml
		Litigation Releases Dated Before Sept. 28, 1995	*See* "SEC Materials—How To Retrieve Print Materials" below.
	SEC Administrative Proceedings:		
		Administrative Proceedings Dated After Sept. 28, 1995	http://www.sec.gov/litigation/admin.shtml
		Administrative Proceedings Dated Before Sept. 28, 1995	*See* "SEC Materials—How To Retrieve Print Materials" below.
	Reports of Investigations:		
		Administrative Proceedings Dated After Jan. 24, 1996	http://www.sec.gov/litigation/investreports.shtml
	Administrative Proceedings Dated Before Jan. 24, 1996		*See* "SEC Materials—How To Retrieve Print Materials" below.
EDGAR:			
	Search Filings by Company		http://www.sec.gov/edgar/searchedgar/companysearch.html
	Other EDGAR Search Tools		http://www.sec.gov/edgar/searchedgar/webusers.htm
	EDGAR Filer Manual (updated Dec. 2015)		https://www.sec.gov/info/edgar/edmanuals.htm
SEC Annual Reports			http://www.sec.gov/about/annrep.shtml
SEC Special Studies			http://www.sec.gov/news/studies.shtml
How To Retrieve Print Materials			*See* "How to Access or Request Public Records Not Accessible via SEC Website" at http://www.sec.gov/answers/publicdocs.htm
NYSE Materials			
	NYSE LISTED COMPANY MANUAL		http://nysemanual.nyse.com/lcm/
	NYSE Rule Filings		http://www.sec.gov/rules/sro/nyse.shtml
	Materials relating to the member regulation operations of the NYSE that		*See* "FINRA Materials"

	now form part of FINRA	below.
NASDAQ Materials		
	NASDAQ Stock Market Rules	http://nasdaq.cchwallstreet.com
	NASDAQ Rule Filings	http://www.sec.gov/rules/sro/nasdaq.shtml
FINRA Materials		
	FINRA Rules	http://finra.complinet.com
	FINRA Regulatory Notices	http://finra.complinet.com
	NASD Rules	http://finra.complinet.com
	NASD Interpretive Material	http://finra.complinet.com
	NASD Notices to Members	http://finra.complinet.com
	Incorporated NYSE Rules	http://finra.complinet.com
	Incorporated NYSE Rule Interpretations	http://finra.complinet.com
	NYSE Rules	http://nyserules.nyse.com/nyse/rules
	NYSE Information Memos	http://www.nyse.com/regulation/rule-interpretations
PCAOB Materials		
	PCAOB Rules	http://pcaobus.org/Rules/PCAOBRules/Pages/Section-2/default.aspx
	Auditing Standards	http://pcaobus.org/Standards/Auditing/Pages/default.aspx
	PCAOB Releases	http://www.sec.gov/rules/pcaob.shtml

U.S. Regulation of the International Securities and Derivatives Markets, § 1.01, KEY SECURITIES LAW ELEMENTS—HISTORICAL EVOLUTION

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 § 1.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Much of the legislation discussed in this book was enacted in response to market excesses and abuses in the 1920s that were thought to have contributed to the market crash of 1929. This legislation reflected a broad tendency toward intervention in the economy that characterized the New Deal, and included the Securities Act of 1933 (the "Securities Act"), [1] the Securities Exchange Act of 1934 (the "Exchange Act"), [2] the Trust Indenture Act of 1939 (the "Trust Indenture Act"), [3] the Investment Advisers Act of 1940 (the "Advisers Act") [4] and the Investment Company Act of 1940 (the "Investment Company Act"). [5] In this book, we focus on the applicability of this legislation and the rules and regulations promulgated thereunder to foreign companies. [6]

These securities statutes have been amended frequently to adapt to changes in the market, but their policy underpinnings and their regulatory framework remain substantially the same. However, in the early 2000s they were thought to be deficient in light of the Enron, WorldCom and other accounting scandals and corporate governance abuses, and, in 2002, then President Bush signed into law the most sweeping legislation affecting public companies since the 1930s—the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"). [7] The Sarbanes-Oxley Act and the rules adopted thereunder significantly amended the Exchange Act and the rules and forms thereunder and under the Securities Act. With the goal of strengthening corporate governance standards, these provisions included, among other measures, requirements for more stringent corporate governance controls than previously existed. [8] Several of the rules adopted under the

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Sarbanes-Oxley Act imposed more detailed public disclosure requirements, although notably with greater applicability to domestic issuers than to foreign private issuers, [9] combined with stricter penalties for wrongdoing. In addition, the Sarbanes-Oxley Act established the Public Company Accounting Oversight Board (the "PCAOB"), a separate private entity subject to oversight by the Securities and Exchange Commission (the "SEC"), to supervise the registration and regulation of firms that audit public companies. Audit firms previously had not been subject to substantive federal regulation.

We discuss compliance with the corporate governance requirements established by the Sarbanes-Oxley Act and the rules adopted thereunder in detail in Chapter 5 and note other changes to the regulatory structure that were effected by the Sarbanes-Oxley Act throughout this book.

In 2010, in response to the global financial crisis, Congress felt it had to make even more radical changes to the regulatory structure than were incorporated in the Sarbanes-Oxley Act. Thus, it enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). [10] The Dodd-Frank Act marked the most significant legislative change in the regulatory framework for bank and non-bank financial institutions since the 1930s. [11]

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Fundamental changes have also been made pursuant to the Dodd-Frank Act in the regulation of derivatives, [12] credit rating agencies and hedge and private equity fund advisers.

As a result of lingering concerns over corporate governance practices even after the changes imposed by the

Sarbanes-Oxley Act, the Dodd-Frank Act included various corporate governance provisions that are generally applicable to public companies listed in the United States, especially regarding executive compensation and compensation committees, although in most cases foreign private issuers are excluded from these requirements. [12.1]

The Dodd-Frank Act also imposed several additional disclosure requirements on U.S. public companies. These included specialized disclosure relating to (a) conflict minerals, (b) mine safety and (c) payments to governments by companies engaged in resource extraction. These disclosure-related mandates were unrelated to the broader financial regulatory purposes of most of the Dodd-Frank Act and presented special challenges for the SEC, because Congress sought to use the SEC disclosure system to promote public policy objectives that were not directly related to traditional concepts of investor protection. [14.1]

The Trump administration has moved quickly to reverse this approach, as discussed in detail in Chapter 4 with respect to conflict minerals and resource extraction payments, and Chapter 14 with respect to a rule recently promulgated by the Department of Labor regarding the fiduciary duty of financial advisors under certain circumstances. More generally, President Trump has stated publicly he intends to undertake a thorough reexamination of the Dodd-Frank Act, [14.2] and it remains to be seen whether he will achieve a significant scaling back of Dodd-Frank, in the form of modification or repeal of existing rules, enforcement priorities or otherwise, during the course of his administration.

Although the primary purpose of the securities statutes when enacted was to protect the retail investor in the domestic markets, their prohibitions and requirements also extended, by the scope of their language, to transactions involving only sophisticated institutions (with the exception of certain exemptions to the registration requirements of the Securities Act and, as discussed

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below, the Investment Company Act). In other words, the statutory structure of the securities legislation when enacted generally failed to include any concept of differential regulation that might impose fewer rules in situations where the only participants are major institutions or professional investors. Because of this omission, the SEC, the statutory body created by the Exchange Act to oversee the application of the statutes, has resorted to administrative creativity to overcome the rigidity of the original statutory structure. Perhaps the best example of that creativity is Rule 144A, discussed in Chapter 7.

Institutional investors are dominant market participants, and they and the financial intermediaries with whom they principally deal have typically been at the forefront of those urging the SEC to take liberalizing steps. Although these investors have been willing to maximize investment opportunity by waiving the protections the structure is designed to afford them, the limited exemptive authority of the SEC that existed until 1996 sometimes made accommodation difficult. In 1996, Congress amended the Securities Act and the Exchange Act to grant to the SEC for the first time the authority to exempt any person, security or transaction, or any class or classes thereof, from the provisions of each act. [15] In this regard, the Securities Act, the Exchange Act and the Investment Company Act were also amended to provide that whenever the SEC is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, it must also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.

Relying in part on this exemptive authority, in 1998 the SEC proposed major changes to the rules governing offerings, embodied in what came to be called the "Aircraft Carrier Release." [16] While the SEC largely withdrew the major restructuring contemplated by the Aircraft Carrier Release in light of extensive criticism, the SEC adopted significant reforms to the U.S. public offering process in July 2005 (the "Securities Offering Reforms"). [17] The Securities Offering Reforms (i) expanded permissible communications outside the prospectus in connection with registered offerings, (ii) clarified the liability framework applicable to registered offerings under the Securities Act, and (iii) streamlined the securities registration process. [18] Prior to the adoption of these significant reforms, the SEC also adopted some of the reforms proposed by the Aircraft

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Carrier Release, such as rules relating to integrating public and private offerings. [19] The SEC has also used this exemptive authority to adopt exemptions from the registration provisions of the Securities Act applicable to securities issued in certain cross-border rights offerings and business combinations. In addition, the Investment Company Act was amended to establish exemptions for private investment companies whose securities are held by an unlimited number of "qualified purchasers" and for swap dealers and similar "market intermediaries." [20] Qualified purchasers include institutional investors and individuals owning at least $5 million in investments. [21]

In 2012, the Jumpstart Our Business Startups Act (the "JOBS Act") [22] was signed into law. The JOBS Act was intended to facilitate capital formation in a variety of ways—including by making the IPO process less burdensome for "emerging growth companies" ("EGCs"), a new class of issuer created by the JOBS Act. Although the provisions of the JOBS Act were designed to facilitate access to the U.S. capital markets for domestic companies, several provisions affect foreign companies as well. The JOBS Act allows an EGC to take advantage of significant regulatory concessions (the so-called "IPO on-ramp" provisions) in carrying out a common stock IPO and for up to five years after an IPO or until an issuer loses EGC status. [23] In late 2015, then President Obama signed into law the Fixing America's Surface Transportation Act (the "FAST Act"), which, among other legislation, included several bills designed to facilitate the offer and sale of securities by providing additional accommodations related to the SEC registration process for EGCs. [24]

The JOBS Act also directed the SEC (a) to amend Rule 144A under the Securities Act to eliminate any restriction on offers of securities sold under Rule 144A, including by means of general solicitation or general advertising, provided that only qualified institutional buyers ("QIBs" or persons the seller, or any person acting on the seller's behalf, reasonably believes to be QIBs) purchase the securities, [25] and (b) to revise its rules to remove the prohibition on general solicitation or general advertising for offerings under Rule 506 of Regulation D under the Securities Act in which all purchasers are accredited investors and the issuer

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takes reasonable steps to confirm their accredited investor status. [26] The SEC's new rules enacting these changes went into effect on September 23, 2013. [27]

Footnotes

1 Securities Act of 1933, 15 U.S.C. §§ 77a–77aa, *as amended*.

2 Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp, *as amended*.

3 Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa–77bbbb, *as amended*.

4 Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–80b-21, *as amended*.

5 Investment Company Act of 1940, 15 U.S.C. § 80a-1–80a-64, *as amended*.

6 Unless otherwise indicated, references to foreign companies or foreign issuers in this book refer to "foreign private issuers" as such term is defined in Rule 3b-4 under the Exchange Act.

7 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002). The Gramm-Leach-Bliley Act, enacted in 1999, also resulted in significant changes in the structure of the securities regulatory framework, particularly with respect to the regulatory regime governing the provision of financial services in the United States.

8 Among other measures, these include the requirements that: (i) CEOs and CFOs certify the accuracy and completeness of their company's periodic reports (with criminal liability for false certifications) and establish and periodically evaluate disclosure controls and procedures and internal control over financial reporting designed to ensure the timely collection and processing of information required to be reported to the SEC and for preparation of financial statements in accordance with generally accepted accounting principles, (ii) all listed companies establish an independent audit committee to hire their auditors and oversee their audits, (iii) CEOs and CFOs disgorge their compensation following a restatement of financial statements resulting

from misconduct, (iv) officers and directors refrain from trading in their company's equity securities during retirement plan blackout periods, (v) no company extend or maintain loans or credit to its executive officers or directors. For further discussion of these requirements, *see* Chapter 5.

9 For example, the Sarbanes-Oxley Act required the SEC to adopt rules requiring companies to rapidly disclose material changes in their financial condition and results of operations. In response to this requirement, the SEC in 2004 significantly expanded the list of items that U.S. issuers must disclose on Form 8-K (which requires domestic issuers to report certain material corporate events on a current basis) and generally shortened the deadline for U.S. issuers to file reports on Form 8-K to four business days after the occurrence of the event requiring disclosure. *See* SEC Release No. 33-8400 (Mar. 16, 2004). Although the SEC did not amend Form 6-K (which requires foreign private issuers promptly to disclose in a submission to the SEC material developments already disclosed publicly outside the United States), foreign private issuers should consider the list of items in Form 8-K in deciding whether particular press releases or home-country filings are material (and thus covered by Form 6-K) and which Form 6-K reports should be incorporated into their Securities Act registration statements. *See* § 4.02[3][c][iii] for a discussion of the Form 6-K requirements.

10 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

11 Pursuant to the Dodd-Frank Act, existing and newly established regulators acting through the Financial Stability Oversight Council have enhanced powers to oversee and control the activities of systemically important financial institutions ("SIFIs"), including setting capital and leverage requirements, restricting activities that threaten the institutions or markets and overseeing compensation and governance practices. All banks and bank holding companies with $50 billion or more of U.S. assets are SIFIs. Proprietary trading by U.S. banks and bank holding companies also has been heavily regulated under the so-called "Volcker Rule," and consumer protection has been heightened with the establishment of the Consumer Protection Bureau. Although outside the scope of this Treatise, for a detailed discussion of the current regulation of the financial services industry in the United States, including the impact of the Dodd-Frank Act, *see* Robert L. Tortoriello, Derek M. Bush, Hugh C. Conroy, Jr., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. Thomson, 2016) Part I.

12 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS.

12.1 *See* Chapter 5.

13 [Reserved.]

14 [Reserved.]

14.1 Similarly in an effort to promote public policy, the Iran Threat Reduction and Syria Human Rights Act of 2012 added § 13(r) to the Exchange Act, under which any issuer of securities that is required to file quarterly or annual reports must make specific disclosure in its public filings if it or an affiliate has knowingly engaged in certain activities or transactions involving Iran or other countries or entities specified in § 13(r). *See* § 4.07[14] for a discussion of this requirement.

14.2 On February 3, 2017, President Trump signed a Presidential Executive Order outlining his core principles for regulating the U.S. financial industry. Executive Order No. 13,772 (Feb. 3, 2017).

15 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (the "NSMIA").

16 SEC Release No. 33-7606 (Nov. 3, 1998).

17 *See* SEC Release No. 33-8591 (July 19, 2005).

18 For a more in-depth description of these rules as adopted, *see* Chapter 3.

19 *See* § 7.02[6] for further discussion of Rule 155 under the Securities Act, which provides a safe harbor for a registered offering following an abandoned private offering and for a private offering following an abandoned registered offering.

20 *See* § 15.06 for further discussion of the rules governing private offerings by foreign investment companies.

See also U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS.

21 *See* § 2(a)(51)(A) of the Investment Company Act.

22 Pub. L. No. 112-106, 126 Stat. 306 (2012).

23 JOBS Act § 101(a). *See generally* Chapter 3 for further discussion of the accommodations available to EGCs.

24 Pub. L. No. 114-94, 129 Stat. 1312 (2015).

25 JOBS Act § 201(a)(2).

26 JOBS Act § 201(a)(1).

27 SEC Release No. 33-9415 (July 10, 2013). *See* Chapter 7 for further discussion of the elimination of the prohibition on general solicitation and general advertising for certain private placements. Acknowledging that allowing general solicitation in private offerings represents a major change in how Rule 506 and Rule 144A offerings can be conducted, the SEC directed its staff to monitor market practices in offerings conducted with general solicitation and proposed a series of additional rule changes that would, if adopted, impose significant new requirements on Rule 506 offerings, particularly those that are conducted with general solicitation. As of January 1, 2017, these rules had not yet been adopted. SEC Release No. 33-9416 (July 10, 2013).

U.S. Regulation of the International Securities and Derivatives Markets, § 1.02, THE SECURITIES ACT

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 § 1.02 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Securities Act was designed to regulate at the federal level offerings of securities to the public; subsequent trading of those securities in secondary market transactions was to be regulated by the Exchange Act. The primary method of federal securities regulation is through disclosure, not administrative approval of the merits of the offering.

The Securities Act requires that every offer and sale of a security involving U.S. jurisdictional means be registered with the SEC unless an exemption is available. [28] There are exemptions for certain types of securities and transactions, including secondary market transactions. A major exemption covers offers and sales not involving a "public offering"—an undefined term. [29] If the security being sold is not registered, the seller has the burden of establishing eligibility for an exemption. A failure to do so allows the buyer to rescind the transaction if it acts within the prescribed period. [30] This ability to rescind solely on the grounds of failure to register, as opposed to misleading disclosure, gives the statute an *in terrorem* effect. For this reason, registration raises critical issues not only for domestic transactions but also for overseas offerings that might flow back into the United States, and many international financings not in fact registered with the SEC are conditioned on receiving an opinion of U.S. counsel that registration is not required.

Registration of public offerings requires preparing and filing a registration statement for review and comment by the staff of the SEC. The registration statement consists essentially of a prospectus, which must remain accurate in all material respects during the offering and, in certain cases, for a period thereafter. The prospectus also must be accurate in all material respects at the time of every sale of a security underwritten by or allotted to an underwriter or dealer, whenever the sale occurs.

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The Securities Act provides a statutory framework for the disclosures an issuer must make to conduct a public offering in the United States. There are detailed rules concerning the type and level of disclosure about the registrant's business that must be provided. The disclosure that must be included in the prospectus does not depend on the nature of the intended audience. Similar rules cover the scope and presentation of financial statements and other financial information. [31] In recognition of the periodic disclosure to the trading markets that reporting companies are required to make pursuant to the Exchange Act, many prospectuses are now allowed to incorporate information by reference to other SEC filings; and "shelf registration" procedures permit securities to be registered in advance and distributed at any time without additional action by the SEC staff. [32]

The SEC historically has been urged to allow well-known foreign companies to use their home-market documents when financing in the United States. In 1991, the SEC and Canadian regulators agreed, in an initial implementation of this approach, on a multijurisdictional disclosure mutual recognition system that benefits substantial Canadian issuers making U.S. offerings. [33] Following its adoption of that system, the SEC shifted away from mutual recognition as such, but modified the disclosures required for foreign private issuers in two significant respects. First, the SEC revised Form 20-F, the principal disclosure form used by foreign private issuers, to replace almost all of the former Form 20-F requirements with international disclosure standards adopted by the International Organization of Securities Commissions ("IOSCO"). Second, the SEC permitted foreign private issuers to present financial statements prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the IASB. [34]

One of the vexing questions under the Securities Act is determining when a distribution is complete. Investors are entitled to rely on a complying prospectus at the time of any sale that is part of the distribution, while no such prospectus requirement exists for subsequent sales in the secondary market. This problem was especially acute for securities issued outside the United States, using a prospectus that does not meet SEC requirements. Years ago, the SEC and

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the private bar established mechanisms to permit offshore offerings to be made free of the U.S. registration provisions. However, there was at the time no consensus about when the offshore distribution was complete so that the securities distributed could be resold in the United States in transactions exempt from prospectus requirements as secondary market sales. [35] This uncertainty was troublesome because every transaction in a security, no matter how remote from its initial sale, must have an exemption from the registration provisions of the Securities Act. [36] The SEC's adoption of Regulation S has virtually eliminated this uncertainty. [37]

Footnotes

28 *See* §§ 3.01 and 3.02.

29 *See* § 4(a)(2) of the Securities Act; § 7.02[1].

30 *See* § 12(a)(1) of the Securities Act; § 11.02[2].

31 *See* § 3.02[1][b] and Chapter 4.

32 *See* Rule 415 under the Securities Act; § 3.02[2]. For a description of changes to shelf registration procedures introduced by the Securities Offering Reforms, *see* Chapter 3.

33 *See* Chapter 13.

34 *See* SEC Release No. 33-7745 (Sept. 28, 1999) (revised 20-F); SEC Release No. 33-8879 (Dec. 21, 2007) (acceptance of IFRS); *see also* the discussions of Form 20-F in §§ 3.03[1][b] and 4.04 and of the SEC's acceptance of IFRS from foreign private issuers in § 4.05[1]. Today, there are approximately 525 foreign private issuers that apply IFRS in filings with the SEC. *See* Wesley R. Bricker, Chief Accountant, SEC, Keynote Address before the 2016 AICPA Conference on Current SEC and PCAOB Developments, Working Together to Advance High Quality Information in the Capital Markets (Dec. 5, 2016).

35 *See* § 8.01.

36 *See* § 5 of the Securities Act.

37 *See* the discussion of Regulation S under the Securities Act in § 8.02.

U.S. Regulation of the International Securities and Derivatives Markets, § 1.03, THE EXCHANGE ACT

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 § 1.03 (11th and 12th Editions 2014-2017)
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The Exchange Act generally requires any company with (i) a security listed on a U.S. exchange [38] or (ii) 2000 or more record holders of a class of equity security, unless fewer than 500 holders are not accredited investors, and $10 million or more in assets to register that class of securities with the SEC, and thereafter, in the case of U.S. companies, to file annual and quarterly reports. [39]

Foreign companies that are not listed on a U.S. exchange but are nonetheless subject to a registration requirement under § 12(g) are obliged to file annual reports, unless they have fewer than 300 U.S. shareholders or they publish specified information in English on their website, so long as in either case their securities are not listed on a U.S. exchange or quoted on the OTC Bulletin Board. [40] In addition, every company, U.S. or foreign, making a public offering of debt or

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equity securities in the United States must file periodic reports for one year and for so long thereafter until the securities offered are held by fewer than 300 persons (or in the case of a foreign company, held by fewer than 300 U.S. persons or, in the case of a class of equity of a foreign company, until U.S. trading volume comprises less than 5% of the class's worldwide trading volume and certain other conditions are met). [41]

The Exchange Act provides the framework for the disclosures an issuer must make in connection with both (i) an initial registration of securities that are listed on a national (U.S.) securities exchange or of equity securities that are otherwise publicly held as described above, and (ii) periodic reports following initial registration or a public offering as described above. The disclosure required for initial Exchange Act registration and subsequent reporting is substantially the same as the disclosure that would be made if the company were making a public offering under the Securities Act—reflecting a judgment by the SEC that there should be little difference between the information needed to make an informed decision to purchase securities in a distribution and that needed to make an informed decision to purchase securities in the secondary market. [42]

The Exchange Act also regulates a wide variety of market activities and participants. It requires disclosure of ownership in excess of 5% of any class of voting equity securities registered under the Exchange Act and sets out rules applicable to tender and exchange offers where, after consummation of an offer, the bidder would be the direct or indirect beneficial owner of more than 5% of any class of registered equity securities (whether or not entitled to vote). [43] These rules are applicable whether or not they conflict with those of another jurisdiction, which may also apply, for example, because the target is a non-U.S.

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company. [44] In addition, the Exchange Act regulates all persons acting in the United States as broker-dealers, clearing agents, information processors or securities depositaries. [45] While only the entity performing the service, not its holding company, if any, is regulated, the SEC has been empowered to require a registered broker-dealer to provide certain financial information about its unregulated affiliates and to restrict upstream distributions of capital by the broker-dealer in certain instances. [46]

In addition, the Exchange Act regulates securities exchanges and contains broad rules barring manipulative market conduct on or off the floor of an exchange. [47] These market manipulation rules are also applied in certain circumstances to activities on markets outside the United States. [48] The principal markets for foreign securities in the United States are the New York Stock Exchange, Inc. (the "NYSE") and Nasdaq. [49] These and the other national securities exchanges, as well as FINRA, are industry self-regulatory organizations, or "SROs." [50] The SROs are required to regulate their member broker-dealers in the

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public interest, and their rules are subject to review and approval by the SEC. Virtually every broker-dealer must be a member of FINRA. [51]

The Exchange Act also requires each issuer that has registered a class of equity securities or otherwise has a periodic reporting obligation under the Exchange Act and its subsidiaries (domestic or foreign) to maintain accurate books and records and an adequate system of internal controls. [52] It bars certain foreign corrupt payments by any company, U.S. or foreign, whose securities are registered, and it prohibits any officer or director from lying to the firm's auditors. [53]

"Insider trading" in connection with transactions in securities and securities-based swaps is also made unlawful by the Exchange Act, although the Congress and the SEC have never defined the offense. Its contours have been established through the application by the courts—sometimes in actions brought by the SEC (in its enforcement capacity) or the Department of Justice and sometimes in suits brought by private parties—of a broad general prohibition against fraud to particular fact patterns involving trading while in possession of material nonpublic information. [54] As a result, the penalties are severe, while the conduct prohibited is sometimes uncertain. [55]

The approach followed in dealing with "insider trading" reflects an important characteristic of the regulation of U.S. financial markets. Often the rules regulating these markets are general in scope and must be fleshed out through interpretation by the SEC staff and through litigation by both the government and the private bar. For this reason, many of the rules about market conduct have their origin in decisional law construing the statutory and regulatory framework.

Footnotes

38 § 12(b) of the Exchange Act. The NASDAQ Stock Market LLC ("Nasdaq") became an independent registered national securities exchange in August 2006. Prior to that time, it had been operated by the National Association of Securities Dealers, Inc. ("NASD," now known as "FINRA") as an interdealer quotation system. *See* SEC Release No. 34-53128 (Jan. 13, 2006). As a result of this change, the securities of issuers listed on Nasdaq automatically became registered under § 12(b), instead of § 12(g), of the Exchange Act. Nasdaq rules had required registration under § 12(g) for the quotation of securities, even though § 12(g) itself would only have required registration if the total assets and number of shareholders of the issuer exceeded the thresholds specified in that section.

39 § 12(g) of the Exchange Act and Rule 12g-1 thereunder. The JOBS Act amended § 12(g) of the Exchange Act to increase the previous holder of record threshold from 500 persons to 2,000 persons. The JOBS Act also created a separate holder of record threshold for banks and bank holding companies, which is 2,000 persons with no limit on the number of investors that are not accredited investors. For all companies, the holder of record threshold was amended to exclude securities held by persons who received the securities pursuant to employee compensation plans in transactions exempt from Securities Act registration.

40 Subject to certain exceptions, the OTC Bulletin Board rules require issuers to be subject to the periodic reporting requirements of the Exchange Act. *See* FINRA Rules, Rule 6530, FINRA Manual. *See also* § 4.02[3], for a discussion of Rule 12g3-2(b) under the Exchange Act, which sets out the circumstances in which foreign issuers may publish specified information in English on their website in lieu of registering under the Exchange Act.

41 In 2007, the SEC adopted rules that substantially liberalize the ability of foreign private issuers to terminate their Exchange Act reporting obligations. *See* SEC Release No. 34-55540 (Mar. 27, 2007); § 4.11.

42 Prior to the Securities Offering Reforms, the Securities Act required that the information actually be

delivered to the investor in some form, while under the Exchange Act the investor had to obtain the information itself—the issuer's only obligation being to file it with the SEC. Recognizing investors' increasing ability to access information through the Internet, the reforms adopted "access equals delivery" rules, which permit the electronic filing of a prospectus to qualify as delivery of the prospectus for Securities Act purposes in certain circumstances. *See* Rules 172 and 173 under the Securities Act. *See also* § 3.02[1][e].

43 *See* §§ 13(d) and 14(d) of the Exchange Act; §§ 6.04, 4.07[9] and 9.07. In addition, there are some provisions that apply to a tender offer for any securities held by a U.S. person, whether or not they are equity securities registered under the Exchange Act. *See* § 14(e) of the Exchange Act and Regulation 14E thereunder; §§ 9.05[4] and 6.04[2].

44 *But see* § 9.05[9] for a discussion of rules exempting from the U.S. tender offer regulations and registration requirements of the Securities Act certain tender and exchange offers for securities of foreign issuers.

45 *See* §§ 15(a) and 17 of the Exchange Act. The Gramm-Leach-Bliley Act eliminated an exemption for banks acting as broker-dealers subject to a number of important, but narrow, exceptions. *See* Robert L. Tortoriello, Derek M. Bush, Hugh C. Conroy, Jr., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. Thomson, 2016), Part II.D.3.b.

46 Rules have been adopted by which distributions to the holding company are subject to certain notice requirements, as well as other restrictions. *See* § 14.08[3][b]. If the holding company is designated as a SIFI under the Dodd-Frank Act by the FSOC, it would be subject to regulation by the Federal Reserve Board.

47 *See* § 9 of the Exchange Act.

48 These circumstances have been limited in the context of U.S. private litigation by *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010) and subsequent cases, discussed in Chapter 11, though the Dodd-Frank Act granted the SEC explicit power, in response to the limitations of *Morrison*, to take action with respect to conduct outside the United States having a significant effect on U.S. markets.

49 Technological developments have spawned a growing number of alternative trading systems ("ATSs") that furnish services traditionally provided solely by registered securities exchanges. Due to concerns that overly burdensome regulation in the United States has been driving ATSs offshore, the SEC adopted more flexible rules that do not require ATSs to register as "exchanges." *See* SEC Release No. 34-40760 (Dec. 8, 1998). Similar concerns over trading being driven offshore resulted in the relaxation of broker-dealer registration requirements for certain dealers in over-the-counter derivatives, or so-called "broker-dealer lite." *See* SEC Release No. 34-40594 (Oct. 23, 1998).

50 In order to register as a broker-dealer with the SEC, a broker-dealer must become a member of a national securities association, except in certain very limited circumstances. The only existing national securities association is FINRA—formerly known as the "NASD" until it was renamed in 2007, at which time it also absorbed the member regulation, arbitration and enforcement functions of the NYSE. *See* SEC Release No. 34-56145 (July 26, 2007). FINRA is now responsible for regulating all securities firms that do business with the public in the United States, including with respect to professional training, testing and licensing of registered persons, arbitration and mediation. FINRA is also responsible, by contract, for regulating Nasdaq, the American Stock Exchange LLC and the International Securities Exchange, LLC. *See* § 14.06[1], Note 249.

51 *See* § 15(b)(8) of the Exchange Act.

52 *See* § 13(b) of the Exchange Act. In addition, § 404 of the Sarbanes-Oxley Act went further by requiring the monitoring and affirmation of internal controls (which it called internal control over financial reporting), and the rules adopted thereunder require that such issuers' annual reports include an internal control report stating that management is responsible for establishing internal control over financial reporting, containing management's evaluation of its effectiveness, and providing the auditor's attestation as to that assessment. *See* §§ 5.03 and 5.04. Lastly, when the SEC implemented the CEO/CFO certification requirement pursuant to § 302 of the Sarbanes-Oxley Act, it also adopted a prior SEC proposal to maintain and certify annually as to the effectiveness of the issuer's disclosure controls and procedures (a broader concept than internal control over financial reporting). *See* § 5.04[3]. SEC Release No. 34-46300 (Aug. 2, 2002) (summarizing the

differences between the SEC proposals and the statutory requirements).

53 Rule 13b2-1 under the Exchange Act; *see* § 5.04[1].

54 *See* § 10(b) of the Exchange Act and Rule 10b-5 thereunder; § 11.05[2].

55 The enactment of Regulation FD, which prohibits selective disclosure by U.S. issuers, was intended to provide greater certainty in this area. *See* SEC Release No. 33-7881 (Aug. 15, 2000); § 3.02[3][c][vi].

U.S. Regulation of the International Securities and Derivatives Markets, § 1.04, THE INVESTMENT COMPANY ACT

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 § 1.04 (11th and 12th Editions 2014-2017)
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The Investment Company Act, the principal source of U.S. regulation of collective investment vehicles, was designed to address through a detailed regulatory scheme specific industry abuses that occurred in the 1930s and earlier. As a result, it is one of the most complex of the U.S. securities laws.

The Investment Company Act covers a wide range of companies. Every "investment company" is subject to regulation, unless expressly exempted or excluded. An "investment company" is defined either in terms of its purpose or in terms of the assets it holds, to minimize the possibility that an entity could inappropriately escape regulation. [56] Thus, the term "investment company" encompasses not only every entity that holds itself out as being engaged primarily in "investing, reinvesting or trading in securities," [57] but also any entity that is engaged in the business of investing, reinvesting, owning, holding or trading in securities (a concept that the SEC staff has interpreted expansively) if securities (excluding U.S. government and agency securities and securities of majority-owned subsidiaries that are not themselves investment companies) represent 40% or more of the value of its assets. [58]

Moreover, in view of the Investment Company Act's remedial purposes, the SEC has applied an expansive interpretation to the definition of "security" in the Act. While the text of that definition is virtually identical to the definitions found in the other securities laws, the staff of the SEC has consistently taken the position that a variety of instruments and items that are not "securities" under those other statutes—such as commercial bank loans, affiliate loans, certain insurance instruments, commercial and other ordinary-course credit arrangements and the like—are "securities" for the purposes of the Investment Company Act. [59]

Any investment company that is not excluded or exempted not only must register with the SEC but also must be structured to fit within the definition of one of three categories of investment companies: a unit investment trust, a face amount certificate company or a management company. Unit investment trusts are entities, organized under a trust indenture or similar instrument without a board of directors or similar body that only issue securities redeemable at net asset value at any time at the option of the holder. Unit investment trusts are therefore generally fixed and unmanaged pools of securities in which the holders have an undivided interest. Face amount certificate companies are extremely rare now. Management companies comprise the rest and are divided into open-end

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and close-end companies. Open-end companies, the investment vehicles commonly referred to as "mutual funds" in the U.S. market, are defined as those having securities redeemable at any time at the option of the holder for the net asset value of the underlying securities; closed-end companies include all others. The requirements applicable to a registered investment company depend in part on its classification. If a company does not fit within one of these categories, it cannot register and therefore cannot do business unless an exemption is available under the statute or granted by the SEC. Exchange-traded funds, one of the most popular types of investment vehicles introduced in recent years, are an example of a structure operating only as a result of SEC-granted exemptions. [60]

There is no doubt that conventional mutual funds and investment companies are intended to be the primary subjects of Investment Company Act regulation. However, the combination of the asset-based definition of investment company and the broad interpretation of the definition of security has also brought within the regulatory range of the Investment Company Act other sorts of entities, sometimes referred to as "inadvertent investment companies," for which the appropriateness of Investment Company Act regulation is far less obvious. These companies include holding companies that own controlling, but less than majority, interests in other companies, as is customary in many markets outside the United States, and finance subsidiaries whose assets consist of loans to their parents and affiliates (although Rule 3a-5 under the Investment Company Act provides that finance subsidiaries meeting certain conditions are excluded from the definition of "investment company"). [61]

A registered investment company is subject to very significant regulatory requirements under the Investment Company Act. [62] While disclosure to investors and potential investors is an important part of the Investment Company Act's scheme, the primary focus is on substantive regulation, including regulation of the following: the make-up and conduct of the board of directors; transactions between an investment company and its promoters, underwriters, advisers and

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other affiliated persons; issuance of debt or other "senior" securities and other borrowings (including certain derivative transactions) that create leverage; investment in other companies; and securities custody arrangements. The extent of these regulations makes the management of an operating company that did not intend to be an investment company, but "inadvertently" fell within the definition, impossible for all practical purposes.

The Investment Company Act and the rules thereunder contain a number of provisions excluding particular types of entities either from the definition of investment company or from the operation of the Act. [63] In addition, the Act grants authority to the SEC to exempt entities either from specific provisions or from its provisions generally, where such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. [64] While this exemptive authority provides necessary flexibility to a rigid statute, in recent practice such exemptions have been both expensive and time-consuming to obtain; other than in cases of routine relief identical to previously granted exemptions, this process now typically requires months and often longer where novel issues are presented.

While the types of companies specified in the Investment Company Act might have been accurate descriptions of the types of investment companies that were in existence when the Investment Company Act was adopted over 70 years ago, they are now proscriptive and limiting because they require investment companies to meet requirements that may be inconsistent with business objectives. Even without the Act's general restriction on offerings in the United States by foreign funds, these mandatory classifications would prevent registration and compliance by foreign funds that operate consistently with legal requirements in the jurisdictions in which they are organized or their securities are offered. For example, offshore-unmanaged pools can be established without redeemable securities, yet such entities are inconsistent with the Investment Company Act's typology.

As another important example of the Investment Company Act's restrictive typology, many entities have been established both in the United States and offshore to hold and "securitize" various types of financial instruments, *e.g.*, mortgages, receivables of various sorts and fixed income securities, such as noninvestment grade bonds. These entities issue securities the payments on which are structured to produce particular cash flows based on payments made on the underlying financial instruments. Often the issuing vehicles issue two or more classes of securities, with different levels of seniority or subordination or different predicted maturity ranges. These "asset-backed arrangements" ("ABAs"), if

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they are not exempt from regulation under the Investment Company Act, do not neatly fit into any of the classifications thereunder or satisfy the resulting requirements. A rule exempting most ABAs from registration under the Act and an amendment to the Act permitting an unlimited number of "qualified purchasers" to invest privately in any vehicle without requiring the vehicle to register as an investment company have helped reduce, but not eliminate, uncertainty with respect to offerings by ABAs. [65]

The Investment Company Act regulates foreign investment companies by restricting their offerings of securities in the United States. A foreign investment company is prohibited under the Act from making a public offering in the United States unless it has received an order from the SEC registering it as an investment company, which generally would impose conditions that parallel the provisions of the Act. Foreign investment companies must apply for such an order through a special process with the SEC rather than following the procedures applicable to U.S. investment companies. [66] The requirements that must be met to obtain such an order are such that, with the exception of a few Canadian investment companies, U.S. public offerings by foreign investment companies are effectively prohibited. While the Investment Company Act does not explicitly address private offerings by foreign investment companies, the SEC staff has attempted to place stringent limitations on such offerings that are derived from the rules applicable to U.S. private investment companies (including restricting U.S. investors to "qualified purchasers" or limiting the number of U.S. beneficial owners to 100). [67] As a result of these restrictions, offerings by foreign investment companies that would be considered private offerings for purposes of the Securities Act may not be deemed private offerings for purposes of the Investment Company Act.

Footnotes

56 § 3(a) of the Investment Company Act.

57 § 3(a)(1)(A) of the Investment Company Act.

58 §§ 3(a)(1)(C) and 3(a)(2) of the Investment Company Act.

59 *See* §§ 15.02 and 12.01.

60 *See*, *e.g.*, *Foreign Fund Inc.*, SEC Release No. IC-21737 (Feb. 6, 1996) (notice of application), SEC Release No. IC-21803 (Mar. 5, 1996) (Order). In March 2008, however, the SEC proposed a rule that would exempt exchange-traded funds from certain provisions of the Investment Company Act and the rules thereunder. *See* SEC Release No. IC-28193 (Mar. 11, 2008); *see also* § 15.03. As of January 1, 2017, this rule had not yet been adopted.

61 In 2007, a number of private equity firms, including Fortress Investment Group LLC and Blackstone Group L.P., carried out initial public offerings in the United States but avoided the need to register under the Investment Company Act principally because the general partnership interests they held in their funds typically are not considered "securities" for purposes of the Act, and their business was considered to be the management of the funds' assets for a fee, rather than investing. *See* § 15.02.

62 In addition, any investment company, such as a large mutual fund or related group of funds designated as a SIFI by the FSOC created under the Dodd-Frank Act, would also be subject to regulation by the Federal Reserve Board.

63 *See* § 15.05.

64 § 6(c) of the Investment Company Act; *see also* § 15.05[7][a].

65 *See* § 15.05[3].

66 *See* §§ 15.03 and 15.04.

67 *See* § 15.06.

U.S. Regulation of the International Securities and Derivatives Markets, § 1.05, THE ADVISERS ACT

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 § 1.05 (11th and 12th Editions 2014-2017)
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The Advisers Act generally requires registration of those in the business of giving advice about securities (other than as an incident to a brokerage business) unless one of the few exemptions from registration is available. [68] The Dodd-Frank Act amended the Advisers Act to eliminate the exemption used by most

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hedge and private equity fund advisers to not register as advisers under the Advisers Act, which applied if the adviser had fewer than 15 clients and did not hold itself out to the public as an adviser. [69] As a result, most advisers must now register, although limited exemptions under the Dodd-Frank Act allow certain advisers to private funds to remain unregistered or to file with the SEC as "exempt reporting advisers." [70] The Dodd-Frank Act did not subject these funds themselves to a registration requirement. [71] While there are no financial or other eligibility requirements for registration, there are rules applicable to, among other activities, the fees that can be charged to clients, dealing as principal with a client, advertising and marketing materials, disclosure of conflicts of interest, information that must be given in advance of establishing a client relationship, and political contributions by the adviser and certain of its personnel. [72] Certain conduct is also prohibited whether or not an adviser is required to register. [73]

Each registered adviser is subject to periodic inspection by the staff of the SEC and must maintain detailed books and records about transactions on behalf of its clients. [74] Regulatory responsibility for oversight and periodic inspection of investment advisers is divided between the SEC and the states, primarily based on the criterion of assets under management. In 1996, the Advisers Act was amended to preclude advisers from registering with the SEC unless they had at least $25 million of assets under management. [75] The Dodd-Frank Act raised that threshold to $100 million of assets under management. It also created a new category called "mid-sized" advisers for advisers with assets under management of between $25 million and $100 million. A mid-sized adviser is generally required to register in the state where it maintains its principal office and place of business instead of with the SEC, unless the adviser advises registered investment companies or business development companies, or is not subject to examination by a state securities authority. [76] However, the antifraud prohibitions of the Advisers Act continue to apply to all advisers.

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The SEC staff had historically applied the Advisers Act and related rules to a registered adviser's dealings with all of its clients—even where the adviser and its clients were located outside the United States and even if the U.S. rules conflicted with the rules in the jurisdictions where they were located. As a consequence, most foreign intermediaries registered separate affiliates as advisers. [77]

Since 1992, the SEC staff has implemented the conclusions that the SEC reached in a comprehensive report that evaluated the Advisers Act, including the staff's extraterritorial application of the act to foreign advisers and their non-U.S. clients. [78] In a series of no-action letters in the 1990s, the staff took the position that a registered foreign adviser is not required to comply with the substantive provisions of the Advisers Act and related regulation with respect to its non-U.S. clients. [79] The letters have also relaxed the criteria necessary to establish the "independence" of a registered adviser subsidiary or affiliate from its parent or other affiliates, so that the parent or other affiliate adviser is not also required to register as an investment adviser. [80]

Footnotes

68 There is a limited exemption for advisers solely to private funds with less than $150 million in assets under management in the United States, and for certain foreign advisers without a place of business in the United States and that (i) during the preceding 12 months had in total fewer than 15 clients and investors in the United States in private funds advised by the foreign adviser, (ii) had assets under management attributable to clients and investors in the United States of less than $25 million, and (iii) do not manage registered investment companies or hold themselves out generally to the public in the United States as an investment adviser. *See* § 16.03.

69 *See* § 16.03.

70 Section 619 of the Dodd-Frank Act, commonly referred to as the "Volcker Rule," limits the ability of bank holding companies ("BHCs"), foreign banking organizations treated as BHCs, and their subsidiaries and affiliates to sponsor or invest in hedge funds and private equity funds.

71 *See* § 16.03[3].

72 *See* §§ 16.05, 16.06, 16.07 and 16.08.

73 *See* §§ 16.07 and 16.08.

74 *See* § 16.11.

75 *See* § 16.02[1][a].

76 *See* § 16.01[1][a]. Notably, mid-sized advisers in New York are required to register with the SEC because New York does not conduct compliance examinations.

77 *See* § 16.01.

78 SEC, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992); *see also* SEC Release No. IC-17534 (June 15, 1990), the concept release preceding the 1992 Report.

79 *See* § 16.01.

80 *See* § 16.01.

U.S. Regulation of the International Securities and Derivatives Markets, § 1.06, THE SECURITIES AND EXCHANGE COMMISSION

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 § 1.06 (11th and 12th Editions 2014-2017)
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The federal securities statutes covered in this volume are administered by the SEC, a statutory body created by the Exchange Act. Its ruling body is a commission consisting of five members appointed by the President of the United States after confirmation by the U.S. Senate, one of whom is designated Chair by the President. [81] The SEC employs several thousand people across various divisions, including the Division of Enforcement, which is empowered to conduct investigations of violations, to issue cease-and-desist orders and to seek relief in the federal courts. Over the more than 80 years during which it has been in existence, the SEC has created an enormous body of precedent, through interpretive rulings, regulations, no-action letters, administrative orders and cases it has instituted in federal courts. Because of the breadth and reach of the statutes administered, the strong tradition of enforcement and the consequences of violating the statutes, most practitioners closely consult the SEC's staff, who are usually quite responsive.

Footnotes

81 § 4 of the Exchange Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 1.07, KEY U.S. ANTI-MONEY LAUNDERING LAWS

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 § 1.07 (11th and 12th Editions 2014-2017)
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The Bank Secrecy Act of 1970 (the "BSA") [82] imposes a variety of recordkeeping, reporting and other anti-money laundering compliance obligations on financial institutions. The list of financial institutions that are subject to BSA regulation includes, among others: banks (including U.S. branches and agencies of non-U.S. banks), trust companies, private bankers, thrifts, brokers and dealers in securities or commodities, FCMs and registered investment companies. [83]

Apart from the regulatory requirements of the BSA, money laundering is a criminal offense under U.S. federal law. [84] The federal criminal anti-money laundering statutes provide substantial penalties for persons who conduct or attempt to conduct certain financial transactions that involve the proceeds of a broad range of enumerated "specified unlawful activities." The laws are extremely broad and are implicated not only by drug trafficking activities but also by many types of "white collar" criminal offenses. [85]

Title III of the USA PATRIOT Act (the "PATRIOT Act"), [86] known as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001, effected a major expansion of U.S. anti-money laundering laws. Among other things, the Patriot Act amended the BSA to impose a variety of new compliance obligations on financial institutions (particularly with regard to transactions and account relationships with non-U.S. banks and other non-U.S. financial institutions), broadened the scope of financial institutions subject to compliance requirements, expanded U.S. civil and criminal forfeiture laws and increased the penalties for criminal anti-money laundering violations.

Footnotes

82 Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 1118 (Oct. 26, 1970), 12 U.S.C. §§ 1951–59, *as amended*, and 31 U.S.C. §§ 5311–32, *as amended*.

83 In May 2003, the Financial Crimes Enforcement Network ("FinCEN")—the bureau of the Treasury Department that is principally responsible for administering the BSA—issued a proposal to extend BSA regulation to certain investment advisers. The proposal was withdrawn in October 2008, however, and FinCEN has not issued a new proposal to require investment advisers to adopt an anti-money laundering policy. *See* § 16.15. *See also* Robert L. Tortoriello, Derek M. Bush, Hugh C. Conroy, Jr., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. Thomson, 2016) Part I.

84 *See* 18 U.S.C. §§ 1956, 1957.

85 For example, Andrew Fastow, the former Chief Financial Officer of Enron, was indicted in October 2002 by a federal grand jury for, among other things, money laundering in connection with his role in various Enron-related frauds. In 2003, executives in Enron's Internet division were also indicted by a federal grand jury for money laundering. The money laundering charges were subsequently dropped against Mr. Fastow when he pleaded guilty to conspiracy to commit securities and wire fraud in January 2004.

86 Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (Oct. 26, 2001).

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

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 2.01 (11th and 12th Editions 2014-2017)
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This chapter provides a general overview of the principal issues a foreign company should consider when deciding whether to offer securities in the United States for the first time, and, if it wishes to do so, whether to offer them in the U.S. public or private markets. The issues are presented in summary form, with references to the detailed discussions appearing elsewhere in this treatise. When we refer to foreign companies and the requirements applicable to them, we are referring to "foreign private issuers"—companies organized outside the United States with either 50% or fewer U.S. shareholders or lacking other specified U.S. connections.

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

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

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 2.02 (11th and 12th Editions 2014-2017)
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[1] Public Offerings

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

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

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

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

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

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

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

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

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

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

[2] Private Offerings

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

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

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

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

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

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

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 2.03 (11th and 12th Editions 2014-2017)
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Before considering the specific issues that might be of concern to a foreign company deciding whether to access the U.S. public market, the ways in which the conduct of a U.S. public offering can affect the foreign component of an international offering should be understood. There are three principal areas: timing, publicity, and disclosure.

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

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

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

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

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

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

[a] Auditor Independence

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

[b] Conduct of Audits

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

[c] Accounting Principles

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

[d] Periods Covered and Segment Breakdowns

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

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

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

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

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

[a] Audit Committee Requirements

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

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

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

We discuss these audit committee requirements in § 5.02.

[b] Controls

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

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

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

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

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

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

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

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

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

[ii] *Disclosure Controls and Procedures*

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

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

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

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

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

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

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

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

[iv] *CEO/CFO Certifications*

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

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

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

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

[v] *Reporting Illegality; Special Investigations*

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

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

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

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

[a] Special Industry Disclosure

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

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

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

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

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

[b] Related Party Transactions

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

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

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

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

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

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

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

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

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

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

[d] Public Filing of Material Contracts

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

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

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

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

[e] Disclosure Requirements to Achieve Social or Political Goals

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[a] Reporting

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

[b] Sales

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

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

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

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

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

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

[7] Delisting and Deregistration

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

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

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

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    - the shares are held by fewer than 300 holders on a worldwide basis or less than 300 holders in the United States;

- It has met all its reporting obligations for 12 months and has filed at least one annual report with the SEC; and
- It has not conducted a U.S. public offering for 12 months, subject to certain limited exceptions.

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

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

U.S. Regulation of the International Securities and Derivatives Markets
1 Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber, Nicolas Grabar & Adam E. Fleisher, U.S. Regulation of the International Securities and Derivatives Markets § 2.04 (11th and 12th Editions 2014-2017)
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As we discuss in Chapter 7, if a foreign company finds that the benefits of a U.S. public offering are outweighed by the challenges, a Rule 144A offering is an attractive alternative. QIBs comprise a substantial part of the U.S. capital market, and the demand they represent can enhance the pricing and increase the size of an international offering, particularly where there is a liquid foreign market where resales can be made after the offering, reducing or eliminating any liquidity discount. We discuss the resale of privately placed securities into markets outside the United States in § 8.02[2].

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

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

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

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

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

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

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

We discuss these and similar issues in § 7.03.

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

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

U.S. Regulation of the International Securities and Derivatives Markets, § 3.01, 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 § 3.01 (11th and 12th Editions 2014-2017)
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In the early 1990s, when the first edition of this book was published, many foreign companies, [1] including many large companies, sought to undertake public offerings or exchange listings or otherwise access the public capital markets in the United States. This phenomenon continued and even accelerated for many years.

However, more recently, and especially since the passage of the Sarbanes-Oxley Act in 2002, there have been at least four major shifts in the way that foreign companies and investors consider global capital pools and flows and global financial markets. These shifts all affect the U.S. capital markets. First, the locus of capital has become far more diversified across the globe, with important potential investors located throughout the world, in Europe, Asia, the Middle East and Latin America, as well as North America. As a result, accessing capital in the United States is less important than it used to be. Second, and related to the first, exchanges and markets outside the United States have become deeper and more liquid, in Asia and Latin America as well as Europe. So for at least some foreign issuers, a U.S. listing may not add a major additional source of liquidity, and for investors, at least some local markets outside the United States provide sufficient liquidity to support their investment. In these cases, the additional liquidity, if any, provided by U.S. markets or exchanges (or other major international markets, such as London) is therefore no longer necessary. Third,

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investors perceive that global accounting, financial and other disclosure standards and trading market quality and integrity have improved in many markets to the point where, as in the case of market liquidity, a listing in the United States, and compliance with its standards, is no longer essential. There is a view that, with global institutional investor pressure and vigilance, local markets outside the United States are not only sufficiently deep and liquid but also sufficiently open and honest to support significant investment. And fourth, at the same time as the advantages to foreign companies of accessing U.S. markets have become less clear, heightened U.S. regulatory burdens, initiated by the Sarbanes-Oxley Act and the Dodd-Frank Act, have increased the apparent disadvantages of accessing the U.S. capital markets in a manner that requires registration or reporting under the U.S. securities laws, and the resultant entanglements with U.S. regulations.

The Sarbanes-Oxley Act reflects the U.S. approach to regulating foreign issuers present in or wishing to access the U.S. market—that is, national treatment. The same rules apply to domestic and foreign issuers. With very limited exceptions, there is no deference to the regulatory requirements of the home country in the case of foreign issuers, whether or not there is a conflict with the home country regulatory regime.

An alternative to the national treatment model is mutual recognition or a finding of equivalency, in which case the United States as host country would rely on, and defer to, the regulatory requirements of the home country. As we discuss in Chapter 13, the United States implemented a Multi-Jurisdictional Disclosure System with Canada, implementing mutual recognition between the two countries. Canadian and U.S. companies as a result can use their home country disclosure documents when raising capital in the host country and can comply with the periodic disclosure requirements of the home country.

However, the United States has not pursued this approach with Europe or other key markets with respect to capital raising, [2] except insofar as it revised the requirements applicable to foreign issuers in Form 20-F, incorporating international standards, and it allowed foreign issuers to use International Financial Reporting Standards in connection with listings or capital raising. Rather, the United States continues to set and revise the ground rules for access to the U.S. capital markets and generally does not defer to the home country. [3]

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While the environment has changed dramatically both within and outside the United States, a foreign company's determination as to whether and how to approach the U.S. markets, as always, depends principally on the company's objectives. These objectives can include one or more of the following:

- raising capital in the United States (separately or as part of a larger global offering);
- entering the U.S. public market to facilitate the use of its securities as consideration for an acquisition from U.S. securityholders;
- obtaining a U.S. exchange listing [4] to broaden its trading market, especially where its local market cannot support global trading or does not satisfy investors' standards;
- taking a less extreme step to broaden its trading market by facilitating over-the-counter trading in the United States; or
- seeking to obtain valuations or analyst coverage that may accompany listing on a U.S. exchange.

The various choices open to foreign issuers can be taken one-at-a-time; they can be viewed as possible incremental steps towards accessing the U.S. markets; and no one choice precludes a different choice in the future.

The principal source of capital in the United States and globally for most foreign issuers, as for most U.S. issuers, is institutional investors. In recent years,

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against the backdrop of the changes in U.S. and global markets described above, foreign issuers that have an adequate local market and seek to raise capital in the United States have in a majority of cases attracted U.S. institutional investors in private offerings without a U.S. listing or extending their offering to the U.S. public market. That approach, which does not require registration of an offering of securities with the SEC or ongoing compliance with U.S. reporting requirements, is described in Chapter 7. In the case of an unregistered private offering accompanying a non-U.S. offering, the issues relating to the non-U.S. offering are discussed in Chapter 8. Any of the other options for accessing the U.S. markets enumerated above, other than facilitating over-the-counter trading in the United States, [5] requires registration of the issuer's securities under the Exchange Act and, in the case of a public offering in the United States, the registration of the transaction with the SEC under the Securities Act.

The relative benefits of accessing the U.S. public markets have become fact-specific and require analysis of the circumstances of particular issuers and particular offering strategies. There is a clear perception that in some cases the benefits do not justify the burdens. [6] Consistent with the market changes enumerated above, a few factors do appear to be noteworthy, including the following:

- Accessing the U.S. public markets and registering securities under the Exchange Act involves a number of complex steps. The legal and regulatory risks and burdens to which a company and certain of its officers become subject by virtue of Exchange Act registration are significant and have increased in recent years.

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- As noted above, global institutional investors have been increasingly willing to invest in securities of issuers from certain markets that do not have a U.S. listing, or even any secondary listing in an international market center. [7]

- Significant numbers of high-tech foreign issuers continue to undertake public offerings and list in the United States and register under the Securities Act and the Exchange Act. [8]
- There seems to be a general consensus, although not unanimity, that valuations remain higher for companies with U.S. listings. [9]

As to the first point, U.S. disclosure and accounting requirements are more onerous in most cases than the requirements imposed by the foreign company's domestic regulator or market. Moreover, the effort and expense required to list or publicly offer securities in the United States can be significantly greater than for listings or public offerings in other markets. Furthermore, there is no assurance that creating an ADR program in the United States—even a listed program—will actually result in significant U.S. trading or that securities offered in the United States will stay there and not flow promptly back into the home market (assuming the issuer has a home market listing as well), thus frustrating an issuer's possible goal of expanding its shareholder base through the creation of an active U.S. secondary market. Once public, additional disclosure or other obligations not in effect at the time of the offering may be imposed, as exemplified by the Sarbanes-Oxley Act. Finally, there is a general belief among many that the litigation, enforcement and liability risk that accompanies U.S. offerings or listings is higher than in other jurisdictions.

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The acuteness of the burdens of Exchange Act registration increased with the enactment of the Sarbanes-Oxley Act, the consequences of which included the following: [10]

- significant changes in the regulation of independent auditors and the environment for audits;
- addition of significant disclosure requirements;
- requirements for the assessment by management and attestation by independent auditors of the effectiveness of internal control over financial reporting; [11]
- imposition of new independence standards and requirements on audit committees; and
- increased attention on the responsibility of principal executive officers and principal financial officers for the disclosure and controls of their companies. [12]

In addition and of particular significance for foreign issuers, the U.S. Congress in passing the Sarbanes-Oxley Act made essentially no provision for foreign issuers and gave the SEC essentially no particular authority to treat foreign issuers differently in making rules to implement the Sarbanes-Oxley Act. As a result, while the SEC did make some significant concessions for foreign issuers (for example, in crafting the requirements for audit committees), the basic contours of the Sarbanes-Oxley Act and the rules thereunder apply to foreign as well as U.S. issuers. Perhaps most importantly, the Sarbanes-Oxley Act may have led to the realization for the first time among foreign issuers generally that the U.S. legal and regulatory system, and the political system in particular, could impose new and greater requirements on foreign issuers than their home or other jurisdictions. Both the additional requirements and the psychological impact of the passage of the Sarbanes-Oxley Act have affected the calculus of foreign issuers in deciding whether to access the U.S. public markets.

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The Dodd-Frank Act, while some of its provisions provided exemptions for foreign issuers, also imposed some additional requirements on foreign issuers. For example, foreign issuers are subject to the conflict minerals and resource extraction payments disclosure requirements imposed by Dodd-Frank as discussed in Chapter 4. On the other hand, foreign issuers are exempt from compensation committee adviser rules applicable to U.S. companies. The SEC has completed rulemaking or has proposed rulemaking relating to nearly all Dodd-Frank imposed mandates. [13]

While the Sarbanes-Oxley Act and the Dodd-Frank Act have added to the burdens of foreign issuers in the U.S. public markets, it is also true that the SEC has taken steps that could alleviate some of the burdens for foreign issuers that access the U.S. public markets. In particular, first, the SEC in March 2007 adopted amendments to its rules making deregistration for foreign issuers under the Exchange Act considerably less onerous. [14] The SEC clearly intends not only to make it easier for a foreign issuer to deregister and leave the public markets of the United States, but also seeks to make it more attractive for a foreign issuer to enter the U.S. public markets by making it easier for it to leave if the entrance is not successful in achieving the issuer's aims. [15]

Second, the SEC in 2007 adopted amendments to its rules under which it would accept from foreign companies financial statements prepared under International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board (the "IASB") without requiring reconciliation to United States generally accepted accounting principles ("U.S. GAAP"). [16] As discussed in § 4.05[1], these reconciliation requirements were in the past among the most onerous burdens for foreign companies accessing the U.S. public markets. [17]

Finally, in June 2005, the SEC adopted the most significant changes in decades to the securities registration and public offering rules under the Securities Act (the "Securities Offering Reforms"). [18] The reforms build on the existing integrated disclosure and shelf registration systems to achieve the SEC's goals

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of modernizing and liberalizing the securities offering and communications processes without compromising investor protection. The reforms have accomplished the following:

- facilitated greater availability of information to investors and the market;
- eliminated barriers to open communications;
- reflected the increased importance of electronic dissemination of information, including the use of the Internet;
- made the capital formation process more efficient; and
- clarified the timing of disclosure liability. [19]

The SEC's reforms were also motivated by its desire to attract a greater volume of transactions by both U.S. and foreign issuers to the U.S. public market through registration. By providing greater flexibility for registered offerings, the reforms aim to reduce reliance on unregistered offerings, particularly unregistered offerings to large institutional investors facilitated by Rule 144A under the Securities Act.

One cornerstone of the reforms was the creation of a new category of issuers referred to as "well-known seasoned issuers" or "WKSIs." A WKSI, as discussed in more detail in § 3.02[3][a][ii], is in general terms a company that has been reporting on a timely basis under the Exchange Act for one year and has public market float not held by affiliates of its common equity of at least $700 million or the foreign currency equivalent. [20] An issuer meeting the requirements for WKSI status, including a foreign issuer, is eligible for "automatic shelf registration," a simpler and more flexible registration process that assures that registered offerings can proceed without SEC review. The ease of market access under automatic shelf registration significantly exceeds that available elsewhere in the global capital markets To the extent that public offerings under automatic shelf registration provide advantages for foreign issuers, this factor may become part of the calculus for a foreign company as to whether it should enter the U.S. public markets and especially, if it is already registered and reporting under the Exchange Act, whether it should maintain that status. [21]

In 2013, Congress passed the Jumpstart Our Business Startups Act (the "JOBS Act"). The JOBS Act is intended to facilitate capital formation in a

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variety of ways—including by making the IPO process less burdensome for "emerging growth companies" ("EGCs"), a new class of issuer including currently private companies with annual revenues of less than $1 billion. [22] The JOBS Act provides relief from some SEC disclosure requirements for an EGC's IPO and for its ongoing reporting for up to five years. The most important relief for foreign issuers is that (a) an EGC is permitted to provide only two years (rather than three) of audited financial statements, and only those two years (rather than five) as selected financial data, in its IPO, and (b) an EGC does not have to provide an independent audit of its assessment of its internal control over financial reporting.

The JOBS Act provides for SEC review of an IPO registration statement of an EGC to remain confidential until 15 days before the road show begins. The SEC already allows confidential review for a foreign issuer that meets certain requirements, [23] and that practice continues for a foreign issuer that meets those requirements and does not file as an EGC. The JOBS Act also permits certain pre-filing and post-filing communications with investors by an EGC, or by a person authorized to act on the EGC's behalf, to determine whether such investors have an interest in a contemplated securities offering. [24]

Notwithstanding these recent developments, given the increased commercial and regulatory quality of non-U.S. markets and the ability of foreign issuers to reach U.S. institutional investors successfully without accessing the U.S. public markets, the extent to which foreign issuers, in particular those outside the technology sector, list on U.S. exchanges and access the U.S. public markets has declined since it peaked in 2001. [25]

Nonetheless, foreign companies continue to make initial offerings and list on exchanges in the United States and maintain such listings, with U.S. exchanges ranking third behind Asia-Pacific exchanges and European exchanges in terms of funds raised in global IPOs in 2015 and the first three quarters of 2016. [26] Although the number of foreign reporting companies continues to

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decline, especially following the adoption of the rules easing requirements for deregistration, the majority of foreign companies that were reporting companies under the Exchange Act at the time of the adoption of the Sarbanes-Oxley Act continue to be Exchange Act reporting companies. [27]

For those foreign companies seeking access to U.S. trading markets, public secondary trading of equity securities [28] in the United States takes place in two principal types of markets: (i) the securities exchanges (the New York Stock Exchange ("NYSE") [29] and Nasdaq, [30] and various regional or other smaller stock exchanges), and (ii) over-the-counter ("OTC") markets including the "electronic bulletin board" operated by FINRA (the "OTC Bulletin Board") [31] and a separate

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OTC market for which certain price information is reported in the "pink sheets." [32]

Listing securities on an exchange requires the issuer's participation and compliance with the relevant listing requirements (including eligibility criteria) of the exchange. [33] It also involves the preparation and filing with the SEC of a registration statement under the Exchange Act, a substantial document setting forth information and financial statements required by detailed SEC rules. Registration under the Exchange Act also triggers requirements to comply with the Sarbanes-Oxley Act and the Dodd-Frank Act. [34] The listing process is discussed in § 3.03, and exchange listing rules applicable to listed foreign issuers are discussed in Chapter 5.

Commencement of secondary trading in the pink sheet OTC market can be accomplished more easily. There are no listing requirements for securities to trade in the pink sheets, and a foreign issuer need not register such securities under the Exchange Act so long as it is exempt from the registration requirements

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of the Exchange Act pursuant to Rule 12g3-2(b) thereunder by, among other things, making available on its website in English certain information. [35] Trading can even start without the issuer's involvement. [36]

A foreign company can go further than facilitating secondary market trading and carry out a public offering to raise capital in the public markets in the United States. This step involves registration of the offering under the Securities Act. Usually, in the case of an equity offering, the securities will at the same time be listed on an exchange, and the listing is subject to a registration requirement under the Exchange Act, which involves a technically separate step that is procedural but not substantive.

If a foreign issuer, particularly one that is already public in another market, follows the two-step process of doing a listing first, followed by a public offering, the existence of the listing will reduce the time pressure on the offering process, and if sufficient time elapses between the two steps, the company may become eligible to use short-form Securities Act registration statements for its offerings. [37] These short-form registration statements incorporate by reference the information about an issuer that is filed with the SEC under the Exchange Act as a consequence of listing and thus facilitate Securities Act registration. The company may also become eligible to use shelf registration, which substantially expedites the offering process, or automatic shelf registration, which goes further to permit immediate U.S. public market access. [38] Securities Act registration of a public offering in the United States is discussed in this Chapter 3, and related disclosure and accounting issues are discussed in Chapter 4.

Footnotes

1 Unless otherwise indicated, references to foreign companies or foreign issuers in this book refer to "foreign private issuers" as such term is defined under the Securities Act and the Exchange Act. A corporation incorporated or organized under the laws of a foreign country is a "foreign private issuer" unless (i) more than 50% of its outstanding voting securities are directly or indirectly owned by residents of the United States and (ii) (a) the majority of its executive officers or directors are U.S. citizens or residents, (b) more than 50% of its assets are located in the United States, or (c) its business is administered principally in the United States. *See* Rule 405 under the Securities Act and Rule 3b-4 under the Exchange Act. For discussion of the application of the definition of "foreign private issuer" in certain circumstances, *see* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rules, Questions 110.02–110.08 (Dec. 8. 2016).

As a result of the reference in clause (i) above to the "indirect" ownership of voting securities, an issuer is required to take account of beneficial ownership reports provided to it or publicly filed (in the United States or other jurisdictions) and to "look through" the record ownership of brokers, dealers, banks and nominees located in the United States, in the issuer's home jurisdiction or in the primary trading market for the issuer's securities to determine the residency of their client beneficial owners. These brokers, dealers, banks or other nominees may be unwilling or unable to provide information about their client accounts, and if the issuer is unable to obtain this information after reasonable inquiry or if the cost of obtaining it is unreasonable, the issuer may assume that the beneficial owners are resident in the jurisdiction where the nominee has its principal place of business. *See* SEC Release No. 33-7745 (Sept. 28, 1999). If a foreign company does not qualify as a "foreign private issuer," it is subject to the provisions of the U.S. securities laws applicable to U.S. issuers.

2 The United States has entered into an agreement with Australia utilizing mutual recognition not in the context of capital raising but rather regulation of financial intermediaries. It provides broker-dealers and stock exchanges access to cross-border investors relying on home country regulation, but it has not been taken advantage of by any market participants.

3 The European Union ("EU"), in contrast, has been more open to regulatory approaches that include elements of mutual recognition. The EU does not rely solely on national treatment in addressing non-EU issuers and other institutions; rather, if the EU finds the regime of a home country "equivalent," it is willing to defer to the home country regime, though activity taking place in an EU jurisdiction will be subject to the liability standards of that jurisdiction. If equivalency is not established, then the national treatment model applies. Equivalency may be important in implementing Brexit, if the United Kingdom ceases to remain a member of the EU single market. A determination of equivalency in particular areas, largely on the basis of UK regulatory structures put in place while the United Kingdom was part of the EU, could give the United Kingdom access to the single market in those areas. The outcome remains altogether uncertain, however, as does the prospect that an equivalency-based mutual recognition regime between the EU and the United Kingdom could provide an impetus for the United States to explore such a regulatory approach in the future.

4 The principal U.S. markets for foreign issuers have been the New York Stock Exchange, discussed in §

3.03[2][b], and Nasdaq, discussed in § 3.03[2][c]. Until 2006, Nasdaq was an automated inter-dealer quotation system, and was not registered as a national securities exchange under the Exchange Act. However, on January 13, 2006, the SEC approved the application of Nasdaq to register the Nasdaq Stock Market LLC, a wholly owned subsidiary of Nasdaq, as a national securities exchange. SEC Release No. 34-53128 (Jan. 13, 2006). Furthermore, on June 30, 2006, the SEC approved certain changes to the rules of the NASD, the predecessor of the Financial Industry Regulatory Authority, Inc. ("FINRA"), to reflect Nasdaq's separation from the NASD (and now FINRA) as a result of its status as a national securities exchange. On August 1, 2006, Nasdaq began operating as an exchange in Nasdaq-listed securities and, on February 12, 2007, it began operating as an exchange in non-Nasdaq listed securities. Exchange registration gives Nasdaq its own Self Regulatory Organization, or SRO, license. *See* SEC Release No. 34-54084 (June 30, 2006).

5 Facilitating such trading generally involves the establishment of an unlisted American Depositary Receipt program. As discussed in § 3.04[1], ADR programs are formally created, and the ADRs are issued, by commercial banks acting as depositaries. Frequently, where an issuer sponsors an ADR program, the depositary bank may agree to bear part of the expense. ADR programs can also be established by a broker-dealer without the issuer's involvement (so-called "unsponsored programs"). Such programs and their impact on issuers are also discussed in § 3.04.

6 *See* Craig Doidge *et al.*, *The U.S. Listing Gap*, Fisher College of Business Working Paper No. 2015-03-07 (2015); Nicholas Calcina Howson, *et al.*, *Reverse Cross-listings – The Coming Race to List in Emerging Markets and an Enhanced Understanding of Classical Bonding*, 47 CORNELL INT'L L.J. 607 (2014); Marlin R.H. Jensen, *et al.*, *When IPOs Migrate*, 4 ACAD. OF ECON. & FIN. J. (2013). Additionally, there seems to be little dispute that the largest and highest profile global offerings, such as large state privatizations, have proceeded without U.S. listings and Exchange Act registration, even while they are accompanied by offerings to U.S. institutional investors. *See* Christopher Hung Nie Woo, *United States Securities Regulation and Foreign Private Issuers: Lessons from the Sarbanes-Oxley Act*, 48 AM. BUS. L.J. 119 (2011); *see also Interim Report of the Committee on Capital Markets Regulation*, 29–38 (Nov. 30, 2006).

7 For example, the state privatizations of Industrial & Commercial Bank of China and Bank of China proceeded with no listing in the United States, and these offerings also had no listing in London, but only in Hong Kong. In 2010, the $22.1 billion initial public offering ("IPO") of Agricultural Bank of China Ltd. proceeded with listings only in Hong Kong and Shanghai. Similarly, the $7.4 billion IPO of the Postal Savings Bank of China in 2016 and the $4.5 billion IPO of Nets A/S opened with listings only in Hong Kong and Nasdaq Copenhagen, respectively. Each of these offerings included a significant placement to U.S. institutional investors and to other global institutional investors. In recent years, Latin American issuers have also increasingly opted for local initial public offerings with a significant placement to the U.S. institutional investors but without registration in the United States.

8 For example, the $25 billion IPO of the Chinese ecommerce company Alibaba, the largest IPO to date, listed on the NYSE.

9 *See* Nicholas Calcina Howson, *et al*. *Reverse Cross-listings – The Coming Race to List in Emerging Markets and an Enhanced Understanding of Classical Bonding*, 47 CORNELL INT'L L.J. 607 (2014); Christopher Hung Nie Woo, *United States Securities Regulation and Foreign Private Issuers: Lessons from the Sarbanes-Oxley Act*, 48 AM. BUS. L.J. 119 (2011).

10 The JOBS Act, discussed below, provides some lessening of the burdens introduced by the Sarbanes-Oxley Act for certain smaller issuers.

11 As discussed in § 5.04[2][a], Note 140 the requirement for an auditor attestation has been eliminated for smaller companies, including smaller foreign companies, by the Dodd-Frank Act.

12 The Sarbanes-Oxley Act is discussed in Chapter 5, *see* § 5.04[2] (describing the requirements for internal control over financial reporting and related required officer certifications), § 5.02[2] (setting out the independent audit committee obligations imposed by § 301 of the Sarbanes-Oxley Act on issuers with securities listed on a U.S. national securities exchange) and § 5.03 (detailing provisions of the Sarbanes-

Oxley Act regulating auditor independence, auditor reports to audit committees, expanded disclosure of principal accountants' fees and audit committee actions and the retention of records relevant to audits and reviews).

13 *See generally* Chapter 4 for descriptions of these provisions.

14 *See* SEC Release 34-55540 (Mar. 27, 2007). *See* § 4.11[2][a] for a discussion of requirements for termination of Exchange Act registration under Rule 12h-6 under the Exchange Act; *see also* Rule 12h-6).

15 Christopher Cox, SEC Chairman, Opening Statements at the SEC Open Meeting (Dec. 13, 2006); *see also* SEC Release No. 34-55540 (Mar. 27, 2007). *See also* Steven M. Davidoff, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79 U. OF CINCINNATI L. REV. 619, 635–37 (2010).

16 *See* SEC Release 33-8879 (Dec. 21, 2007).

17 *See* Steven M. Davidoff, *Rhetoric and Reality: A Historical Perspective on the Regulation of Foreign Private Issuers*, 79. U. OF CINCINNATI L. Rev. 619, 639–43 (2010).

18 SEC Release No. 33-8591 (July 19, 2005) (the "Securities Offering Reform Release"); *see also* SEC Release No. 33-8501 (Nov. 3, 2004); SEC Release No. 33-7606 (Nov. 3, 1998), as amended by SEC Release No. 33-7606A (Nov. 13, 1998).

19 The SEC's actions relating to liability as part of these reforms are discussed in § 11.03. The other aspects of these reforms are addressed principally in § 3.02.

20 A WKSI also cannot be an "ineligible issuer." *See* §3.02[3][a][ii].

21 While the Securities Offering Reforms did facilitate initial public offerings to some degree, the greatest advantages accrued to large issuers, U.S. and foreign, that are already public in the United States.

22 The JOBS Act defines an EGC as an issuer with total annual gross revenues of less than $1 billion during its most recent financial year. An issuer that was an EGC as of the first day of that financial year will remain an EGC until (i) the last day of the financial year five years after its initial public offering, (ii) the last day of the financial year in which it has annual gross revenues of $1 billion or more, (iii) it has issued more than $1 billion in nonconvertible debt during a three-year period, or (iv) it is a "large accelerated filer" (generally, a company with a public float of at least $700 million that has been publicly reporting for at least one year). By its terms, the JOBS Act generally applies equally to domestic and foreign EGCs.

23 *See infra* Note 69 and accompanying text.

24 *See* § 3.02[3][b][iv].

25 *See* SEC, Division of Corporation Finance, International Registered and Reporting Companies (Dec. 31, 2015).

26 In 2015, U.S. exchanges accounted for 17% of funds raised in global IPOs, compared to 46% for Asia-Pacific Exchanges and 35% for European exchanges. In the first three quarters of 2016, U.S. exchanges accounted for 17% of funds raised in global IPOs, compared to 53% for Asia-Pacific exchanges and 25% for European exchanges. *See* Ernst & Young, *Global IPO Trends 2015 Q4* (2015) and Ernst & Young, *Global IPO Trends 2016 Q3* (2016).

27 As of December 31, 2015, 923 foreign companies from 53 countries were periodically reporting to the SEC under Exchange Act requirements, whereas only 434 foreign companies were reporting to the SEC in 1990. *See* SEC, International Registered and Reporting Companies (Dec. 31, 2015). The 923 foreign companies represent a decline from the high of 1,344 in 2001. The number had hovered at around 1,200 from 2003 to 2006. As of November 1, 2016, a search of the SEC's Electronic Data Gathering and Retrieval system ("EDGAR") shows that 503 foreign companies had filed notices of deregistration since the March 2007 changes to deregistration.

28 For a discussion of special considerations relating to the registration of debt securities, *see* § 3.05.

29 An issuer wishing to list equity securities on the NYSE can choose from three NYSE markets: NYSE, NYSE MKT and NYSE Arca. Listings on the NYSE are for large- and medium-sized companies. NYSE MKT supports small-cap companies with less strenuous criteria. *See* § 3.03[2][b] for a description of the listing

criteria for NYSE and NYSE MKT. NYSE Arca is an all-electronic exchange that primarily lists exchange-traded notes, funds and other products.

30 An issuer wishing to list equity securities on Nasdaq can choose from three Nasdaq markets: Nasdaq Global Select Market ("Nasdaq/GSM") Nasdaq Global Market and Nasdaq Capital Market. Listings on the Nasdaq/GSM are for large- and medium-sized companies, with Nasdaq Global Markets and Nasdaq Capital Market listings available for smaller companies. The requirements to list on the Nasdaq Global Market and Nasdaq Capital Market are less difficult to meet than current NYSE requirements, especially with respect to the requirements for inclusion of shares of common stock of foreign issuers (or ADRs representing such shares) in the Nasdaq Capital Market.

31 In connection with its becoming a national securities exchange, Nasdaq separated from the NASD (the predecessor of FINRA), which is a self-regulatory organization that had originated Nasdaq and had later been its parent. *See* SEC Release No. 34-53128 (Jan. 13, 2006); SEC Release No. 34-54084 (June 30, 2006). As part of the plan of separation from the NASD, Nasdaq sold its interest in the OTC Bulletin Board to the NASD and only offers certain technological services and operational support, while FINRA (as the successor to the NASD) has full responsibility for all other matters. *See* SEC Release No. 34-54084 (June 30, 2006); NASD/Nasdaq Trade Reporting Facility Frequently Asked Questions (FAQs) (Feb. 14, 2007). The OTC Bulletin Board permits FINRA members that are market-makers to view, enter, update and display quotations, solicitations for quotations and indications of interest for particular OTC securities that are not traded on any national securities exchange. Brokers for investors wanting to trade in securities quoted on the OTC Bulletin Board generally contact one of the listed market-makers in the securities. *See* SEC Release No. 34-38456 (Mar. 31, 1997). *See* FINRA Rules, Rule 6500, FINRA MANUAL.

32 The pink sheets, which are now distributed electronically by OTC Markets Group Inc. and were originally named for the color of the paper on which OTC quotes were distributed, display quotes from broker-dealers for OTC shares. For OTC corporate debt, OTC Markets Group Inc. distributes "yellow sheets." As with the OTC Bulletin Board, brokers for investors wishing to trade generally contact one of the listed market-makers.

For a discussion of the SEC's rules governing "alternative trading systems" and "internal broker-dealer systems" adopted in response to the creation of Internet-based alternative electronic trading systems for secondary trading, *see* § 14.10[1].

33 The OTC Bulletin Board does not impose substantive requirements on an issuer seeking to obtain a quotation for a class of securities. However, in contrast to issuers whose securities are quoted in the pink sheets, issuers must generally be subject to and current with the reporting requirements of the Exchange Act. These issuers tend to be smaller, and so the various accommodations for smaller companies may apply.

34 *See* §§ 3.02[1][b] and 4.04 for a discussion of Form 20-F, the Exchange Act registration statement for foreign issuers. Such registration requirements, as well as periodic reporting and certain other requirements to which a company becomes subject as a result of Exchange Act registration, including those obligations imposed on companies by the Sarbanes-Oxley Act and the Dodd-Frank Act, are also discussed in Chapter 4 and Chapter 5.

In 1994, the SEC adopted Rule 3a12-11 under the Exchange Act, and amended certain rules under the Exchange Act, in order to reduce previous regulatory distinctions between debt securities listed on a national securities exchange and those traded in the OTC market. SEC Release No. 34-34922 (Nov. 1, 1994). The changes simplified registration procedures under the Exchange Act for listed debt securities and exempted listed debt securities from the borrowing restrictions and proxy rules of the Exchange Act (other than the antifraud rules and certain other rules that relate to the transmission to beneficial owners of proxy and consent materials and information statements).

In 2006, the SEC permitted NYSE member organizations to trade debt securities on the NYSE that are not registered under § 12(b) of the Exchange Act, but are issued by NYSE-listed companies or their wholly owned subsidiaries and that meet certain other conditions. *See* SEC Release No. 34-54766 (Nov. 16, 2006); SEC Release No. 34-54767 (Nov. 16, 2006); SEC Release No. 34-55496 (Mar. 20, 2007). The NYSE Bonds market provides trading opportunities for a wide variety of debt, including corporate, foreign issuer, non-U.S. dollar denominated and municipal debt.

35 *See* the discussion regarding Rule 12g3-2(b) under the Exchange Act in § 4.02[3][a][iv].

36 ADR issuers must comply with SEC Rule 10b-17 (requiring timely notice to FINRA of certain corporate actions, including dividends, stock splits, reverse splits, name changes, mergers, acquisitions, dissolutions, bankruptcies or liquidations, at least 10 days prior to the record date). Issuers who fail to report such corporate actions in the required time may be subject to fines up to $5,000. *See* FINRA's Notice to Member 10-38. ADR depositaries, as the ADR issuers, comply with this requirement when they seek OTC listing.

37 The short-form registration statement for foreign issuers is Form F-3. *See* § 3.02[1][b] for a discussion of the eligibility requirements.

38 *See* Rule 415 under the Securities Act and the eligibility requirements for the use of Form F-3. Shelf registration, including "automatic shelf registration," is discussed in § 3.02[2][C].

U.S. Regulation of the International Securities and Derivatives Markets, § 3.02, REGISTERED PUBLIC EQUITY OFFERINGS IN THE UNITED STATES

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 § 3.02 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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A foreign company making a public offering in the United States must, like a U.S. issuer, register the securities being offered under the Securities Act. An issuer becomes subject to the reporting requirements of the Exchange Act as a consequence of the registered public offering, [39] regardless of whether it lists on

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an exchange, although it must separately register under the Exchange Act if it does list on an exchange. [40] Filing a registration statement under the Securities Act or registering securities under the Exchange Act (in connection with a Securities Act filing or on its own) also triggers the applicability of the Sarbanes-Oxley Act and the Dodd-Frank Act. [41]

[1] Overview of Registration Under the Securities Act

[a] General Statutory Scheme

Any offer or sale of securities must be registered with the SEC under §5 of the Securities Act, unless an exemption is available. With limited exceptions, no exemption is available for U.S. public offerings. Accordingly, public offerings must be registered to comply with § 5 of the Securities Act. Registration is accomplished by filing a registration statement with the SEC, which must become effective before sales can be made.

As a practical matter, the offering process can be divided into three stages, because of the provisions of § 5 of the Securities Act. The first stage is the "quiet period," which is the period after the decision to proceed with an offering has been taken but before the registration statement is filed. The second stage is the "waiting period" between filing and effectiveness of the registration statement, and the third stage is the "post-effective period" after the registration statement becomes effective. [42] Various rules govern what kind of offers may or may not be

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made during each of the three stages. Violations of restrictions on offers during each stage are sometimes referred to as "gun-jumping."

As noted above, and as discussed more fully in §3.02(2)(c) below, because shelf registration statements of WKSIs are automatically effective, there is no second stage for WKSIs in most cases. Further, as a result of exceptions from many of the pre-filing offering restrictions for WKSIs, the concerns for WKSIs regarding pre-filing activities are much reduced.

The Securities Act defines "offer" as including "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value." [43] Because "offer" is defined so broadly, the issuer, the underwriters and all others involved in the process must be careful to distinguish between permissible communications and illegal offers and not engage in communications and activities that might be viewed as impermissibly affecting the market for the securities to be offered. Any unusual publicity about the issuer or the proposed offering made in, or, in some cases, accessible in, the United States in advance of the filing or between the filing and its effective date may be viewed by the SEC as impermissible because it is likely to stimulate public interest in these securities and thus precondition the market. Publicity can be a significant issue in a global offering with a U.S. tranche, primarily because other jurisdictions do not impose such strict limitations.

The registration statement sets out extensive information about the business and financial condition of the issuer and about the offering in accordance with detailed SEC rules. [44] While the SEC does not formally approve the contents of a registration statement or prospectus (and indeed it is a criminal offense to state that the SEC has given such approval), [45] and does not make any determination of the merits of the offering, the SEC staff does review almost all registration statements of issuers that have not filed previously under either the Securities Act or the Exchange Act. As part of that review process, the staff provides comments about disclosure that it believes is not in compliance with the SEC's rules or is otherwise unclear, incomplete, insufficient or unsubstantiated.

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The following sections set forth the basic procedures and considerations for SEC registration, including forms, timing and prospectus delivery.

[b] Registration Forms

Foreign companies [46] generally file their Securities Act registration statement on one of two SEC forms: [47] Form F-1 (a so called "long-form" registration statement) or F-3 (a so called "short-form" registration statement). [48] Each form requires the disclosure about an issuer that is called for by Form 20-F. [49] *****************In addition, each form also requires information regarding the nature and terms of the particular offering. [50] The principal difference between the forms is the amount of information that may be incorporated by reference from Exchange Act reports.

Form F-1 allows eligible registrants to incorporate by reference their Form 20-F filed prior to the effective date of the Form F-1 and any specified Form 6-K s submitted to the SEC prior to that effective date. Form F-1, however, does not permit incorporation from subsequently filed documents. Registrants eligible for the backward incorporation by reference permitted under Form F-1 must have filed all required reports under the Exchange Act for a period of 12 months (or such shorter period as they have been subject to those requirements) and have filed an annual report on Form 20-F with the SEC. Therefore, initial public offerings in the United States and any follow-on offerings before a registrant's first annual report has been filed are required to be on Form F-1 without the benefit of any incorporation by reference. [51]

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Form F-3 allows both backward incorporation by reference and forward incorporation of any Form 20-F s or Form 6-K s filed or submitted to the SEC after the effective date of the Form F-3. [52] This not only expedites preparation of the Form F-3 but also facilitates keeping it current after its effective date, which is important in connection with shelf-registration. [53]

Qualification to use Form F-3 depends upon whether the issuer meets certain conditions and the length of time that it has been filing periodic reports under the Exchange Act. [54]

A foreign company generally may register securities on Form F-3 if (i) it has been required to file reports with the SEC for at least 12 months (provided that all reports required to be filed have been filed in a timely fashion) and has filed at least one annual report on Form 20-F, (ii) its common stock held by nonaffiliates has an aggregate worldwide market capitalization (or "public float") of at least $75 million and (iii) it has not defaulted on certain payments. [55] The public float requirement is not applicable if at least one class of the issuer's common equity is listed on a national securities exchange and it does not sell more than one-third of its public float over the 12-month period (including the current sale). [56]

The public float requirement also is not applicable if the issuer is issuing nonconvertible securities, other than common equity, and (i) has issued (as of a date within 60 days prior to the filing of the registration statement) at least $1

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billion over the prior three years in nonconvertible securities, other than common equity, in primary offerings for cash (not through exchange offers) registered under the Securities Act; (ii) has outstanding (as of a date within 60 days prior to the filing of the registration statement) at least $750 million of nonconvertible securities, other than common equity, issued in primary offerings for cash (not through exchange offers) registered under the Securities Act; (iii) is a wholly-owned subsidiary of a WKSI; [57] or (iv) is a majority-owned operating partnership of a real estate investment trust that qualifies as a WKSI [58]

The public float requirement also is not applicable for use of Form F-3 in connection with secondary offerings, certain rights offerings, dividend or interest reinvestment plans, conversion of convertible securities and the exercise of warrants. [59]

In addition to incorporation of information by reference to Exchange Act reports, a Form F-3 must also provide information regarding material changes in the foreign company's business and financial condition that have occurred since the end of the fiscal year covered by the Form 20-F incorporated by reference in the registration statement, [60] as well as regarding significant business acquisitions, changes in accounting principles, corrections of previous accounting errors and material dispositions of assets outside the normal course of business, if that information is not contained in filings (or Form 6-K submissions) under the Exchange Act incorporated by reference. [61]

Financial statements included in an annual report on Form 20-F may not suffice to meet the requirements of the Securities Act. In particular, if the financial statements in the annual report on Form 20-F are not sufficiently current to comply with the requirements of Item 8 of Form 20-F, current financial statements must be included in the prospectus or an amended Form 20-F. [62]

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The fee for filing a registration statement under the Securities Act (other than an automatic shelf registration statement) is a percentage of the estimated maximum aggregate offering price of the securities being registered. [63] No registration fees are due when an automatic shelf registration statement on Form S-3 or F-3 is initially filed by a WKSI. Instead, WKSIs are allowed to pay the necessary filing fee at the time of each shelf takedown (*e.g.*, when the prospectus supplement is filed) or at any time prior to each takedown. [64]

[c] Timing Considerations

Depending in large part upon whether it has previously offered its securities publicly in the United States or listed its securities on a U.S. stock exchange, an issuer may require a considerable amount of time and planning to prepare a registration statement under the Securities Act. The issuer is generally responsible in the first instance for the preparation of its registration statement, with the assistance of its counsel and independent accountants.

For an issuer that has not previously prepared a Securities Act or Exchange Act registration statement, the length of time required to compile the necessary information and draft the registration statement often depends on the amount of work needed to prepare audited consolidated financial statements. The financial statements—which can require substantial restatement and revision of the issuer's normal financial statements—generally must include audited statements of income, cash flows and statements of changes in equity for the three most recent fiscal years and audited balance sheets as of the end of the three most recent fiscal years, in each case audited in accordance with generally accepted auditing standards in the United States. [65] For foreign issuers, these financial statements, and any required financial statements for interim periods, generally must be in

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accordance with U.S. GAAP or IFRS as issued by the IASB or reconciled to U.S. GAAP. [66] The registration statement must also include certain income statement and balance sheet items for five years. [67] An EGC is also permitted to provide only two years (rather than three) of audited financial statements, and only those two years (rather than five) of selected financial data, in its IPO registration statement. [68] This accounting work can take months to prepare, [69] especially when the foreign issuer does not already report under IASB-adopted IFRS.

In certain cases, foreign companies may submit draft registration statements to the SEC on a confidential basis: (1) a foreign government registering its debt securities; (2) a foreign private issuer that is listed or is concurrently listing its securities on a non-U.S. securities exchange; (3) a foreign private issuer that is being privatized by a foreign government; or (4) a foreign private issuer

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that can demonstrate that the public filing of an initial registration statement would conflict with the law of an applicable foreign jurisdiction. [70] Under the JOBS Act, EGCs may also submit a draft IPO registration statement for confidential SEC review.

The staff insists that confidential submissions by foreign issuers be substantially complete to be eligible for review and that the financial statements be current at the time of submission (although as in the case of formal filings, an estimated price range and size of offering is not required at that time). The staff has indicated that it will expect the auditor's report to be signed and dated at the time the draft registration statement is first submitted, unless special arrangements have been agreed in advance with the Office of International Corporate Finance.

If a registration statement is confidentially submitted to the SEC and commented upon in this manner, the preliminary prospectus will typically be distributed upon the first public filing of the registration statement after all SEC comments have been incorporated.

Upon the first public filing, issuers must also file publicly the first confidential submission and all amendments thereto. The SEC makes all comment and response correspondence publicly available no earlier than 20 business days after it has declared a registration statement effective.

For foreign issuers that qualify as EGCs and choose to take advantage of any of the benefits available to EGCs, the confidential filing process should follow the rules and SEC guidance provided in connection with the implementation of the JOBS Act, which differ in some respects from the guidance for confidential submissions by foreign issuers. For example, EGCs must publicly file confidential submissions at least 15 days before commencing a road show.

Once a registration statement has been filed, it may be reviewed by the staff, [71] who will give their comments in writing. [72] Not all filings are reviewed.

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However, a filing will almost always be selected for review if it is an initial public offering or other first filing by the issuer, and chances of review of later filings are heightened if there has been a material change in the issuer's business or structure or financial condition. [73] While the period of SEC review may vary widely, the SEC staff will generally take about one month to review and comment initially. [74] Depending on the nature and extent of the comments, it should generally be possible to respond to them within a week or two. Responses to the SEC's comments are generally incorporated into an amendment to the registration statement, which is accompanied by a letter explaining the amendment and otherwise addressing the comments. Successive rounds of comments may be made by the SEC staff, although generally with shorter review times than the initial comments. Once the comments have been addressed to the satisfaction of the reviewers, the registration statement, as amended, will be declared effective on a date selected by the issuer. [75]

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In the United States, in initial public offerings and other heavily marketed offerings it is customary to distribute the preliminary prospectus widely to prospective investors. In such cases, where the issuer anticipates that the staff will review a registration statement and may have extensive comments, particularly in the case of initial public offerings, it generally makes a "quiet filing" when the confidential submission process described above is not available; it files the registration statement with the preliminary prospectus but does not widely distribute the prospectus or commence marketing efforts until one or more rounds of SEC staff comments have been received and addressed. The preliminary prospectus generally does not contain pricing and certain other information relating to the offering not available or not determined at the time of filing, but is otherwise generally complete.

After the comment process is completed and, in the case of an initial public offering involving confidential review, the registration statement containing the form of preliminary prospectus is filed publicly and the preliminary prospectus, which will now include the price range and offering size, [76] is distributed to investors, executive officers of the issuer and representatives of the underwriters typically participate in road shows, arranged between institutional investors and management at which the preliminary prospectus is made available and management responds to questions. The transmission of electronic road shows, which are presentations by video or Internet, is permitted, provided that conditions regarding use of a free writing prospectus applicable to electronic road shows are satisfied. [77] During this marketing period, the underwriters obtain indications of interest regarding the securities being marketed. [78] This is commonly referred to as "bookbuilding." [79]

At the conclusion of this bookbuilding period (which may last from a few days to several weeks), the lead underwriters negotiate the share price and size

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of the offering with the issuer and/or selling shareholders based on the indications of interest and other relevant factors. [80] In a public offering of shares that are already listed on a securities exchange, pricing is usually based on the quoted share price or a formula related to that price. After the share price and offering size are set, the underwriting agreement is signed. [81]

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In the case of initial public offerings and other registration statements that do not follow delayed-offering procedures under shelf registration, [82] the amendment to the registration statement containing the final prospectus may be filed and declared effective by the SEC on request either before or after the pricing of the securities. In the former case, which is far more common, the amendment will be filed and the registration statement declared effective without information in the prospectus about the public offering price and the composition of the underwriting syndicate. The offering must be priced within 15 business days after effectiveness. [83] In the latter case, the amendment is known as a "pricing amendment" and contains a final prospectus that includes the pricing and underwriting information previously omitted from the preliminary prospectus.

If the securities of a foreign company will, when sold, be listed on a national securities exchange, the issuer and the underwriters may decide to time the pricing of the securities so that they trade first at the opening of business on the U.S. exchange. Alternatively, the pricing of newly issued securities that are also being listed on an overseas exchange that is expected to be the primary trading market may be timed so that they trade first on that overseas exchange, where the trading will benefit from greater liquidity. In any event, in light of the time

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differences between trading hours on U.S. and overseas markets, having the registration statement declared effective prior to pricing, either by using shelf registration where available or by utilizing Rule 430A, provides the greatest flexibility.

If there is a need to update the disclosure about the issuer or make any corrections to the information in the preliminary prospectus, participants in a registered securities offering need to assess whether such updates or corrections arising since the date of the most recent preliminary prospectus circulated to potential investors should be included in a new preliminary prospectus or, more likely, a free writing prospectus, which, in either case, would be circulated to investors prior to pricing. [84] Consideration should also be given to the length of time between conveyance of the corrected or updated information to investors and the pricing of the securities offering during which investors would be able to process the updated disclosure.

After effectiveness, and as soon as possible after pricing, relevant pricing terms and any other material changes are conveyed to investors, usually orally in the case of equity securities (or through a term sheet in the case of debt securities), the form of which has usually been pre-agreed between the issuer and the underwriters. The underwriters generally confirm their sales orally, followed by a written confirmation of sale that is required by SEC regulations to include specific information. [85] The final prospectus (including the pricing information) is filed with the SEC within two business days of pricing.

In purely domestic U.S. transactions, the closing typically occurs three or four business days later, while in U.S. offerings by non-U.S. issuers, the closing sometimes does not occur until five or more business days later. [86] Regardless of the length of the settlement period, the closing is subject to certain conditions being met, including the delivery of legal opinions and accountants' negative comfort letters and the absence of material adverse changes in the issuer's business or serious disruptions in the financial markets.

[d] Requirements Regarding Disclosure in the Preliminary Prospectus of Price Range and Estimation of Number of Shares to be Sold

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If the registrant is not an SEC-reporting company prior to filing the registration statement, Item 501(b)(3) of Regulation S-K requires the preliminary prospectus first "circulated," or distributed to the market, to contain an estimated price range (which, according to SEC staff guidance, cannot be wider than $2 (if the maximum price is $10/share or less) or 20% of the high end of the estimated range (if the maximum price is greater than $10/share) and an estimated maximum size of the offering. [87] With respect to foreign registrants that are listed in their home country prior to filing, the SEC staff has often permitted such registrants to provide share price information for the home market as of a recent date in lieu of the price range information referred to above. Filings during the period when comments are received and responded to and prior to the circulation of the preliminary prospectus and marketing customarily do not carry a price range or final estimated offering size. [88]

If the registrant is an SEC-reporting company prior to filing a registration statement, it is not required to include a price range or indicative offering size in the preliminary prospectus.

[e] Requirements Regarding Prospectus Delivery

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[i] *General Framework*

Underwriters are required to deliver preliminary prospectuses to prospective purchasers in initial public offerings. Delivery to such purchasers must take place at least 48 hours prior to sending them confirmations of sale. [89]

Section 5 of the Securities Act requires that a final prospectus containing all required information must precede or accompany the confirmation of sale sent to each purchaser and must be sent prior to the delivery of securities. [90] This requirement is deemed to be satisfied as long as the final prospectus is filed with the SEC by the required filing date provided in Rule 424 under the Securities Act [91] or the issuer has made a good faith and reasonable effort to file such a prospectus within the required time under Rule 424, and if the issuer has not timely filed the prospectus, the issuer files the prospectus as soon as practicable thereafter. [92] This allows settlement and delivery of securities to investors with only a

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confirmation from the underwriter (which is often electronic) and no delivery of a final prospectus.

Section 4(a)(3) of the Securities Act and Rule 174 thereunder impose a prospectus delivery requirement in certain cases on dealers that are not underwriters. The requirement applies in the case of sales by dealers of unsold allotment securities. [93] Section 4(a)(3) also contains a general prospectus delivery requirement for secondary market sales by dealers for 40 days after the later of the *bona fide* offering date and the effective date of the registration statement (90 days for an issuer that has not sold securities pursuant to an effective prior registration statement). Rule 174 eliminates or reduces this requirement in most cases in connection with registered offerings. In particular, (i) it eliminates the requirement for issuers that are reporting companies immediately prior to the effectiveness of the registration statement, (ii) it eliminates the requirement for offerings pursuant to shelf registration statements except with respect to the first *bona fide* offering off the shelf, and (iii) it reduces the requirement from 40 (or 90) to 25 days in the case of offerings of securities listed on a U.S. national securities exchange. The result of this regulatory framework is generally to require prospectus delivery by dealers in the case of unsold allotment securities at any time and in the case of initial public offerings for 25 days in the case of securities listed on a national securities exchange and for 90 days in the case of securities not so listed. Dealers may rely on SEC filing under Rule 172 to satisfy their delivery requirement (other than for blank check companies), so that no prospectus need be delivered if the filing requirements of Rule 172 are satisfied. [94]

[ii] *Electronic Document Distribution*

The SEC expressly permits the Internet to be used for the dissemination of mandatory disclosure documents in a U.S.-registered offering. [95] The same liability rules apply to documents distributed electronically as to documents distributed in paper form. SEC rules provide that electronic access to certain mandatory

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disclosure documents satisfies the delivery obligation. [96] In order for electronic delivery to satisfy the SEC's requirements for the delivery of other mandatory disclosure documents (such as a preliminary prospectus in an initial public offering), the SEC requires either evidence of actual receipt of the documents by the investor [97] or a combination of the following:

- notice that a document is available electronically;
- access to the Internet or to the electronic medium employed; and
- consent to delivery through the electronic medium employed.

To satisfy the first element, notice, an investor should receive written notice of electronic delivery of the particular required document, unless an issuer or market intermediary can otherwise establish that delivery has been made. If the document is physically delivered or delivered by electronic mail, that communication itself, because it permits certification of receipt, should be sufficient notice. If the document is posted on a website, however, separate advance notice is necessary. Moreover, messages posted to an investor's account on a broker-dealer's website do not fulfill the notice requirement. [98]

To satisfy the second element, access, the electronic medium employed for delivery should not be so burdensome to use as to prevent access. [99] In addition, to demonstrate access either there should be an adequate opportunity for the recipient to retain a permanent record of the electronic information—by printing or downloading, for example—or the recipient should have ongoing electronic

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access equivalent to personal retention. [100] Thus, information posted on a website for only a brief period of time is unlikely to constitute adequate access, and a document made available by posting on the Internet, through on-line services, or by similar means should be accessible for as long as the delivery requirement for that document applies. [101] Finally, to establish access, an investor must be provided with a paper version of the document if the investor exercises its prerogative to revoke its prior consent to electronic delivery or merely requests a supplemental paper copy. [102]

Information on a website is deemed part of a prospectus only if an issuer or person acting on behalf of an issuer (including an intermediary with delivery obligations) acts to make the website part of the prospectus. Close proximity of information on a website to a prospectus does not, by itself, make that information an "offer to sell," "offer for sale" or "offer" within the meaning of the Securities Act, although it may result in the documents being delivered together. Regardless of proximity to the prospectus, website content should be reviewed in its entirety to determine whether it contains information that is inconsistent with the prospectus or otherwise may raise liability concerns. Hyperlinks to or from a website may make the hyperlinked information part of the prospectus and are generally avoided.

To satisfy the third element, consent, an investor should be apprised of the specific type of electronic medium to be used, the potential costs associated with electronic delivery, the duration of the consent and the documents for which consent will be effective and the fact that the consent is revocable at any time. Consent will not be deemed to have been obtained merely by an investor's failing affirmatively to object when notified of proposed electronic delivery. [103]

Investors may consent to electronic delivery telephonically, as long as a record of the call is retained. The record must indicate the breadth of the consent and the electronic media to be used. Further, such consent must be obtained in a manner that ensures its authenticity.

An investor may provide global consent to electronic delivery covering all documents of multiple issuers, so long as the consent is adequately informed. In such cases, particular care must be taken to ensure that the investor understands

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that it is providing a global consent to electronic delivery. [104] Where an investor has provided its global consent, its right to revoke in connection with a global consent may be limited to an "all issuers or none" basis. Although the consent must specify the electronic media to be used, it need not specify the medium to be used by any particular issuer. A global consent need not identify the issuers it covers and may permit additional issuers to be added later without further consent.

When an issuer offers securities to its own employees, the requirements for electronic delivery will be deemed to be satisfied (i) when an employee uses the issuer's electronic mail system to execute his or her duties or (ii) where an employee can be expected to receive through alternate means e-mail messages sent to employees.

In 2001, the SEC for the first time (and so far the only time) declared effective a registration statement providing that the issuer would communicate with investors only through the Internet. [105] This registration statement was submitted to the SEC by The American Life Insurance Company of New York with respect to its proposed issuance of variable annuity contracts. The related SEC releases reflected important departures from the prior SEC pronouncements regarding the electronic delivery of materials insofar as the SEC did not require that American Life provide notice of website postings or provide paper versions of any documents posted on the Internet with respect to the annuities in question.

Other than with respect to its adoption of Rule 172, the SEC has not extended the American Life decision to other contexts involving delivery of preliminary prospectuses. The SEC noted that its American Life decision "reflects the particular facts and circumstances applicable here" and should not be read "as predetermining the outcome in any other circumstance." [106] Indeed, the SEC could seek to distinguish this ruling on the basis of the nature of the securities involved. [107] Nevertheless, the SEC did indicate that it had revisited its past

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pronouncements on electronic delivery in light of the Electronic Signatures in Global and National Commerce Act [108] and was reviewing whether these previous pronouncements should be modified. Future SEC action in this area may, as in the past, be taken through interpretive guidance.

[2] Shelf Registration

[a] Overview

A shelf registration statement is used to register future offerings without the need to provide details regarding those offerings at the time the shelf becomes effective. Once a shelf registration statement has become effective, securities can be publicly offered and sold under it (referred to as a "taking down" securities "off the shelf") without further approval from the SEC.

Compared with conventional registration procedures, shelf registration presents significant advantages in terms of an issuer's ability to consummate an offering quickly to take advantage of market opportunities. Having an effective registration statement on file allows immediate communications with prospective investors without raising "gun-jumping" considerations (although the issuer must comply with free writing prospectus requirements for any writing [109]). Except for disclosure in a prospectus supplement of material recent developments insofar as they have not previously been disclosed in a filing under the Exchange Act that is incorporated by reference, the description of the issuer (and any guarantor) will have been completed in advance of the offering and will be included (or incorporated by reference) in the base prospectus included as part of the already effective registration statement. [110] Because the shelf registration statement is already effective, an offering can ordinarily be made without delay

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for review or action by the SEC. An underwriting agreement can be signed and sales of securities to investors made and confirmed immediately (although, in practice, a preliminary prospectus supplement is generally prepared and used, it is not required to be filed until after such use).

A shelf registration statement can register sales of new securities by their issuer (a "primary shelf"), resales of outstanding securities by their owners (a "secondary shelf") or a combination of the two. A foreign issuer that is eligible to use Form F-3 for primary offerings may file a shelf registration statement on that form regardless of whether the offerings being registered are to be made on an immediate basis, a delayed basis or a continuous basis. [111] Shelf registration can be used for secondary offerings of securities whether or not the issuer of those securities would be eligible to use Form F-3 for a primary offering. [112]

A shelf registration statement generally expires three years (subject to a limited extension) [113] after the initial effective date of the registration statement. As a result, new shelf registration statements must be filed every three years, with unsold securities and unused fees carried forward to the new registration statement. [114] The three-year expiration rule, however, does not apply to secondary-only [115] or acquisition shelf registration statements that are not automatic shelf registration statements. [116]

The unallocated or "universal" shelf registration process allows issuers to register, and pay a fee for, an aggregate dollar amount of securities of different classes on a single shelf registration statement. [117] While entities that are not

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WKSIs must specify the particular classes of securities they are registering, the registration fee is not allocated among those classes at the time of filing and the classes may include both debt and equity securities. For each offering of securities off that shelf registration statement, the prospectus supplement lists the amount and class of securities being offered, and the value of the offering is subtracted from the total dollar amount of securities registered. [118] As an additional option, a WKSI may elect to pay the necessary filing fee at the time of each shelf takedown rather than prepaying fees. [119]

[b] General Procedures

A shelf registration statement contains a basic prospectus, usually referred to as a "base prospectus," providing the same information regarding the issuer that is included in a conventional prospectus, including information incorporated by reference from the issuer's most recent annual report on Form 20-F and subsequent filings under the Exchange Act. The base prospectus, however, usually contains only a general description of the types of securities that could be offered "off the shelf" and of the various ways in which such securities could be distributed. In order to have maximum flexibility, a company may provide in general terms for the issuance of many different types of securities. In addition, provision may be made for several different means of distribution, such as firm commitment or "best efforts" underwritings, agency placements and direct sales.

To comply with the Trust Indenture Act, if debt securities are registered the company must also file, as exhibits, forms of the trust indentures under which those securities are to be issued. [120]

Rule 430B under the Securities Act permits information that is unknown or not reasonably available to be omitted from a base prospectus in delayed offerings and later included in a prospectus supplement, an Exchange Act report incorporated by reference or a post-effective amendment. Market practice has generally been to use a prospectus supplement. The prospectus supplement for each specific offering would generally include terms of the securities being offered, the pricing, the plan of distribution (including any underwriting or sales arrangements) and, if necessary, disclosure of material recent developments concerning the issuer not included in incorporated documents. Rule 430B also provides that issuers eligible to use Form S-3 or F-3 for primary offerings may in certain circumstances described below omit information about the identities of

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selling securityholders and the amount of securities to be sold by such holders. [121] The prospectus supplement must be filed with the SEC, but no SEC action is required with respect to the prospectus supplement.

Rule 430B provides that information contained in a prospectus supplement will be deemed part of the related registration statement. Rule 430C codifies similar provisions relating to shelf registrations by issuers not eligible to use Form S-3 or F-3 for primary offerings. As a result, prospectus supplements will be considered part of the related registration statement for purposes of liability under § 11 of the Securities Act as of the dates described below.

The date on which the information in a prospectus supplement will be deemed to be part of the related registration statement for purposes of § 11 liability of issuers and underwriters only will be determined as follows:

- for supplements filed in connection with most shelf takedowns, under Rule 430B, the earlier of the date that the supplement is first used [122] and the date and time of the first contract of sale of securities to which the supplement relates; [123] and
- for other supplements filed under Rule 430B or 430C, as applicable, as of the date the prospectus supplement is first used.

Rule 430B creates a new effective date for most delayed offerings for purposes of shelf registration statement liability under § 11 for issuers and underwriters. That effective date is the date a prospectus supplement filed in connection with the takedown is deemed part of the registration statement. [124] The undertakings included in Item 512 of Regulation S-K require issuers to agree to this § 11 liability as of the dates described above.

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The updating of the effective date based on use of prospectus supplements for § 11 liability purposes, however, does not apply to directors or signing officers of the issuer or to auditors or other experts. Unless a registration statement is updated by a prospectus supplement filed to provide updating information pursuant to § 10(a)(3) of the Securities Act or by a prospectus supplement reflecting fundamental changes in the information set forth in the registration statement, a prospectus supplement filing will not create a new effective date for directors or signing officers of the issuer. [125] Similarly, the effective date for auditors and other experts will not change with the filing of a prospectus supplement, unless the prospectus supplement (or any Exchange Act report incorporated by reference into the prospectus or registration statement or any post-effective amendment) contains new audited financial statements, a new report or opinion or other information requiring the filing of a new consent under § 7 of the Securities Act.

Many foreign issuers use a shelf registration statement to facilitate a medium-term note ("MTN") program. In this case, the issuer and the placement agent(s) for the program prepare a prospectus supplement that covers the entire projected amount of MTNs to be issued and describes the general terms of the MTNs and the particulars of the distribution arrangements. As individual MTNs are sold, definitive maturity, interest rate and pricing information is detailed in a pricing supplement "sticker," which either is affixed to the cover of the prospectus supplement or comprises a separate sheet. [126] For shelf registration purposes the sticker is a separate prospectus supplement and, like other prospectus supplements, is filed with the SEC without any need for SEC action. [127] As discussed above, it is also deemed to be part of the registration statement and triggers a new effective date.

Foreign governmental issuers that use Schedule B [128] may also file shelf registration statements if they have had an effective registration statement in the United States, and have not defaulted on payments of principal or interest within the last five years. [129] In the case of securities that are guaranteed by a foreign government, the SEC staff has occasionally permitted the issuer to file a shelf

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registration statement on the basis that the related government had satisfied this "seasoning" requirement, even though the issuer itself had not. [130]

[c] Automatic Shelf Registration

As a result of the Securities Offering Reforms, WKSIs [131] can use a more flexible version of shelf registration, called "automatic shelf registration," for filings on Form S-3 or F-3. [132] Automatic shelf registration statements and post-effective amendments become effective immediately upon filing, without SEC staff review that would delay effectiveness, [133] and are deemed filed on the proper form. [134] These provisions effectively ensure that under automatic shelf registration there are no SEC staff regulatory obstacles, in particular no risk of delay because of SEC review, to immediate access to the U.S. public markets.

Under the rules, WKSIs can register an unspecified amount of securities to be offered, without indicating whether the securities will be sold in primary

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offerings or secondary offerings on behalf of selling securityholders. Further, under Rule 430B under the Securities Act, automatic shelf issuers are permitted to omit from the base prospectus not only information that is unknown or not reasonably available to the issuer, but also the following additional information: (i) whether the offering is a primary or secondary offering, (ii) the description of the securities, other than the name or class of the securities, (iii) the names of any selling securityholders, and (iv) any plan of distribution. Omitted information may be incorporated by reference to Exchange Act reports [135] or be contained in the prospectus or prospectus supplement that is deemed to be part of the registration statement.

Issuers may register classes of securities without allocating the mix of securities registered among the issuer, eligible subsidiaries or selling securityholders. [136] Rule 413(b) under the Securities Act also permits WKSIs to add new classes of securities or securities of an eligible subsidiary to an automatic shelf registration statement at any time before the sale of those securities by filing an automatically effective post-effective amendment, as described above, to register an unspecified amount of the new class of security. Additional information about the new class, including additional disclosures, may be included in the amendment, a prospectus supplement or Exchange Act report incorporated by reference. New issuers and new guarantors may also be added by filing an automatically effective post-effective amendment. [137]

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An issuer that qualifies for WKSI status based only on its aggregated registered nonconvertible securities other than common equity can only register nonconvertible securities other than common equity on an automatic shelf registration statement, unless that issuer is also eligible to register a primary offering of its securities on Form S-3 or F-3, in which case it can register any offering of its securities for cash using automatic shelf registration. [138]

Under the rules, no fees are due when an automatic shelf registration statement is initially filed. Instead, WKSIs are allowed, but not required, to pay the necessary filing fee at the time of each shelf takedown (*e.g.*, when the prospectus supplement is filed) or at any time prior to each takedown. If an issuer elects to take advantage of this "pay-as-you-go" filing fee approach, the cover page of each prospectus supplement filed should include a fee table presenting the calculation of the registration fee. Fees must be actually paid within the time required for filing the related prospectus supplement under Rule 424, but a four business day cure period has been provided in Rule 456(b)(1)(i) under the Securities Act for issuers who make a good faith effort to timely pay the fee. As is the case under the rules applicable to all issuers, the amount of the filing fee is calculated based on the fee schedule in effect at the time of payment (*i.e.*, upon filing if paying fees in advance or at the time of a takedown if paying-as-you-go) in accordance with Rule 457 under the Securities Act, and thus the fee amount may vary depending on the time of payment. [139]

[3] Rules Governing Communications

[a] The Communications Regime

[i] *Overview of Rules Governing Prohibited and Permitted Communications During the Three Offering Stages*

Section 5 of the Securities Act and related rules impose varying restrictions on the types of communications that can be made during each of the three stages in the offering process: the quiet period, the waiting period and the post-effective period. [140] The release of a communication during the offering process would violate § 5 if it constitutes an impermissible "offer" (a term that has broad meaning in the Securities Act). [141] A communication does not violate § 5 if it falls

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within a safe harbor excluding it from the definition of "offer" under § 2(a)(3) of the Securities Act, doesn't otherwise constitute an offer or is a permissible offer.

Communications in violation of § 5 (so-called "gun-jumping") could cause the SEC to delay the proposed offering, or, upon completion of the offering and sale, could give purchasers a strict liability right to rescind their purchases. Even communications that are released in compliance with U.S. securities laws may prompt the SEC in certain circumstances to require the inclusion of the publicly-released information into the registration statement, thereby subjecting the offering participants, including the issuer, to Securities Act liability for the content of such communications. Because of these concerns, offering participants must pay careful attention to the issuer- or offering-related publicity released during the offering process. Publicity issues in the context of a global offering with a U.S. component are particularly complicated, primarily because other jurisdictions do not impose as strict limitations as the United States.

In connection with the Securities Offering Reforms, the SEC acknowledged that the previous regulatory scheme unnecessarily hindered communications that would be helpful to investors and provided different classes of investors unequal access to information. [142] In addition, the SEC recognized that the distinction between permissible communications and illegal offers violating § 5 of the Securities Act is not clear and requires a "facts and circumstances" analysis and discourages the disclosure of truthful information that can be useful to the market. To reduce the uncertainty and promote the dissemination of more information regarding offerings to all investors, the reforms liberalized many of the restrictions on communications prior to and during offerings.

[ii] *Categorization of Issuers Under Securities Offering Reforms*

A determination as to whether a communication constitutes an impermissible offer and the related SEC regulatory regime is based on several factors, including the timing of the communication, the nature of the communication and the status of the issuer (*i.e.*, whether it is a WKSI, a "seasoned issuer," an "unseasoned issuer," a non-reporting company, an ineligible issuer or an EGC).

The Securities Offering Reforms created new categories of issuers, the most significant of which is a WKSI. [143] A WKSI is generally a company that,

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within 60 days of the determination date described in the next paragraph, (i) meets the registrant requirements of Form S-3 or F-3, including having timely filed its Exchange Act reports for the preceding 12 calendar months, and (ii) either (1) has a worldwide market value of its voting and nonvoting common equity held by nonaffiliates of at least $700 million [144] or (2) (x) has issued in the preceding three years at least $1 billion aggregate principal amount of registered nonconvertible securities, other than common equity, in primary offerings for cash [145] and (y) registers only nonconvertible securities, other than common equity (unless the issuer also meets the $75 million public float requirement of Form S-3 or F-3). [146] , [147]

The determination date for WKSI status of an issuer is the later of (i) the time of filing of the issuer's most recent shelf registration statement and (ii) the time of the issuer's most recent annual amendment to a shelf registration statement, which typically occurs at the time of filing the issuer's most recent annual report on Form 10-K or 20-F (or the time by which the report should have been filed if not filed by the applicable due date). In addition, to qualify as a WKSI,

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the issuer may not fall within the category of "ineligible issuers" described below.

Other categories of issuers created by the Securities Offering Reforms include "seasoned issuers" (issuers eligible to use Form S-3 or F-3 to register a primary offering of securities), [148] "unseasoned issuers" (issuers that are required to file reports under §§ 13 or 15(d) of the Exchange Act, but do not satisfy the requirements of Form S-3 or F-3 for a primary offering of its securities) [149] and "non-reporting issuers" (issuers that are not required to file reports under § 13 or § 15(d) of the Exchange Act, including issuers that voluntarily file Exchange Act reports).

Issuers that fall within specified "bad boy" or certain other specified categories are ineligible to qualify as WKSIs and, therefore, are not eligible for automatic shelf registration, discussed in § 3.02[2][c]. In addition, ineligible issuers may not use free writing prospectuses, except that ineligible issuers other than blank check companies, shell companies and penny stock issuers may use free writing prospectuses that are limited to descriptions of the terms of the offered securities or the offering. [150]

Ineligible issuers include:

- issuers that are not current in their Exchange Act reports (as of the relevant date of determination), [151] other than reports on Form 8-K filed to disclose (i) entry into or termination of a material definitive agreement, (ii) creation, acceleration or increase of a direct financial obligation or off-balance sheet

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  arrangement, (iii) costs associated with an exit or disposal plan, (iv) a material charge for impairment of assets, (v) nonreliance on previously issued financial statements due to an error in such financial statements, or (vi) with regard to asset-backed securities, any informational or computational material, a change in credit enhancement or other external support, or any update of material pool characteristics; [152]
- blank check companies, shell companies (other than a business combinationrelated shell company) and penny stock issuers (in each case, at any time over the past three years (including predecessors));
- limited partnerships offering and selling their securities (other than in a firm commitment underwriting);
- issuers that have filed for bankruptcy or insolvency or that have had an involuntary bankruptcy petition filed against them (if the case is not dismissed within 90 days) or the conversion of a bankruptcy case to

a voluntary proceeding within the past three years; [153]

- an issuer or any entity that was at the time a subsidiary of an issuer [154] that was convicted within the past three years of a felony or misdemeanor described in § 15(b)(4)(B) of the Exchange Act, such as larceny, making of false reports or robbery;
- issuers the registration statements of which are, or within the past three years have been, the subject of refusal or stop orders under the Securities Act; or
- issuers (or their subsidiaries) that within the past three years have been made the subject of a judicial or administrative decree or order finding a violation of the antifraud provisions of the federal securities laws or requiring the cessation of violations of the antifraud provisions of the federal securities laws, or prohibiting certain conduct or activities regarding the antifraud provisions of the federal securities laws. [155]

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For purposes of WKSI status, ineligible issuer status is determined at the time of determination of WKSI status. The date of determination as to whether an issuer is an ineligible issuer for purposes of eligibility to use free writing prospectuses is either (i) the time of filing the corresponding registration statement or (ii) for offerings registered pursuant to Rule 415, the earliest time after filing the corresponding registration statement at which the issuer or another offering participant makes a *bona fide* offer of the securities registered. [156]

[iii] *Safe Harbors for Permitted Communications During Any Offering Period*

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[A] Safe Harbor for Release of Factual Business Information by All Issuers

As part of the Securities Offering Reforms, the SEC adopted a nonexclusive safe harbor from "gun-jumping" violations that permits ongoing communication of regularly released "factual business information" at any time during the offering process by or on behalf of all issuers (other than investment companies and business development companies). [157] This protection essentially codifies the SEC's view that factual communications do not violate § 5 of the Securities Act. [158] Under Rules 168 (for reporting issuers) and 169 (for non-reporting issuers) under the Securities Act, factual business information is defined to include the following types of information: [159]

- factual information about the issuer or its business or financial developments or other aspects of its business (for all issuers);
- advertisements of, or other information about, the issuer's products or services (for all issuers);
- dividend notices (only for reporting issuers); and
- information set forth in any report or other materials that a reporting issuer files with, or furnishes to, the SEC under the Exchange Act (only for reporting issuers). [160]

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Factual business communications are not be required to be filed with the SEC.

To qualify for the protection of the safe harbor, the issuer must have previously released the same type of information in the ordinary course of its business, and the timing, manner and form in which the information is released or disseminated must be materially consistent with past disclosure. For non-reporting issuers, the information must also be intended for persons, such as customers or suppliers, other than in their capacity as investors or potential investors, and it must be released by employees or agents of the issuer who have historically provided such information. [161] The rules do not establish or require any minimum time period to satisfy the regularly released condition, but the Securities Offering Reform Release provides that the issuer must have some "track record" of releasing the particular type of information, which could include only one previous release. [162] Communications containing information about a registered offering or information disseminated as part of the offering activities do not qualify for this safe harbor. [163] Factual business information generally does not include predictions, projections, forecasts or opinions with respect to the valuation of a security. [164] In addition, the rules provide that the safe

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harbor is not available for any communication that is part of a plan or scheme to evade the requirements of § 5 of the Securities Act.

In practice, issuers may release customary shareholder reports, advertise their products, issue press releases concerning material business developments and respond to legitimate unsolicited requests for factual information about their affairs. However, until the offering of the company's securities in the United States has been completed, it would be inadvisable for a foreign company to (i) schedule a meeting or call with U.S. securities analysts or any similar group that would be unusual in light of past practices or in which it would be difficult to avoid questions and speculation about the offering of securities, (ii) engage in any public relations activities in the United States that are unusual in the light of past practices and the nature of the information being communicated or (iii) instigate, or cooperate in the preparation of, any press report in the United States regarding the company or its key officers that is unusual in light of past practices and the nature of the information being communicated. A company may also engage in its customary activities consistent with its past practices outside the United States with respect to publicity, disclosure and announcements. [165]

Notwithstanding the SEC's modernized and liberalized approach to communications, an illustration of the different national approaches to permissible levels of publicity is the level of advertising that has preceded many privatizations in Europe, which were preceded by full-scale television and press advertising campaigns and distributions of brochures describing the company and the offer process that were considered to be an integral part of the marketing efforts, even though offers technically could be made only on the basis of prospectuses that contained mandated disclosure. [166] In the United States, by contrast, even after the 2005 changes in communication rules, a more conservative approach should be taken to avoid violations of § 5 of the Securities Act and, even when permissible, because it is unlikely that offering participants and their counsel

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could become comfortable with such activities under the civil liability provisions of § 12(a)(2) of the Securities Act and Rule 10b-5 under the Exchange Act. [167]

[B] Safe Harbor for Release of Forward-Looking Information by Reporting Issuers

In recent years, Congress and the SEC have encouraged and, in some cases, required issuers to disclose forward-looking information that they judge would be useful to the market and investors. [168] Consistent with this development, Rule 168 under the Securities Act includes a safe harbor from gun-jumping violations that permits the ongoing communication of regularly released forward-looking information at any time during the offering process by or on behalf of reporting issuers only. [169] Rule 168 defines forward-looking information for purposes of the safe harbor to be limited to the following types of information: (i) projections of the issuer's revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items, (ii) statements about management's plans and objectives for future operations, including plans or objectives relating to the products or services of the issuer, (iii) statements about the issuer's future economic performance, including statements of the type contemplated by MD&A, and (iv) assumptions underlying or relating to any of the foregoing information. The safe harbor for forward-looking information is subject to the same conditions regarding consistency with past practice as apply to the safe harbor for factual business information released by reporting issuers. [170] In addition, as with the safe harbor for factual business information, the safe harbor for forward-looking information is not available for any communication that is part of a plan or scheme to evade the requirements of § 5 of the Securities Act.

[b] The Quiet Period: Before Filing a Registration Statement

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Except for communications by WKSIs and "test the waters" communications by EGCs, [171] offers made prior to the filing of a registration statement are violations of § 5 of the Securities Act. [172] However, certain forms of communications that might otherwise be considered to be "offers" are permissible during the quiet period, provided the applicable restrictions are complied with, as discussed below.

[i] *Bright Line Exclusion for Communications Made More than 30 Days Before Filing a Registration Statement*

Rule 163A under the Securities Act provides that a communication made by or on behalf of any issuer more than 30 days prior to the filing of a registration statement will not constitute an "offer" in violation of § 5. This nonexclusive safe harbor is only available for communications made "by or on behalf of" [173] the issuer (communications by an underwriter are not covered, even if authorized or approved by an issuer) that do not reference a securities offering that is or will be the subject of a registration statement and only if "reasonable steps" were taken by the issuer to ensure that a permissible communication is not redistributed or republished during the 30-day period prior to filing. [174]

[ii] *Certain Notices of Public Offering Pursuant to Rule 135*

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At any time prior to filing a registration statement, an issuer may publicly disclose that it intends to make a public offering of securities if certain conditions are met. Any such public announcement must state that the notice does not constitute an offer of any securities for sale, and it may contain no more information than the name of the issuer; the title, amount and basic terms of the securities proposed to be offered; the anticipated time of the offering; a brief statement of the manner and purpose of the offering; information on whether the issuer is directing the offering to only a particular class of purchasers; and any statements or legends required by the laws of any state or foreign country or administrative authority. [175] Underwriters may not be named. [176]

[iii] *Use of Free writing Prospectuses by WKSIs Before Filing a Registration Statement*

Rule 163 under the Securities Act permits WKSIs (or their agents or representatives, other than an underwriter or dealer) [177] to make unrestricted oral and written offers before filing a registration statement, but any written offer will be considered a free writing prospectus and will generally have to be filed upon filing a registration statement or amendment covering the securities. [178] These

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communications, while exempt from the gun-jumping restrictions, are subject to the liability standards applicable to offers, as well as the antifraud provisions of the federal securities laws. [179]

[iv] *Permitted “Test the Waters” Communications by EGCs*

The JOBS Act permits pre-filing and post-filing communications with institutional investors by an EGC, or by a person authorized to act on the EGC's behalf, to determine whether such investors have an interest in a contemplated securities offering. These communications may be oral or written, but may only be made to QIBs or institutional accredited investors. [180] Unlike written communications by WKSIs during the quiet period, written "test the waters" communications by EGCs are not required to be filed as free writing prospectuses.

The "test the waters" provisions of the JOBS Act are available to an EGC with respect to the offering of any security and are not limited to an IPO of common stock. An EGC engaging in "test the waters" communications in connection with an exchange offer or merger must comply with applicable regulatory requirements under the Exchange Act, such as filings required under Exchange Act Rules 13e-4(c), 14a-12(b) and 14d-2(b) for pre-commencement tender offer communications and proxy soliciting materials in connection with a business combination. An issuer must determine whether it qualifies as an EGC at the time it engages in "test the waters" communications, and SEC staff FAQs clarify that if a company engages in "test the waters" communications while it is an EGC and subsequently loses EGC status, the SEC will not view the "test the waters" communications as having violated § 5 of the Securities Act. [181]

Notwithstanding the changes introduced by the JOBS Act, both issuers and underwriters will be subject to potential federal securities law antifraud liability, including liability under § 12(a)(2) of the Securities Act and § 10(b) of the

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Exchange Act, for any oral or written communications that are permitted by the "test the waters" provisions of the JOBS Act. As part of its review of a registration statement, the SEC staff often requests copies of any materials used in "test the waters" communications.

[v] *Marketing-Related Considerations During the Quiet Period*

[A] Premarketing/Investor Education/Pilot Fishing

Premarketing is an umbrella term used to describe a range of activities undertaken by market participants prior to the formal launch of an offering of securities, including investor education initiatives (and underwriter sales force meetings in support of such initiatives), pilot fishing (also called presounding), "test the waters" communications by EGCs, pre-deal research and nondeal road shows. [182] Issuers conducting premarketing activities both inside and outside the United States also will have to consider local law requirements, including the Market Abuse Regulation in the European Union.

Premarketing is used for a variety of reasons, including to assess the depth of demand for a proposed offering, gather market feedback for a potential transaction structure or provide investors more opportunities to engage with management and learn about the issuer. Although premarketing activities were once more commonly a feature of European offerings, they are increasingly being used in U.S. offerings. Premarketing may be particularly important during periods of high market volatility, helping to minimize the chances of having to "pull" a deal after formal launch.

Premarketing activities are featured in a variety of transactions, including IPOs, U.S. registered follow-on equity offerings and equity and debt offerings under Rule 144A and/or Regulation S. In the context of U.S. registered offerings, premarketing activities in the United States during the quiet period are subject to the restrictions on communications discussed above and are generally limited to communications that fall within the safe harbors afforded by Rules 163A or 135 under the Securities Act, communications by WKSIs pursuant to Rule 163 under the Securities Act and "test the waters" communications by EGCs.

Investor education refers to meetings between research analysts (employees of the underwriters) and prospective investors (and without the participation of investment banking personnel) to discuss an issuer and its securities prior to

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the commencement of marketing. [183] Investor education meetings are designed to assist investors in better understanding the issuer and the offering and are not intended to market or make solicitations in respect of a proposed transaction. In the context of a U.S. registered offering, investor education meetings may only be conducted after a registration statement has been publicly filed and thus do not take place during the quiet period. *See* § 3.02[3][c][iii][A] for a discussion of investor education activities carried out after the public filing of a registration statement in the United States.

Pilot fishing refers to meetings between an issuer, investment bankers and potential investors prior to launch to discuss a proposed transaction to obtain feedback on appropriate benchmark offerings and valuation multiples to help bankers determine the range of valuations that would be appropriate to the planned offering. From the perspective of an issuer, pilot fishing is seen as a useful way to gain feedback about investor concerns and appropriate timing for a transaction before an offering is publicly announced. From the perspective of an investor, pilot fishing offers the opportunity to meet with management at an early stage of the process and to get better acquainted with the issuer ahead of formal launch.

In the context of U.S. registered offerings, pilot fishing activities in the United States during the quiet period are subject to the same restrictions on communications as discussed above with respect to investor education—that is, they can only be conducted after a registration statement has been publicly filed, [184] except that "test the waters" communications by EGCs may be made to QIBs and institutional accredited investors at any time. *See* § 3.02[3][b][v] for a discussion of pilot fishing activities carried out after the public filing of a registration statement in the United States. Pilot fishing communications with non-U.S. investors outside the United States may be permissible in global IPOs that include a non-U.S. registered portion of the offering. In addition, in a global IPO with a U.S. registered component, pre-deal research may be distributed outside the United States at any time, provided certain restrictions are complied with. [185]

[B] Side-by-Side Private Placements/Cornerstone Investors

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Premarketing considerations are implicated in the context of a side-by-side private placement and public offering. [186] In side-by-side private offerings, sophisticated, typically institutional investors that have a preexisting relationship with the issuer may agree to purchase shares in a private transaction at the same time as the public offering is executed. These investors are often called cornerstone investors. Outside the context of U.S. registered offerings, potential cornerstone investors are not unusual and typically are approached by investment bankers or by the issuer directly following a pilot fishing exercise (and need not have a preexisting relationship with the issuer). Typically discussions with potential investors for a side-by-side investment are started prior to the filing of a registration statement to maintain the ability of the parties to conduct the transaction on a private basis, [187] and those cornerstone investors will receive restricted shares (*i.e.*, shares that are not freely tradable) at closing. [188]

To aid in their investment decision, cornerstone investors benefit from the information shared through the pilot fishing exercise and, subject to signing a confidentiality agreement, are often given nonpublic information about the issuer (which is later made available to all investors through the prospectus disclosure), including, in the case of a U.S. registered offering, a draft registration statement. Normally, the cornerstone investor agrees to pay the offering price, which is still undetermined when the investor commits. The participation of a cornerstone investor, in the case of a U.S. registered offering, generally is disclosed in the registration statement, [189] and, as evidence of the issuer's ability to generate demand in the offering, can be an effective premarketing tool. A cornerstone investor generally enters into separate purchase arrangements with the issuer, allowing it to opt out of its commitment if the final disclosure document changes in a materially adverse way from the draft reviewed by the investor.

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In contrast to cornerstone investors, which have separate purchase arrangements with the issuer, an "anchor investor" may purchase a significant portion of an offering but applies for shares through the underwriters, the same as other institutional investors. Because they purchase through the underwriters after the registration statement is effective, anchor investors receive freely tradable shares. The involvement of anchor investors can help to generate demand in a bookbuilding process, but anchor investors are generally not named in the prospectus. [190]

[c] The Waiting Period: After Filing a Registration Statement

Communications by the issuer regarding the offering are also restricted during the period between the filing of the registration statement and its effectiveness, although the issuer may make oral [191] offers during this period, and written offers subject to certain conditions. Subject to certain exceptions (as discussed below), under the Securities Act written offers can only be made using the statutory prospectus, and under SEC rules in the case of a non-reporting issuer (*e.g.*, in the context of an IPO), only when the maximum number of shares and a price range for the offering are included on the front cover of the preliminary prospectus.

[i] *Rule 134*

Rule 134 under the Securities Act provides a nonexclusive safe harbor from the gun-jumping provisions for limited public notices about an offering made after any issuer files its registration statement. [192] The notices may include the following information:

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- information about an issuer and its business (including where to contact the issuer);
- information about the terms (but not the use of detailed term sheets) of the securities being offered, including:
    - the title of the securities (including a designation as to whether the securities are convertible, exercisable or exchangeable and as to the ranking of the securities);
    - information about final interest rates and yield to maturity information, including information on securities with comparable maturities and credit ratings, or if the final maturity, interest rate provisions or yield are not known, the probable final maturity, interest rate provisions or yield range, so long as, in each case where it is required, the prospectus includes a price range; [193] and
    - the price of the security or, if not known, the method of its determination or a *bona fide* estimate of the price range, in which case the registration statement must include the price range;
- a brief description of the intended use of proceeds of the offering;
- certain factual information about an offering, including underwriter information, the anticipated schedule of the offering and a description of marketing events, and the type of underwriting (if, in each case, this information is already disclosed in the prospectus), as well as the names of the underwriters and their additional roles, if any, within the underwriting syndicate (*e.g.*, lead book-running manager);
- a statement about the permissibility or status of the investment under Employee Retirement Income Security Act of 1974, as amended ("ERISA"); and
- factual information about procedures for account opening and submitting indications of interest and conditional offers to purchase (*e.g.*, a broker could inform investors of the procedural aspects of any auction or a directed share program) and procedures regarding directed share programs and other participation in offerings by officers, directors and employees of the issuer. [194]

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Rule 134 allows those providing notices in reliance on Rule 134 to include the uniform resource locator, or "URL" address to the statutory prospectus that notifies investors where they can obtain the statutory prospectus, which can also be satisfied by the inclusion of an active hyperlink to that prospectus. If a URL is not included, Rule 134 requires use of a prescribed legend (if a registration statement has not yet become effective) or the inclusion of the name and address of persons from whom a written prospectus for the offering may be obtained. In addition, communications soliciting indications of interest under Rule 134(d) are only permissible if a statutory prospectus (including a price range where required) is available. [195]

[ii] *Permitted "Test the Waters" Communications by EGCs*

As discussed above in § 3.02[3][b][iv], the JOBS Act provides exceptions from § 5 of the Securities Act that permit pre- and post-filing oral and written communications by EGCs to QIBs and institutional accredited investors. Under the "test the waters" provisions of the JOBS Act, issuers and their authorized representatives are permitted to gauge interest in a potential offering prior to establishing a price range for a preliminary prospectus. Section 105(c) of the JOBS Act expressly permits such communications to determine whether potential investors "might have an interest in a contemplated securities offering," but does not permit an issuer or its authorized representative to solicit binding orders from potential investors as part of these communications. The SEC staff has addressed the question whether, in the course of "test the waters" communications, prospective investors in EGC securities offerings can be asked for nonbinding indications of interest ("IOIs") before a preliminary prospectus has been made available to the broker-dealer personnel soliciting the nonbinding IOIs. [196] The question arises because Rule 15c2-8(e) under the Exchange Act prohibits solicitation of customer orders after a registration statement has been filed, unless a preliminary prospectus, which must include a price range, is made available to

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the broker-dealer personnel soliciting the orders. The SEC guidance distinguishes between solicitation of customer orders, which involves soliciting a commitment, and solicitation of nonbinding IOIs. Investment banking personnel can ask a potential customer how many shares the customer may be willing to purchase at a specific offering price, provided the potential customer is not then committed to purchase the securities.

[iii] *Marketing Considerations During the Waiting Period*

[A] Premarketing/Investor Education/Pilot Fishing

Premarketing [197] during the waiting period refers to communications made after the first public filing of the registration statement, but before all SEC comments on the registration statement have been cleared (in contrast, the "marketing" stage generally commences after launch of the transaction, that is to say, after all SEC comments have been cleared). [198] During the waiting period, premarketing activities are subject to the same restrictions on publicity governing other types of communications after filing of the registration statement. While oral communications are permissible, written communications are limited to statutory and free writing prospectuses, Rule 134 notices and "test the waters" communications by EGCs.

As a result of these restrictions on publicity, premarketing activities during the waiting period are generally limited to oral presentations by research analysts to prospective investors in investor education meetings, [199] oral presentations by investment bankers and the issuer to prospective investors in pilot fishing meetings, [200] "test the waters" communications by EGCs and, with respect to offerings outside the United States, pre-deal research distributed outside the United States.

As discussed above, investor education meetings between research analysts and prospective investors are designed to assist investors with price discovery and, more generally, to give investors a better understanding of the issuer and the offering. There is very little guidance from U.S. regulators regarding the various legal issues raised by investor education meetings. As a result, financial institutions typically have policies and procedures for investor education activities in

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various contexts. Investor education meetings may take place only after a registration statement is filed, but typically conclude before formal marketing has begun. Investor participation is generally restricted to a limited number of QIBs (in general not more than 20 or so accounts across all lead managers participating in the offering). Investor education meetings, which typically are private, one-on-one meetings with individual investors, are limited to oral communications in person, by telephone or via videoconference. Telephone calls are typically scripted and monitored. Pre-approved slideshows containing appropriate legends may be used. The information shared at investor education meetings must be factual in nature, neutral in tone and limited to information that is publicly available or contained in the registration statement. Material, nonpublic information is typically not disclosed, and views on specific valuations, price targets or financial projections are typically not expressed (and indications of interest are not sought). Orders must not be solicited or obtained at investor education meetings. Records of meetings are typically kept, including the date and time of meetings and the contact information of those who attended, and attendees generally receive the preliminary prospectus, once available.

During the waiting period, pilot fishing activities in the context of a U.S. registered IPO may take place in the United States. As with other forms of pre-marketing permitted during the waiting period, the information disclosed in the context of a pilot fishing exercise must be limited to oral communications. The limitations on numbers of investors, and use of approved, scripted materials in investor education meetings, discussed above, apply generally to pilot fishing activities.

In the context of a U.S. registered IPO, the distribution of pre-deal research in the United States is prohibited, except in the context of EGCs. [201] In a global IPO with a U.S. registered component, pre-deal research may be distributed outside the United States at any time, provided certain restrictions are complied with. [202]

If the issuer already has listed securities, premarketing becomes less practical since such efforts may require investors to be "wall-crossed" well in advance of a proposed offering. Wall-crossing refers to the practice whereby issuers who already have a shelf registration statement on file with the SEC confidentially premarket a public securities offering to a limited number of potential investors before announcing their intention to raise capital publicly. To mitigate selective disclosure concerns in these types of offerings, before an issuer engages in pilot fishing, it would require the potential investors to agree in

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advance to maintain the confidentiality of issuer-related information provided to them and to agree not to trade until public announcement of the offering (or its abandonment). Because wall-crossed investors are potentially in possession of material nonpublic information, should the deal not proceed, these investors may need to be "cleansed" before they could trade in the issuer's securities. Cleansing is usually accomplished through the issuance of a press release that publicly discloses the material (previously) nonpublic information or by waiting a certain period of time, often called a "cleansing period," for the information to either be released or otherwise become stale.

[B] The Road Show

A road show is a presentation by senior management (usually accompanied by representatives from the lead underwriters) designed to market a forthcoming offering of securities. [203] Road shows are used by U.S. and foreign issuers to market offerings for equity, debt and convertible securities both in the context of registered offerings (*e.g.*, IPOs and follow-on offerings) and unregistered offerings (*e.g.*, offerings in reliance on Rule 144A or Regulation S).

Road shows are used for a variety of reasons. They can generate investor interest in an offering and help underwriters in their bookbuilding efforts. Road shows also give prospective investors an opportunity to learn about the issuer, the management and the reasons for the proposed offering. Road shows vary in their length of time. For IPOs, where issuers generally are less familiar to the investor community than reporting companies, road shows can last for up to two weeks. For other types of offering by more frequent issuers, a road show can be done in one or two days. Depending on the type of offering, frequent issuers may decide against organizing a road show, relying instead on a brief press release and investor calls as a means to market the offering.

Except for "test the waters" communications by EGCs and for WKSIs in a U.S. registered offering, a road show can begin only after the registration statement has been filed (and normally after all SEC comments have been cleared and a preliminary prospectus has been prepared). Road shows typically finish before the registration statement is declared effective. Although WKSIs are permitted to conduct a road show before filing of the registration statement, the issuer and its advisors will need to consider several issues before commencing the road show. First, the road show will be subject to liability under § 12(a)(2) of the Securities Act and Rule 10b-5 under the Exchange Act. Second, Regulation FD applies to

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WKSI road shows taking place before the filing of a registration statement. This means that material nonpublic information contained in the road show must be either removed or made publicly available (or, alternatively, the issuer may require recipients of the road show to expressly agree to keep it confidential). Third, the road show presentations (that are not oral presentations) will need to include a free writing prospectus legend. Because of these considerations, WKSIs generally wait until the registration statement has been filed before commencing the road show.

During the waiting period, oral offers are permitted and permissible written offers are limited to the preliminary prospectus and free writing prospectuses. Traditional road shows, consisting of live in-person presentations or meetings, are oral communications. A slide deck, videos, visual aids or other materials accompanying the live presentations are also oral communications, provided that any handouts distributed at the presentations are returned by the attendees at or before completion of the presentation. [204] A live stream of a road show presentation, live telephone conversation or broadcasts to overflow rooms at live road shows are also oral communications.

Under Rule 433 of the Securities Act, a road show that is a written communication is a free writing prospectus. [205] Under Rule 405 of the Securities Act, a "written communication" consists of any communication that is written, printed, a radio or television broadcast, or a graphic communication. [206] A "graphic communication" includes "all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, electronic mail, Internet Web sites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation … [but] shall not include a communication that, at the time of the communication, originates live, in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means." [207] Accordingly, recorded road shows (including live telephone calls, videos or webcast conferences that are recorded by the originating party), slides and other handouts distributed at the road show presentation but not collected from attendees at or before completion of the presentation, information posted on websites and all radio or television broadcasts (whether or not live). are written communications and, thus, free writing prospectuses.

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A road show that is a free writing prospectus will need to be filed with the SEC if it relates to the IPO of common equity or convertible equity securities by a non-reporting issuer *unless* at least one *bona fide* electronic road show (otherwise known as a retail road show) is made generally available to investors. [208] In practice, issuers make *bona fide* electronic road shows available to the public, and, as such, IPO road shows are rarely filed with the SEC.

All road shows, whether an oral or written communication and whether or not filed with the SEC, are subject to liability under § 12(a)(2) of the Securities Act and Rule 10b-5 under the Exchange Act. [209]

[iv] *Permitted Use of a Free Writing Prospectus*

[A] Overview

Before the adoption of the Securities Offering Reforms, written offers (other than by means of the preliminary prospectus), even those made after filing of the registration statement but before the registration statement was effective, were violations of § 5 of the Securities Act. To eliminate this outmoded prohibition and promote the dissemination of useful information, the SEC introduced the concept of the "free writing prospectus" in the Securities Offering Reforms and provided an exemption for written offers other than a preliminary prospectus that meet the conditions for use of a free writing prospectus. [210] These rules define a "free writing prospectus" as any written communication representing an offer to sell or a solicitation of an offer to buy securities that is or will be the subject of a registration statement that does not otherwise satisfy the statutory

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prospectus requirements. [211] Where a free writing prospectus is prepared by or on behalf of, [212] or used or referred to by, the issuer, it is defined as an "issuer free writing prospectus." Whether a particular communication is an offer will be determined, as was the case in the past, based on the particular facts and circumstances of the communication, and not all communications related to an offering will be an offer required to fall within the framework for free writing prospectuses.

Rule 164 under the Securities Act provides a nonexclusive safe harbor for the use of a free writing prospectus by an eligible issuer [213] or any other offering participant (including an underwriter or dealer) after an eligible issuer has filed a registration statement and the conditions set forth in Rule 433 under the Securities Act are satisfied. [214] Most ineligible issuers (and their offering participants) may use free writing prospectuses the contents of which are limited to descriptions of the terms of the offered securities and the offering. [215] Where Rule 164 applies, Rule 433 contains the eligibility, legend, [216] filing and record

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retention [217] requirements for using a free writing prospectus after a registration statement has been filed. [218]

Rule 433, which permits the use of a free writing prospectus, does not provide any line-item or other specific disclosure or informational requirements, other than a legend. The free writing prospectus will not have to be filed as part of the registration statement and, thus, will not be subject to liability under § 11 of the Securities Act. Moreover, the SEC has amended Rule 408 to make clear that a failure to include information from a free writing prospectus in a registration statement will not be considered, by itself, an omission of material information required to be included in the registration statement. Any free writing prospectus, regardless of whether it was filed, will be subject to liability under § 12(a)(2) of the Securities Act and Rule 10b-5 under the Exchange Act. [219]

Rule 433 prohibits a free writing prospectus from containing any information that "conflicts with" any information in the registration statement. Based on informal guidance from the SEC staff, the SEC's intention is to prohibit only free writing prospectuses that cannot be reconciled with the statutory prospectus. Accordingly, any free writing prospectus that makes clear it is correcting, updating or otherwise revising information in a statutory prospectus will be permitted (and, indeed, encouraged).

[B] Preliminary Prospectus Requirements for Non-Reporting and Unseasoned Issuers

Use of a free writing prospectus by seasoned issuers and WKSIs and related offering participants is not conditioned on actual delivery of a preliminary prospectus. Rule 433 under the Securities Act requires a free writing prospectus used in these circumstances to include the URL address of the SEC's website where the preliminary or base prospectus may be accessed. [220]

Use of a free writing prospectus by non-reporting and unseasoned issuers and related offering participants is permitted only if the most recent statutory

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prospectus accompanies or precedes the free writing prospectus. [221] The statutory prospectus would not have to be provided through the same medium as the free writing prospectus so long as it is provided at the required time. For electronic free writing prospectuses, this delivery requirement may be satisfied by including a hyperlink to the most recent prospectus. This ability to satisfy the delivery requirement by a hyperlink contrasts with the SEC's prior guidance that advance consent must be provided for electronic delivery, [222] and is an example of the manner in which the Securities Offering Reforms represented the beginning of an SEC effort to encourage and rationalize the use of electronic means of communications. Once an investor has been sent a preliminary prospectus, additional free writing prospectuses may be distributed to the investor without having to provide another statutory prospectus, unless there has been a material change to the information in the preliminary prospectus. After effectiveness and availability of a final prospectus, no earlier statutory prospectus may be provided, and offering material other than the final prospectus may be used only if accompanied or preceded by a final prospectus.

[C] Filing Conditions

Under Rule 433, issuers will generally be required to file free writing prospectuses on or before the date of their first use [223] under the following circumstances:

- Where a free writing prospectus is prepared by or on behalf of the issuer or used or referred to by the issuer—an "issuer free writing prospectus."
- Where a free writing prospectus prepared by or on behalf of or used by an offering participant other than the issuer contains material information about the issuer or its securities that has been provided by or on behalf of the

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  issuer— "issuer information"—that is not already contained or incorporated in the registration statement or a filed free writing prospectus. [224] This condition does not apply if the free writing prospectus contains information prepared on the basis of or derived from issuer information but not issuer information itself.
- Where a free writing prospectus prepared by or on behalf of or used by the issuer or any offering participant contains a description of the final terms of the issuer's securities or of the offering, after such terms have been established for all classes in the offering (in which case the free writing prospectus would have to be filed within two days after the later of (i) the date such terms became final for all classes and (ii) the date of first use). [225]

As discussed below, an important exception to the timing of filing a free writing prospectus relates to an independently prepared media publication, which is required to be filed within four business days after the issuer or offering participant becomes aware of its publication or first broadcast.

A free writing prospectus would not have to be filed by the issuer if it did not contain substantive changes from or additions to a previously filed free writing prospectus. In addition, a free writing prospectus used at the same time as a communication in a business combination transaction subject to Rule 425 under the Securities Act will not have to be filed if certain conditions imposed in connection with the rules applicable to business combination transactions are met. [226]

While the rules do not generally require that offering participants file free writing prospectuses that they prepare (*e.g.*, communications with proprietary underwriter information), a free writing prospectus prepared by an offering participant other than the issuer that is distributed in a manner reasonably designed to lead to its broad, unrestricted dissemination would require filing by that

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offering participant on or before the date of first use, unless it has already been filed. [227]

Rule 164 under the Securities Act permits an issuer or any other person to cure any immaterial or unintentional failure to file or delay in filing a free writing prospectus without losing the ability to rely on the safe harbor. The cure provisions are available if a good faith and reasonable effort was made to comply with the filing condition and the free writing prospectus is filed as soon as practicable after the discovery of such failure. Similarly, an immaterial or unintentional failure to include the specified legend in a free writing prospectus will not preclude reliance on the safe harbor so long as a good faith and reasonable effort was made to comply with the legending condition and the free writing prospectus is amended to include or correct the legend as soon as practicable after discovery of the omitted or incorrect legend. [228] In addition, a free writing prospectus including the correct legend would have to be retransmitted by substantially the same means as, and directed to substantially the same prospective purchasers to whom, the free writing prospectus was originally transmitted. [229]

[v] *Treatment of Certain Communications Under Free Writing Prospectus Rules*

[A] Media Publications

Rule 433 under the Securities Act provides for special treatment of free writing prospectuses that are independently prepared and published by the media. When issuers or offering participants provide issuer or offering-related information to the media, its publication or broadcast (in any format) will constitute a free writing prospectus if the written distribution of such information by the issuer or offering participant would constitute a written offer. Except for

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WKSIs, publication of such information prior to filing a registration statement would violate § 5 of the Securities Act, unless otherwise exempted.

For independently prepared media publications that are free writing prospectuses [230] and for which no payment is made or consideration given by or on behalf of the issuer or other offering participant, Rule 433 requires the issuer (or offering participant if appropriate) to file the publication with the required free writing prospectus legend within four business days after the issuer or offering participant becomes aware of its publication or first broadcast. For non-reporting and seasoned issuers, in these instances, the statutory prospectus would not be required to precede or accompany distribution of the free writing prospectus. [231]

[B] Offers on Websites

Rule 433 makes clear that an offer of an issuer's securities that is contained on an issuer's or offering participant's website, or hyperlinked by the issuer or offering participant from its website to a third-party website, is considered a written offer and, unless exempt, a free writing prospectus. In addition,

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the information on the hyperlinked website could be part of that free writing prospectus.

[C] Historical Information on an Issuer’s Website

Historical issuer information that is properly identified as such and located in a separate section of an issuer's website containing historical information (*e.g.*, archives) would not be considered an offer (and, therefore, is not a free writing prospectus) even if accessed at a later time—unless such information is used or referred to (by hyperlink or otherwise) in connection with an offering, including by incorporation by reference.

[D] Term Sheets

A free writing prospectus (or portion thereof) that contains only a description of the issuer's securities being offered or of the offering, regardless of who prepared or used it, will not be subject to filing unless it reflects the final terms of the securities being offered or the offering and until final terms have been established for all classes in the offering. Thus, preliminary term sheets or other materials limited to describing the terms of the securities being offered that do not contain the final terms of those securities or the offering may be free writing prospectuses but will not be required to be filed. The filing of a final prospectus supplement under Rule 424 under the Securities Act will not satisfy the filing requirement for a final term sheet (despite the fact that the timing of the filing requirement will in many cases be the same for both documents). [232]

[vi] *Interaction of Communications Rules with Regulation FD*

As discussed in Chapter 4, Regulation FD (Fair Disclosure) requires that whenever an issuer intentionally discloses material nonpublic information, it must do so through a general public disclosure, and that whenever an issuer learns that it has made a non-intentional selective disclosure, it must make public disclosure of that information promptly. [233] Primary registered offerings of securities are generally not subject to Regulation FD, and the following disclosures made by an issuer in communications in connection with a registered securities offering are not subject to Regulation FD:

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- a registration statement filed under the Securities Act for sales of securities by an issuer (but not for registration statements related only to secondary sales), including a prospectus included in such registration statement; [234]
- a free writing prospectus used after filing of a registration statement;
- a communication falling within the exception to the definition of prospectus contained in clause (a) of § 2(a)(10) of the Securities Act (for so-called "free writings");
- any other preliminary prospectus under § 10(b) of the Securities Act;
- a notice permitted by Rule 135 or communication permitted by Rule 134 under the Securities Act; and
- an oral communication made in connection with a registered offering after filing of the registration statement.

At the same time, the Securities Offering Reform Release makes clear that many of the communications that are not deemed to be "offers"— *e.g.*, regularly released factual business information, regularly released forward-looking information or pre-filing communications—are subject to Regulation FD.

Though Regulation FD does not apply to foreign private issuers, compliance is indicative of best practice, and relevant to questions of insider trading. [235]

[d] The Post-Effective Period: After a Registration Statement Becomes Effective

The SEC has a long-standing position that so long as an issuer is "in registration" it should not engage in communication activity outside the prospectus that could be deemed an "offer." An issuer remains "in registration" after the effectiveness of a registration statement through the end of the period that prospectus delivery requirements apply. [236] Rule 174 under the Securities Act eliminates the prospectus delivery period required by §4(a)(3) of the Securities Act for issuers that are reporting companies immediately prior to the effectiveness of a registration statement; however, a prospectus is required to be delivered by dealers in the case of unsold allotment securities and in the case of initial public offerings for 25

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days in the case of securities listed on a national securities exchange and for 90 days in the case of securities not so listed, measured from the later of the *bona fide* offering date and the effective date of the registration statement. [237]

In order to avoid publication of information by a company in registration that could constitute an impermissible offer, issuers should not initiate investor relations or new publicity efforts following an IPO during the prospectus delivery period. [238] Issuers can respond to legitimate inquiries for information about the company's financial condition and business operations, but such communication should be limited to factual information and should not include such things as predictions, projections, forecasts or opinions with respect to value. [239]

Rule 134, discussed above in § 3.02[3][c][i], also permits an issuer to advertise its public offering after the filing of the registration statement in a press release. Typically, such press releases are used to announce a successful offering and are therefore released after pricing following effectiveness of the registration statement. Underwriters also often publish a limited advertisement known as a "tombstone ad" after a successful offering. Tombstone ads are subject to the same, Rule 134-based limitations as to content if issued when communication restrictions continue to apply during the post-effective period.

[e] Research Reports [240]

The issuance of research reports during, or in connection with, an offering, even an IPO, historically has been a customary market practice outside the United States. [241] In the context of U.S.-registered IPOs, however, research reports generally are not distributed in or into the United States because of liability concerns and, except with respect to EGCs, [242] restrictions in § 5 of the Securities Act. [243] In the context of U.S. registered offerings by U.S. reporting

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issuers or certain eligible foreign private issuers (as defined below), the distribution of research reports in or into the United States is permissible under § 5 of the Securities Act, provided the conditions of certain nonexclusive safe harbors are met, but is still subject to prudential restriction because of liability concerns.

To ensure compliance with rules governing the content and dissemination of research reports, the practice in global offerings is to distribute research report guidelines to all offering participants. [244]

[i] *Research Reports in the Context of U.S.-Registered IPOs*

In the context of U.S.-registered IPOs, underwriting syndicates, for the reasons discussed above, generally prohibit the release of research reports in or into the United States during a prescribed blackout period, which typically runs until the later of (i) completion of the distribution of securities that are the subject of the offering and (ii) 25 calendar days [245] after the pricing date of the offering. In the context of global offerings with a U.S. registered component, underwriting syndicates may permit the release of research reports outside the United States (subject to applicable local law requirements). [246]

[ii] *Research Reports in the Context of U.S.-Registered Offerings by U.S. Reporting Companies or Foreign Private Issuers Meeting Certain Conditions*

Underwriters for an offering by a publicly traded company often will have issued research reports about the company and may wish to update those reports in advance of or during an offering. The SEC recognizes that research is essential to an efficient market. Nevertheless, it believes that investors purchasing securities in a registered offering should rely primarily on disclosure in the prospectus and any free writing prospectus.

Accordingly, the SEC has promulgated limited, nonexclusive safe harbors under the Securities Act with respect to the dissemination of certain communications around the time of an offering that protect broker-dealers participating in

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the offering from § 5 liability if they distribute research reports regarding the issuer at these times but only if specified conditions are satisfied. The exceptions that allow the publication of research reports and other information during a U.S. public offering acknowledge that, in the case of seasoned issuers, the policy of ensuring that offers to investors are made only on the basis of the disclosure in the prospectus is outweighed by the importance of keeping such issuers' existing shareholders and the market informed. Such issuers have a wide market following, and most investors already have much information about them. [247]

[A] Research Reports by Broker-Dealers Participating in the Offering

Provided certain conditions are met, Rule 139 under the Securities Act permits broker-dealers that are or will be participating in a U.S. public offering of securities to publish research reports [248] about an issuer [249] or its securities at any time during the offering (*i.e.*, whether before or after filing of the registration statement or before or after effectiveness of such registration statement).

The issuer must be a seasoned reporting company under the Exchange Act (*i.e.*, eligible to use Form S-3 or Form F-3) or a foreign private issuer that satisfies the following criteria: (i) it meets the registrant eligibility requirements for the use of Form F-3 other than certain reporting history requirements, (ii) it meets the Form F-3's public float requirement or is offering nonconvertible securities other than common equity and (iii) it has had securities trading on a "designated offshore securities market" (as defined in Regulation S under the Securities Act) for at least 12 months or has a worldwide market value of its outstanding common equity held by nonaffiliates of $700 million or more (such an issuer, an "Eligible Foreign Private Issuer"). [250] To take advantage of the Rule 139 safe harbor, research reports on the issuer must be published in the regular

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course of the broker-dealer's business and cannot represent the initiation of coverage on the issuer or its securities or the reinitiation of such coverage following a previous discontinuation. [251]

Rule 139 also permits broker-dealers that are or will be participating in a U.S. public offering of securities to publish research reports about the issuer's industry at any time during the offering (*i.e.*, whether before or after filing of the registration statement or before or after effectiveness of such registration statement), provided certain conditions are met. For industry reports, (i) the issuer [252] must be a reporting company under the Exchange Act or an Eligible Foreign Private Issuer, (ii) the research report must include similar information with respect to a substantial number of issuers in the issuer's industry or contain a comprehensive list of securities recommended by the broker-dealer, (iii) the analysis regarding the issuer or its security should be given no greater prominence than that given to other securities or issuers and (iv) the broker-dealer must publish such research reports in the regular course of its business and, at the time of publication, is including similar information about the issuer or its securities in similar reports. [253]

[B] Research Reports by Broker-Dealers About Securities Other Than Those Being Offered

Broker-dealers that are or will be participating in an offering of securities of an issuer [254] may also publish at any time during the offering (*i.e.*, whether

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before or after filing of the registration statement or before or after effectiveness of such registration statement) certain information with respect to certain other securities of the issuer, [255] provided that the issuer is a reporting issuer current in its Exchange Act reports or an Eligible Foreign Private Issuer. [256] In addition, the broker-dealer must have previously published or distributed, in the regular course of its business, research reports on the types of securities that are the subject of the reports (though not necessarily securities of the subject issuer). [257]

[iii] *Research Reports by Broker-Dealers Not Participating in the Offering*

A broker-dealer not participating in an offering of securities (whether in the context of U.S registered IPOs or U.S. registered offerings by U.S. reporting companies or foreign private issuers meeting certain conditions) may publish research with respect to such securities at any time during the offering (*i.e.*, whether before or after filing of the registration statement or before or after effectiveness of the registration statement) if such broker-dealer (i) is not compensated for such publication by persons participating in the offering, (ii) is not acting under any direct or indirect arrangement or understanding with the issuer, any selling securityholder, any participant in the distribution of the securities or any other person interested in the securities and (iii) publishes the research report [258] in the ordinary course of its business. [259]

[iv] *Research Reports in the Context of U.S.-Registered Offerings by EGCs*

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The JOBS Act provides that pre-deal research reports on an EGC do not violate the "gun-jumping" restrictions in the Securities Act. This exemption from the gun-jumping restrictions applies to all public offerings of common stock by EGCs (not just EGC IPOs). The JOBS Act provides that the publication or distribution of a research report by a broker or dealer about an EGC that is the subject of a proposed public offering of common stock pursuant to an SEC registration statement does not constitute an offer for sale or offer to sell a security for purposes of § 2(a)(10) or § 5(c) of the Securities Act, regardless of whether the registration statement has been filed or is effective, and regardless of whether the broker or dealer will participate in the offering. [260]

This lifting of prohibitions on underwriter research is more expansive than the safe harbor provided by Rule 139 under the Securities Act for pre-offering research, which is designed to permit the continuation of ordinary course research on companies that are already publicly traded. The definition of "research report" as used in the JOBS Act is also broader than the definition of "research report" used in Rule 139, in that it includes oral communications. This difference is rooted in the difference in objectives between the JOBS Act (fostering research coverage of EGCs to facilitate their common stock offerings) and Rule 139 (not interfering with ongoing publication of research reports).

By eliminating research reports on EGCs from the definition of "prospectus" in § 2(a)(10) of the Securities Act, the JOBS Act also affects the liability regime of the Securities Act, because research reports on EGCs are no longer subject to liability for material misstatements or omissions under § 12(a)(2). Because § 12(a)(2) refers separately to oral statements, however, materially defective oral communications may still fall within § 12(a)(2)’s liability provisions, whether or not they are research reports. In addition, research reports will still fall within the definition of "offer" covered by the antifraud provisions of § 17 of the Securities Act enforceable by the SEC.

Significantly, the JOBS Act also does not limit the potential for federal securities law antifraud liability for research reports under § 10(b) of the Exchange Act. Accordingly, underwriters generally are unwilling to accept the liability risk associated with publishing research concerning EGCs that is permitted by the JOBS Act.

[v] *Distribution of Research Reports Outside the United States*

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The restrictions resulting from § 5 of the Securities Act do not apply to activities abroad with respect to concurrent offerings outside the United States by non-U.S. issuers, so long as those offerings are being made in reliance on the exemption from the registration requirements of § 5 provided by Regulation S under the Securities Act. Thus, so long as research reports are isolated from the United States, they should not be restricted by § 5 of the Securities Act. [261] Isolation is generally accomplished by limiting mailings to addresses outside the United States, placing a restrictive legend [262] on the face of the reports and

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sending a cover letter or other form of notice together with each report that highlights the prohibitions against distribution to U.S. persons or into the United States. [263]

[vi] *Disclosure Liability Applicable to Research Reports*

One issue that must be considered in connection with the issuance of research reports, including in particular Rule 138 or Rule 139 research reports by broker-dealers participating in a U.S. public offering, is the potential liability associated with the contents of such reports. There is a risk that an investor might sue the distributor of the research report, and possibly the issuer, on the basis of any material misstatements or omissions in the report. Because Rule 138 and Rule 139 provide that covered research reports are not "offers for sale" or "offers to sell" for purposes of §§ 2(a)(10) and 5(c) of the Securities Act, liability for any material misstatement or omission would arise principally under § 10(b) of the Exchange Act and Rule 10b-5 thereunder. [264] Although the preparer of the report might be willing to accept the potential liability risks associated with the contents, because it presumably has satisfied itself as to their accuracy, the issuer also might be held liable for such contents if it has been involved in the preparation of the report (including by holding informational meetings with brokerdealers or otherwise providing comments to the report). [265]

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In the past, the practices of U.S.-based investment banking firms and their non-U.S. affiliates on the one hand, and their European-based counterparts on the other, diverged with respect to the distribution of research relating specifically to an issuer that is the subject of an offering. While many European financial houses routinely distributed such research in the United States if Rule 139 was available (subject to a "blackout period," typically of one to two weeks prior to distribution of the preliminary prospectus), most U.S. firms did not distribute such research in the United States even where Rule 139 was available due to liability concerns (although a number of U.S. underwriters countenanced industry-wide research that merely referred to the issuer). [266] Increasingly, however, U.S. firms have been willing to distribute research during an offering in reliance on Rule 139, in some cases stripping out the recommendation with respect to the issuer's securities to attempt to minimize liability concerns.

These liability concerns, and the resulting restrictions on the distribution of research, have created a regulatory dilemma in the United States and elsewhere. The reluctance of market participants to provide forward-looking information, such as projections and forecasts, in a prospectus filed as part of a registration statement [267] means that forward-looking information is frequently available to investors only orally from members of the syndicate and through research reports. Not only do restrictions on this information impede investor access to forecasts, but brokers' salespeople are frequently pressed to inform clients orally of the view of the in-house analyst even when research reports are not being distributed. Under these circumstances, investors often get an oversimplified view of the analysts' impressions, without the detailed and nuanced analysis that a written report would provide.

[vii] *Publicity Considerations Concerning Internet Communications*

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Under the Securities Act, communications via the Internet are treated as written communications, like those in newspapers or other traditional media. Issuers restrict publicity during an offering and are similarly advised not to establish or expand websites during the period that publicity restrictions may be in effect—typically until the end of the prospectus delivery period. [268] However, consistent with the ability of issuers to disseminate ordinary course corporate communications not relating to an offering under the standard U.S. publicity restrictions, issuers may continue to use an existing website during an offering for ordinary course communications, as long as that information does not conflict with information in the prospectus for the offering. [269] Press releases that can be issued pursuant to Rules 134, 135, 135c, 168 and 169 under the Securities Act, [270] and the preliminary and final prospectuses, can also be posted on an Internet site. [271]

U.S. restrictions on the distribution of research apply equally to the distribution of research over the Internet. Research reports of the type intended for distribution exclusively outside the United States cannot be posted to a website, unless measures are implemented to ensure that the reports cannot be accessed in the United States. However, research reports complying with the provisions of Rules 138 and 139 under the Securities Act may be placed on the Internet sites of broker-dealers without the research being deemed an "offer" for purposes of § 5 of the Securities Act. These rules, however, do not permit an issuer to publish or distribute the same information on its website. [272]

[4] Global Offerings and Interaction with U.S. Public Offering Requirements

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U.S. rules and regulations have imposed a standard pattern on registered public offerings in the United States, and much of the complexity of global offerings involving U.S.-registered offerings is generated by the way in which foreign regulatory regimes impose conflicting patterns. In many cases, the non-U.S. component of a global offering is made in a way that is exempt from the application of the regulations that would apply to an offer to the public in the foreign countries in which the global offering is made. The exemption typically relied on in many countries is the so-called "professionals" exemption, which in certain circumstances permits offers and sales of securities to be made to institutions and other market professionals with few regulatory requirements. If the international offering includes a public offering in one or more national markets, however, various registration and regulatory requirements of that country may apply, and these requirements will have to be integrated with the U.S. rules. In such a situation, complex issues are likely to arise that will have to be identified and resolved at an early stage in the offering process.

[a] The U.S. Registration of Securities Offered and Sold Outside the United States

When a global offering involves a U.S. public offering and the issuer is a foreign issuer, the issuer and the underwriters must decide whether any of the shares to be offered and sold outside the United States should be registered under the Securities Act. So long as the offerings outside the United States are made in accordance with Regulation S under the Securities Act, there is generally no need to register the securities that are offered and sold abroad. [273] However, because regional demand often cannot be anticipated completely accurately at the time of registration, underwriters typically will register more securities than they expect to place in the United States. Moreover, the registration of some of the shares

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offered and sold abroad would permit resales into the U.S. market that are required to be registered, for example, by dealers that purchase the securities in the offering outside the United States and wish to sell them immediately in the United States during the prospectus delivery period mandated by § 4(a)(3) of the Securities Act. For offerings of securities expected to trade primarily in a market outside the United States, the amount of additional securities registered is typically about 10% to 15% of the tranche of securities being offered outside the United States. Foreign issuers whose securities are expected to be traded primarily in the United States should register a significantly higher percentage (and perhaps all) of the offering.

The number of shares that will be offered in the United States generally is estimated at the time the registration statement is initially filed and that number (together with a percentage of the shares offered outside the United States to take account of possible resales of shares into the United States when securities dealers are required to deliver a prospectus by § 4(a)(3) of the Securities Act) is registered under that registration statement. [274] The number of shares to be registered may be increased by an amendment to the registration statement prior to its effectiveness, but, except for automatic shelf registration statements and certain registration statements filed by investment companies, once a registration statement is effective, additional securities (including securities of the same class) can only be registered by filing a new registration statement. [275]

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Regardless of whether any or all of the international shares are to be registered, the registration statement in a global offering need not contain the prospectus to be used abroad because the initial offers and sales outside the United States are not required to be registered, [276] and, accordingly, the obligation to use a prospectus that complies with the requirements of the Securities Act does not apply to them. The registration statement should state clearly in these circumstances that it only covers offers and sales initially made in the United States and, if international shares are being registered, resales into the U.S. market when a registration statement is required to be in effect or a U.S. prospectus delivered. [277]

[b] Offering Documentation in a Global Offering with a U.S.-Registered Component

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In the case of a U.S.-registered offering, the offering documentation consists of the relevant registration statement and prospectus and any free writing prospectuses. Preparation of the prospectuses or other offering documentation to be used in the various countries in which a global offering will be conducted can take a great deal of time. A global offering, in particular one with multiple listings, will often involve at least two prospectuses, one for the home market of the issuer, typically prepared in connection with a retail offering or listing pursuant to home market rules and in the local language, and a second, international prospectus, usually prepared in English for institutional investors outside the home market. [278] There are many variations on this theme: multiple prospectuses for public offerings in various countries outside the home market (*e.g.*, Japan and the United States) prepared in accordance with public offering rules in those countries; a separate international version of the prospectus prepared for use in the U.S. public offering component of the offering; a single "global" prospectus used in every jurisdiction, and so on. [279]

While offering participants generally make an effort to make the contents of each prospectus substantively consistent, the judgment in that regard needs to take into account the incremental risks that that will entail as further described below. If home-market rules require particular information that is not required in the United States, should it be included, even if unusual, in a U.S. prospectus? What if the information required abroad seems too risky to include from a liability standpoint in a U.S. prospectus (such as financial projections)? The answers to these questions can vary depending on the circumstances. The typical approach is to include all information required in the home-market prospectus in the U.S. and international prospectuses if it does not raise U.S. liability concerns, and to exclude immaterial or irrelevant information and, in some cases,

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information that raises U.S. liability concerns. An example of frequently excluded immaterial or irrelevant information is home-country GAAP financial information required in the home market but not in the United States or elsewhere (*e.g.*, parent company (unconsolidated) financial statements are required in many jurisdictions but not in the United States). [280] Such information is often excluded from the U.S. and international prospectuses on the grounds that it adds little, if anything, to a U.S. or international investor's understanding of the issuer, and it sometimes can be confusing (especially if the local GAAP information is very different from U.S. GAAP or IFRS). In some instances, such additional financial or other information has been included as an annex to the prospectus, headed by a legend that it is being included to comply with home-market statutory or regulatory requirements or home-market practice.

Financial projections required in some markets are a much trickier proposition. Although U.S. rules require discussion of known material trends and uncertainties in respect of financial results and performance, they do not require projections. Accordingly, there is a risk that if projections are published by the company elsewhere and not included in the U.S. prospectus, the U.S. prospectus will then be viewed as having omitted a material fact necessary to make the statements therein not misleading, giving rise to potential liability. [281] If projections are more negative than an investor would otherwise expect from the historical financial information included in the prospectus, then inclusion of those projections would appear necessary to comply with the trend requirement. Where, however, the projections are either consistent with or more favorable than historical information would suggest, including them may subject the issuer to liability under § 11 of the Securities Act and a duty to update. [282] The typical approach in order to avoid this dilemma is to attempt to convince the local regulators that financial projections should not be included given the global nature of the offering and the fact that they would not customarily be included in the prospectuses

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for other parts of the world. This argument is often accepted by regulators, although it may be necessary to include, in lieu of projections, an "outlook" or similar section in which the issuer's prospects are presented in a narrative form, without specific financial projections. Where financial projections cannot be avoided in the home market, consideration should be given to potential liability concerns, on the one hand, and whether omission of the information would cause any required information or any other information in the prospectus to be misleading. [283]

An important logistical question is which prospectus will be the "master" document from which other versions will be copied or translated. The local market prospectus is sometimes chosen as the lead document. If the international and U.S. markets are expected to play a very substantial role in the offering, the international or U.S. offering prospectus may be the primary focus, with translations into other languages prepared when the English draft has matured to an appropriate stage. This approach is especially common where a U.S. public offering prospectus is being prepared.

The timing issues can be quite complex when multiple public offerings are involved and regulators in more than one country each must review a prospectus prepared in accordance with their rules. Much advance planning is needed to ensure that all preliminary filings are done in time, that comments by each regulator can be addressed effectively in each prospectus before it is finalized and that any necessary approvals can be obtained in order to facilitate commencement of the offering on a global basis at the same time. [284]

Special attention also must be paid to the regulatory process in the home market insofar as it relates to whether there will be a final prospectus, or only the original one circulated to investors. In U.S. public offerings, the preliminary prospectus circulated to potential investors in an IPO would contain an indicative price range, the final price would be conveyed to investors either orally or through a free writing prospectus following the effectiveness of a registration statement but prior to the time of sale, and a final prospectus, including all pricing information, would be filed with the SEC in accordance with Rule 424 under the Securities Act. [285] This is not true in many other jurisdictions, where there is

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only one prospectus circulated in connection with the bookbuilding, subscription or other marketing process. If changes need to be made to update information provided in the U.S. preliminary prospectus through a free writing prospectus or otherwise, conflicts can arise between jurisdictions because there is no mechanism for amending or updating the prospectus in certain markets.

The amount of time needed to translate a prospectus into another language should not be underestimated. If an outside translation service is used, for example, a considerable amount of time and effort might be necessary to refine the translation, such as in relation to descriptions of technical aspects of a business. Agreement should be reached early in a transaction as to which party will take responsibility for the accuracy of any translations.

Finally, the due diligence and verification procedures customary in each jurisdiction are likely to be different in certain respects. [286]

[c] Publicity Considerations in the Context of a Global Offering

It may be useful to contrast the U.S. and U.K. rules on publicity in order to highlight some of the difficulties that arise in global offerings. The United Kingdom, like many other jurisdictions, permits much more publicity about an initial public offering outside the offering document than does the United States. Large global equity offerings in the United Kingdom and elsewhere in Europe sometimes have been preceded by full-scale media advertising campaigns and distributions of brochures describing the issuer and the offering process. Such advertising is permitted if certain procedural requirements are followed. English law also permits unlimited communications that are invitations or inducements to subscribe for securities that do not comply with such procedural requirements so long as they are addressed only to persons falling within certain exemptions, the most commonly used of which are for communications made to or directed at investment professionals and high net worth individuals. These sorts of communications could in fact be widely available—on publicly available web pages, for example—but because they are expressly addressed only to investment professionals and high net worth individuals (by way of a legend), and because any

subsequent offer and actual sales of the securities would only be made to qualified investors under the United Kingdom's Prospectus Rules, widely available communications that would not be permissible under U.S. rules are permissible in the United Kingdom. Conflicts between the U.S. and other systems can arise in global offerings, especially by non-reporting issuers, because, except in limited circumstances, [287] the U.S. securities laws require that publicity efforts by non-reporting issuers be restricted to jurisdictions outside the United States. Difficulties can develop, for example, if advertisements are placed in publications that are also distributed in the United States. For these publications, steps must be taken to prevent the publication in their U.S. editions of advertising materials that could constitute an offer. In some transactions, offering participants have sought to document their efforts to avoid U.S. publicity by getting certain publications to agree in writing not to publish advertisements in specified jurisdictions. [288]

The SEC is particularly sensitive about such matters. In a global equity offering involving a U.K. issuer, where advertisements prepared for publication outside the United States inadvertently appeared in the U.S. edition of *The Financial Times*, the SEC expressed concern and requested an explanation from the offering participants. Despite the liberalization of publicity rules that resulted from the Securities Offering Reforms, the U.S. prohibition against pre-offering publicity for unseasoned issuers and non-reporting issuers will continue to prevent offering participants from placing paid advertisements in U.S. publications or U.S. editions of non-U.S. publications.

As discussed above, SEC rules provide a number of exceptions to the restrictions on publicity related to an offering, especially with respect to activities conducted outside the United States by foreign issuers. Rule 135 under the Securities Act permits an issuer to disclose certain limited information in advance of the filing of a registration statement, while Rule 134 under the Securities Act permits certain limited communications by any party after the filing of a registration statement. [289] In contrast to limitations on information about the offer, routine corporate communications for purposes other than inducing the purchase or sale of the securities being distributed that are consistent with past practice are generally permissible under either Rule 168 or Rule 169 under the Securities Act, subject to certain conditions. [290] Thus, press releases published

with reasonable regularity regarding financial results or the occurrence of material events with respect to an issuer can generally be issued in the ordinary course of business.

In the case of large, high-profile offerings, restrictions on publicity may become prudent far in advance of the actual offering, especially where there is intense market interest in the offering. In these circumstances, the broad ambit of § 5 of the Securities Act will always create some uncertainty as to whether even "normal" publicity activities could be viewed as offering activities or efforts to condition the market, even following the adoption of certain provisions of the Securities Offering Reforms intended to facilitate greater availability of information to investors and the market. This in turn may lead the issuer to modify its behavior in a way that is detrimental to the flow of information to the market (*i.e.*, by withholding information that in the ordinary course it would otherwise make public), an unintended result of the U.S. restrictions.

As a technical matter, the U.S. restrictions regarding publicity and the other restrictions resulting from § 5 of the Securities Act do not apply to activities abroad with respect to concurrent offerings outside the United States by non-U.S. issuers, so long as those offerings are being made in reliance on the exemption from the registration requirements of § 5 provided by Regulation S under the Securities Act. Regulation S permits advertisements in connection with offerings outside the United States so long as they are not contained in a publication with a "general circulation" in the United States. [291] Moreover, Preliminary Note 9 of Regulation S states expressly that nothing in it "precludes access by journalists for publications with a general circulation in the United States to offshore press conferences, press releases and meetings with company press spokespersons in which an offshore offering is discussed, provided that the information is made available to the foreign and United States press generally and is not intended to induce purchases of securities by persons in the United States." [292] Customary practices in foreign markets, such as the preparation and distribution of research reports in connection with an offering, full-scale television and press advertising campaigns or the use of offering incentives, as occurred in several of the U.K. privatizations, [293] are not intended to be affected by Regulation S.

Notwithstanding these provisions of Regulation S, prior to 1997, significant uncertainty surrounded the question of whether and when representatives of publications with a general circulation in the United States could participate in offshore press activities, especially one-on-one interviews. Offering participants had been uncertain about what activities might be construed as being "intended to induce purchases … by persons in the United States." [294] Partly in response to this uncertainty, in 1997 the SEC adopted Rule 135e, which contains a safe harbor for foreign private issuers and foreign governments that invite journalists to participate in such activities so long as:

- the relevant activity is conducted offshore; [295]
- at least part of the offering is conducted outside the United States; [296]
- access to the offshore press activities is provided to members of the U.S. and foreign press; and
- any offering-related materials provided to the press that may be of significant interest to U.S. investors contain a prescribed cautionary legend. [297]

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In connection with the general access requirement, the SEC's adopting release clarified that this requirement does *not* prohibit one-on-one meetings with representatives of U.S. publications, or of publications with a general circulation in the United States, so long as prior or subsequent thereto the issuer or its representatives conduct offshore a press conference to which both the U.S. and foreign press are provided access. [298]

Rule 135e has had a beneficial effect on market practice regarding the limitations on publicity imposed on foreign issuers outside the United States, clarifying the scope of permissible press communications and substantially liberalizing the ability of foreign issuers to conduct one-on-one interviews with members of the U.S. and non-U.S. press. Precisely because Rule 135e has had a liberalizing effect, however, foreign issuers and underwriters must continue to pay careful attention to the content of any permitted publicity. Even if statements abroad are exempt from the prohibitions of § 5 of the Securities Act by virtue of Regulation S, Rule 135e or another applicable rule, the SEC may require them to be reflected in a U.S. registration statement if the SEC staff deems them material, they have not yet been reflected in the U.S. disclosure document and the Regulation S offering is in conjunction with a registered offering in the United States; this risk is particularly significant in the case of public statements involving forward-looking information. The SEC staff has been vigilant in this regard and carefully scrutinizes offshore press activities by monitoring the Internet and otherwise in connection with registered offerings to detect the offshore release of information during an offering that is not contained in the registration statement. [299] Also, to the extent that communications by issuers or underwriters

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permitted by Regulation S or Rule 135e are reported in the United States, transaction participants may find themselves liable under U.S. law for material misstatements or omissions in the communication. [300] Because of the SEC's vigilance in this area, U.S. legal advisers generally caution issuers and their underwriters that statements made under Rule 135e should be limited to those they are prepared to have included in the statutory prospectus or a free writing prospectus and warn that strict measures should be adopted to ensure that

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research reports prepared in connection with the offering outside the United States do not find their way into the United States, including by way of the Internet.

The declining importance of U.S.-registered portions of global offerings and the substitution of, for example, Rule 144A offerings to large U.S. institutional investors have reduced the influence of the SEC and the risk to global offerings in respect of these concerns. In addition, the 2012 change to Rule 144A to eliminate the prohibition on offers to non-QIBs allows for publicity in the United States in offerings made in reliance on both Rule 144A and Regulation S. While market participants have not significantly changed offering practices as a result of this liberalization, the concern about non-U.S. communications potentially violating Rule 144A no longer exists. Offering participants that use the flexibility to publicize the 144A portion of the offering in the United States also need not worry about violating Regulation S's prohibition on directed selling efforts so long as the publicity efforts are not directly or exclusively targeted at non-QIB U.S. persons who could not otherwise participate in the offering.

U.S. and non-U.S. underwriters will often coordinate publicity efforts and agree to restrictions on the timing and nature of offering-related publicity efforts across jurisdictions to ensure compliance with U.S. and foreign laws and practices. The global coordinator for the offering is likely to take steps to ensure a unified presentation of the offering to the market. Such steps often include insisting that the underwriters in all syndicates conduct their marketing efforts on the same schedule and that all syndicates follow rules imposed by the global coordinator to preclude any syndicate or group of underwriters from gaining a marketing advantage; however, in a number of cases the syndicates will agree that marketing or premarketing efforts permitted in one jurisdiction can begin prior to the global marketing effort.

Publicity guidelines prepared by U.S. legal advisors in a global offering by a non-U.S. issuer will typically seek to isolate publicity conducted outside the United States. In the case of corporate communications, the isolation is generally accomplished by imposing limitations on contacts by an issuer with members of the press and investment analysts located in the United States, by imposing procedures to ensure that contacts with the press and investment analysts outside the United States do not give rise to publicity in the United States and by limiting the contents of commercial announcements in the United States and communications with U.S. shareholders and employees to certain factual information. [301]

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One issue that sometimes arises in connection with an initial U.S. listing by a foreign issuer is the desire of company management to conduct interviews in New York with members of the media at or near the time of the listing ceremony. Unless any publication of such interview or the information provided therein does not constitute an offer of securities [302] or qualifies under Rule 134, such publication may violate the publicity restrictions of § 5 of the Securities Act unless it can be treated as a media free writing prospectus under Rule 433 under the Securities Act. For a non-reporting issuer, such a free writing prospectus would be permissible if, among other things, (i) the issuer has not paid or given other consideration for the independently prepared media communication and (ii) the issuer's statutory prospectus has previously been filed with the SEC. [303]

In addition, although as a legal matter management of a non-reporting company may, in appropriate circumstances, be able to conduct an interview in connection with the company's listing, practical considerations must also be taken into account. Indeed, a significant concern that can arise in connection with a listing interview is that information not be given to the market that was not contained in the registration statement or otherwise conveyed to investors. Prior to the adoption of the Securities Offering Reforms that permitted the use of media free writing prospectuses, the disclosure of such information was in fact the concern most frequently raised about such interviews by the SEC staff. The disclosure of new or different information in a listing interview that was not previously provided to investors is still a relevant consideration under Rule 159, which focuses for liability purposes on the information conveyed to investors at or prior to the time of sale. [304] Advisors generally seek to ensure that such interviews, if conducted, do not go beyond factual information contained in the registration statement or already otherwise conveyed to investors.

Furthermore, in concurrent U.S. and international offerings, U.S. securities counsel have traditionally permitted foreign issuers to post prospectuses and other offering information relating to the international offering on a website, provided, prior to filing of the registration statement with the SEC, that:

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- such information is not in English;
- the information can be viewed only after confirmation by the person seeking access to such information that he or she resides outside the United States; [305]
- the first page encountered on the website displays a prominent legend in English, stating that the offering information on the website is intended to be available only to residents of countries other than the United States; [306] and
- subsequent pages of the website bear a legend in English indicating that the information contained is not for distribution in the United States.

Securities counsel have also permitted foreign issuers to post English-language prospectuses and other offering information relating to the international offering prior to filing of the registration statement, but only where access can be gained solely by persons holding passwords allocated to non-U.S. residents. Counsel generally advise that offering information not be communicated via electronic mail (unless it cannot be forwarded or copied), unless it is limited to information contained in a press release or notice complying with Rule 134 or Rule 135 under the Securities Act, the communication is being treated as a free writing prospectus or, in the case of a global offering with an unregistered international tranche, procedures are in place to ensure that each of the recipients of the electronic mail is resident outside the United States. Dissemination that is not controlled to specifically identified addressees should be prohibited.

[5] Structure of Underwriting Arrangements

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Public offerings of securities in the United States are generally made through a syndicate of underwriters led by one or more "book runners" or managing (or "lead") underwriters (some or all of whom are sometimes referred to as "representatives"). The underwriting agreement, which defines the relationship between the issuer and the underwriters, is generally prepared in preliminary form by counsel for the underwriters and is required to be filed as an exhibit to the registration statement (in the case of an offering pursuant to a shelf registration statement, through a filing following execution of the underwriting agreement that is incorporated in the registration statement by reference). It is not finalized until the "pricing" of the offering, when the issue price, underwriters' compensation and other final terms are fixed. At that time, the agreement is generally signed by the representative or representatives on behalf of the underwriting group.

In the underwriting agreement, the underwriters agree, subject to specified conditions, to purchase the offered securities on a set future closing date. Each underwriter of a U.S. offering is responsible to the issuer only for its individual underwriting commitment. [307] The underwriting agreement typically includes representations and warranties by the issuer regarding the material accuracy of the registration statement and the prospectus and the issuer's legal status and financial condition. The agreement also describes in detail the conditions to be fulfilled by the issuer prior to the closing, including delivery of legal opinions, officers' certificates and other documents.

Global distributions often are made by a single underwriting syndicate, which may comprise U.S. and non-U.S. underwriters, though on occasion they may be conducted by two or more regional underwriting syndicates. [308] When a

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multiple syndicate structure is used, one syndicate customarily will cover the issuer's home market, while another syndicate will cover the rest of the world. Separate syndicates also may be formed to cover public offerings or significant private placements in particular countries, such as the United States. [309] Syndicate activities generally are overseen by one or more banks acting as global coordinators, whose responsibilities include negotiating the underwriting agreement with the issuer and/or selling shareholders, carrying out due diligence, managing stabilization activities and overseeing offering publicity. [310]

When a multiple syndicate structure is used, the syndicates usually enter into an intersyndicate agreement providing for coordination and allocation of geographic markets among them. [311] Lead managers are generally appointed to oversee each syndicate, while the global coordinators oversee all the syndicates, often maintaining a position through an affiliate in each syndicate in order to be able to monitor more closely their respective levels of demand and bookbuilding activities.

[a] Settlement

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In U.S. underwriting agreements, the closing date is generally the third (in the case of debt offerings) or fourth (in the case of equity offerings) business day after pricing. [312] The SEC has proposed an amendment to the Exchange Act rule governing standard settlement cycles [313] that, if adopted, would shorten the standard settlement cycle in the United States for certain securities transactions, including underwritten offerings of debt securities that price on a customary timetable, from third business day settlement to second business day settlement. [314]

[b] *Force Majeure* Clauses

Termination provisions (sometimes known as "*force majeure* clauses") included in underwriting agreements for domestic offerings in the United States have generally limited underwriters' grounds for termination to a fairly narrow scope. [315] One reason has been the position of the SEC staff that a *force majeure* clause permitting an underwriter to terminate its obligations upon (i) the occurrence of immaterial events affecting the issuer or the securities markets in general or (ii) an inability to market the securities would cause the offering to be characterized as a "best efforts" or contingent offering. [316] As a result, in contrast to firm commitment underwritings, such offering would become subject to the requirement that customer funds be escrowed and to certain other restrictions. [317]

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Underwriters have also been willing to accept limited *force majeure* clauses for U.S. domestic offerings because they are at risk only during the limited period [318] between the signing of the underwriting agreement and the closing. In contrast, the length of time between the signing of the underwriting agreement and the closing of an offering outside the United States varies depending on the jurisdiction and the type of securities offered. [319] The period of underwriting risk in global offerings following the U.S. pattern is now generally limited to a three- to five-business day period between pricing and closing. However, significant differences in the nature of the risk accepted by underwriters continue to exist. In a standard offering by a private issuer, the underwriting agreement typically contains a *force majeure* clause that permits an underwriter to terminate its obligations in the event of significant market upheaval, suspension of trading of the issuer's shares or acts of war and the like. [320] Thus, if there is a sharp downturn in market conditions between the signing of the underwriting agreement and the closing as a result of any of the events specified in the *force majeure* clause, the underwriters have the ability to walk away from the transaction. [321] Underwriters tend to view the unilateral right to declare a *force majeure* event and to terminate the transaction as a fundamental part of the protections provided them by the underwriting agreement. [322]

In some markets where a local retail offering accompanies the international offering, the closing of the retail offering may occur before the closing of the international offering. In such instances, it may not be possible to terminate the offering once the retail offering has closed, and underwriters have, at least in markets where this result is unavoidable, accepted the result that there is no right of termination between the closing of the retail offering and the closing of the international offering. To mitigate this risk, underwriters would seek to shorten this gap.

[c] Indemnity Provisions

Generally speaking, indemnity provisions do not vary markedly between different types of offerings. [323] Where shares are being offered only by one or more of the issuer's shareholders or by both the issuer and one or more of its

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shareholders, there is frequently considerable negotiation as to which party should indemnify the underwriters (or if both parties will do so, the level of their respective obligations). [324] As a general rule, most underwriters will seek a full

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indemnity from both the issuer and the selling shareholders in such circumstances, although they may, depending on the relative bargaining strengths of the relevant parties, ultimately accept indemnities from the selling shareholders up to the gross proceeds to be received by them. A selling shareholder that is not involved in day-to-day management of the company— *e.g.*, a financial investor who does not exercise a significant degree of control over the company—can often limit the indemnity it provides to cover only information about itself that is included in the prospectus. Another possibility is to require the underwriters to pursue an indemnity claim against the issuer first, and then to proceed against the selling shareholder only if the indemnity claim is not satisfied by the issuer after a certain period.

[d] Lock-up Provisions

Lock-up provisions in underwriting agreements restrict the issuer and any selling shareholders from selling or announcing the intention to sell (without the prior written consent of the underwriters and subject to certain limited exceptions) any of the securities being offered or securities convertible into those securities, for a specified period. In equity offerings, directors, officers and major shareholders of the issuer typically enter into similar lock-up arrangements pursuant to individual agreements signed at the time the underwriting agreement is executed. There will often be some negotiation regarding which of the shareholders, directors and officers of the issuer will enter into a lock-up agreement and what carve-outs to the lock-up agreements will be granted in advance. The exceptions that permit the sale of locked-up securities before the termination of the lock-up period are often highly negotiated and tailored to the specific characteristics of the issuer and the type of securities being offered (although certain exceptions, such as the settlement of existing warrants or convertible securities by the issuer, or the transfer of securities as *bona fide* gifts from an officer or director, provided the recipient agrees to be bound by the lock-up terms, are relatively standard).

There are two main reasons for lock-up arrangements. The primary rationale is to prevent overhang and provide for an orderly market by limiting sales into the market while an offering is being absorbed. A second reason for the use of lock-up arrangements relates to the market's perception of the confidence in the issuer of the shareholders, directors and officers that are subject to the lock-up. A key to an offering's success is the market's belief that the share price will rise, and a perception that well-informed investors such as the issuer's management, directors or major shareholders are "cashing out" could significantly harm the price.

The lock-up period in equity offerings is usually 30-180 days (with IPOs tending toward the longer period) after pricing. Because overhang and market

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perception are greater concerns in the context of equity offerings, the lock-up period in debt offerings is usually significantly shorter than in an equity offering and often limited to the time between pricing and closing. Some debt offerings are executed with no lock up at all, and lock-ups in debt offerings do not customarily apply to directors, officers or major securityholders.

Lock-up provisions used in the context of a public offering in the United States must be disclosed in the registration statement. FINRA also imposes certain obligations in respect of lock-up agreements. [325]

[e] Choice of Law

Generally speaking, the underwriting arrangements for a U.S.-registered offering by a foreign private issuer have almost always been governed by the laws of the State of New York (although in relatively rare instances, English law has governed). In global offerings with more than one syndicate, underwriters increasingly accept an underwriting agreement, especially for the home market, governed by the local law of the jurisdiction of the issuer or selling shareholder.

[f] Overallotment Options and Syndicate Short Sales

It is customary for offerings, especially of equity securities, to be accompanied by "overallotment," whereby the managing underwriter is given the authority by the underwriting syndicate to offer and sell more shares than the underwriters have contracted to purchase from the issuer on a "firm" basis. By overallotting shares, the managing underwriter can create a short position that allows the underwriters to purchase shares in the market in the period immediately following the offering as part of their after-market stabilization activities. In order to protect the underwriters in circumstances in which the shares purchased in the aftermarket are not sufficient to cover the short position created through overallotments, particularly where the price of the offered shares increases in aftermarket trading, the issuer typically will grant the underwriters a so-called "overallotment option" (also called a "green shoe option"). [326] The option generally allows the underwriters, for a period beginning with the execution of the underwriting agreement and ending 30 days later, [327] to elect to purchase from the issuer, at the public offering price less the commissions provided

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for in the underwriting agreement, an additional number of shares equal to up to 15% of the number of shares the underwriters have committed to purchase. The option is often limited to use solely for the purpose of covering any overallotments made on behalf of the syndicate by the managing underwriter. [328]

If the offering is a success and the stock performs well in the immediate aftermarket, and there are therefore no post-offering syndicate purchases in the

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market, the managing underwriter will exercise the option on behalf of the syndicate for the number of shares that have been overallotted, and the syndicate will earn the same commissions on the additional shares as it earned on the so-called "firm shares." [329] If, however, the syndicate has purchased shares in the market, the overallotment option will generally be exercised only to cover the syndicate's short position that remains after the shares purchased in the market by the syndicate have first been applied for that purpose. When the number of shares overallotted exceeds the shares underlying the option, the syndicate must cover the amount of the excess—a so-called "naked" short position—solely through purchases in the market. [330] Of course, when shares purchased in the market are used to cover overallotments, the commissions associated with the exercise of the overallotment option are foregone. Any profits or losses arising out of syndicate activities in the market are typically allocated among the underwriters *pro rata* to their underwriting commitments, subject to agreed limits. [331]

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Where the underwriters have not yet decided to exercise the overallotment option at the time of closing, in order to be able to deliver securities to the initial investors in settlement of all allotments, including overallotments (which are indistinguishable from the rest of the allocation), they may need to borrow securities. [332] The borrowing may be arranged with securities lenders if there is an existing market for the class of securities being offered or with preexisting shareholders of the company if there is no such existing market, such as in an IPO. [333] The borrowed securities must be freely tradable and, therefore, cannot be borrowed from an affiliate of the issuer without SEC registration (which, however, should be easy to accommodate in the context of registering the overall offering).

Another issue to consider in relation to short sales is that the restrictions of Regulation M will be deemed to continue through the exercise of the overallotment option unless the overallotment option is only exercised to cover the net syndicate short position at the time of exercise. [334] Accordingly, closing out and then re-establishing a short position prior to exercise of the overallotment option (referred to as "refreshing the shoe") would bar the underwriters from purchasing shares in the market until the option is exercised or terminated, unless the

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ADTV exemption were available [335] (which will not be the case, for example, in a U.S. initial public offering by an issuer that does not have an existing established market for its stock outside the United States). The underwriters' ability to refresh the shoe also must be consistent with the underwriting agreement and the prospectus, as well as with restrictions on underwriting compensation (since the aftermarket sales price when the short position is re-established may exceed the public offering price of the shares in the offering). [336]

[g] Characterization of Underwriters as a Fiduciary

In its 2005 "eToys" decision, the New York Court of Appeals sustained, at the pleading stage, an issuer's claim for breach of fiduciary duty against the lead underwriter in an IPO based on the allegation that the underwriter assumed an additional "advisory relationship that was independent of the underwriting agreement." [337] Specifically, the complaint alleged that the lead underwriter intentionally underpriced the IPO of what was then eToys, Inc., and then allocated shares to customers obligated to return to the underwriter a portion of their profit on reselling the shares. Until this decision, courts rarely had permitted an issuer to pursue fiduciary duty claims against an underwriter, other than with respect to improper use of confidential information. The court accepted that a fiduciary relationship typically involves a higher level of trust than is present in arm's-length business transactions, as well as the well-established proposition that where there is a contract, it determines the parties' relationship. Nonetheless, the court found that the fiduciary relationship claim was based not on the underwriter's role as such, but rather on an allegedly independent advisory relationship it had established with the issuer, particularly with respect to setting the price for the offered shares. [338] A subsequent case in the Appellate Division of the New

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York Supreme Court considering the question of an underwriter's duty to its client in a different context emphasized the narrow scope of the eToys decision. [339] Nevertheless, in light of the holding in the eToys decision, it has become customary to include so-called "eToys" language in underwriting agreements to clarify that the transaction in question is of an arm's-length nature, that the underwriters are not acting as agents or fiduciaries of the issuer and that the issuer has relied on its own legal and financial advisors in making relevant business determinations.

[h] Success Fees

Section 11(e) of the Securities Act limits the liability of an underwriter under § 11 of the Securities Act to the total price at which the securities underwritten by it and distributed to the public were offered to the public unless "such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting." [340] Issuers and sellers outside the United States sometimes provide a "success fee" that may only be for the benefit of the global coordinators or lead managers of the offering in order to give them an additional incentive to ensure a successful transaction. In the context of a U.S.-registered offering, an underwriter's limitation of liability under § 11(e) might be lost if the underwriter receives a benefit from the issuer in which all other underwriters similarly situated did not share on a *pro rata* basis. Because of the serious consequences, practitioners generally advise that the success fee be structured in a way that avoids the risk of losing this limit on liability. For example, if the desire is to reward the global coordinators or lead managers for their special efforts, the syndicate could itself agree on an allocation of commissions that disproportionately rewards the lead managers, such as by increasing the *praecipium* percentage. Such a reallocation of commissions among syndicate members is generally thought to be consistent with § 11(e) because § 11(e) addresses disproportionate benefits from the issuer but does not preclude disproportionate allocations of the commissions by

and among the underwriters themselves. [341] Another possible approach, if there is more than one syndicate, is to provide the success fee to certain members of the non-U.S. syndicate but not to members of the U.S. syndicate (provided there is no understanding through which a portion of the success fee is to be shared with members of the U.S. syndicate).

[6] Directed Share Programs

Issuers sometimes elect to implement directed share programs, or so-called "friends and family" programs, in connection with IPOs of equity. These programs became particularly popular for IPOs in the technology area in the late 1990s until 2001, but their popularity has waned since then. [342] A directed share program allows an issuer to set aside a portion of the shares to be offered, typically between 2% and 10% of the total offering, for sale by the underwriters to directors, officers and employees of the issuer, their friends and family, and other specified investors.

In general, there are no restrictions under the Securities Act on the types of persons or entities that can participate in directed share programs or on the size of these programs. However, the SEC expressed concern that the implementation of directed share programs might lead to premature and illegal offers of securities that would constitute "gun-jumping" violations of § 5 of the Securities Act. [343] In the registration process, the SEC staff routinely requested that issuers provide supplemental information on the mechanics of offers and sales of shares to investors in directed share programs, including copies of all written communications with prospective investors under these programs. The SEC staff also stated that underwriters should not require purchasers in directed share programs to open and make deposits in brokerage accounts—or otherwise effectively commit to purchase shares—prior to effectiveness of the registration statement. Rule 134 and the Securities Offering Reforms facilitated communications in directed share programs, particularly by liberalizing the contents of communications of offering timing, mechanics and similar matters that are not offers. [344]

FINRA's rules, however, which apply to the underwriters and other broker-dealers participating in these offerings, [345] do effectively limit the types of persons or entities that can be allocated shares in directed share programs in certain circumstances. For example, FINRA's Rule 5130 prohibits FINRA members from selling "new issues" of equity securities to any account in which certain types of "restricted persons" (including, among others, broker-dealers and most of their employees, owners and affiliates and their immediate family members) have a beneficial interest. [346] Although Rule 5130 contains an exemption from this general prohibition for securities that "are specifically directed by the issuer," this exemption is not applicable to securities directed by the issuer to certain categories of restricted persons (including broker-dealer personnel, finders and fiduciaries) unless these persons or their immediate family members are employees or directors of the issuer, the issuer's parent or a subsidiary of the issuer or the issuer's parent. [347] Because FINRA's rules govern the conduct of its broker-dealer members and not the conduct of the issuer, the question of whether a specific person or entity can participate in a directed share program is ultimately one for underwriters' counsel.

Certain provisions of FINRA Rule 5131 further affect the conduct of directed share programs. Among other things, FINRA Rule 5131 requires officer and director lock-up agreements in IPOs, or other restrictions on the transfer of an issuer's shares in such offerings, to apply equally to securities obtained by officers and directors in directed share programs. [348] FINRA Rule 5131 also requires the managing underwriters to notify the issuer and ensure public

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announcement is made of any impending release or waiver of any lock-up agreement or other restriction on the transfer of the issuer's shares. [349]

[7] Due Diligence Investigation

Underwriters of U.S. public offerings must (with the assistance of their counsel) conduct a due diligence investigation of the company if they are going to assert the benefit of certain defenses to civil liability under the Securities Act in the event of material misstatements in the registration statement or material omissions of statements required to be made therein or that make the statements contained therein misleading. Under § 11 of the Securities Act, issuers have strict liability for any such material misstatements or omissions. Underwriters, as well as directors and certain officers, are also liable unless they "had, after reasonable investigation, reasonable ground to believe and did believe … that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." [350] If statements in a registration statement are made by experts, then directors, officers and underwriters can rely on those statements without independent investigation as long as they have no reason to believe (and do not in fact believe) that the statements include any material misstatement or omission. Accountants are experts, and therefore their opinions on the audited financials may be so relied upon. [351]

Section 12(a)(2) of the Securities Act applies corresponding liability, with a corresponding diligence-based defense, for material misstatements or omissions in a prospectus. A seller has an affirmative defense to § 12(a)(2) liability if

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he or she can prove that he or she "did not know, and in the exercise of reasonable care could not have known," of the untrue statement or omission. For a discussion comparing "reasonable care" to due diligence, including whether reasonable care requires investigation, *see* § 11.03[2][b].

Given the importance of these defenses, underwriters have developed procedures designed to enable them to show they exercised the requisite level of diligence. As discussed below, the intensity of these procedures usually varies with the type of offering, with initial public offerings at the more intensive end of the spectrum and offerings of investment grade debt by frequent issuers at the less intensive end. They generally include discussion by underwriters and their counsel with various parties, supplemented by a review of key documents. Typically, discussions will include a review of operations with the company's chief operating officer, a review of financial condition, accounting standards and controls with the chief financial officer and the issuer's accountants, [352] and a review of existing and potential litigation or governmental proceedings with the issuer's internal counsel. Additional discussions may be held with important customers, suppliers or lenders, external counsel to the issuer for significant litigation or regulatory matters, controlling shareholders or other third parties with a special relationship with the issuer, particularly in the context of initial public offerings.

Certain documents effective or prepared during the periods for which financial information is furnished (typically three to five years) will be reviewed. These documents may include research reports and significant press releases; SEC and stock exchange filings; the issuer's constituent documents; minutes of relevant shareholders', board of directors' and committee meetings (and in many cases materials prepared for those meetings); material contracts, agreements, licenses and franchises; documents relating to regulatory issues, insurance and intellectual property; the accountants' reports to the company about the adequacy of its accounting procedures and controls; and reports of counsel regarding ongoing litigation. [353]

The accountants will be asked to deliver a "comfort" letter to the underwriters at the time the underwriting agreement is signed and a "bring down" letter reaffirming the accuracy of the comfort letter at closing. The letter gives comfort with respect to certain financial information contained in the prospectus and describes certain procedures the accountants have followed for the period subsequent to the date of the latest financial statements (whether annual or interim) included in the prospectus—the comfort, in effect, is that the accountants have compared certain financial information in the prospectus to the books

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and records of the company and the numbers agree, and that the procedures have not uncovered any undisclosed specified events since the date of the last published financial statements (so-called "negative comfort" or "negative assurance") such as incurrence of material new debt or material losses or other events affecting stockholders' equity. [354] The underwriters also receive opinions from

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their counsel and from the company's counsel on various matters, as well as assurances, in so-called 10b-5 letters, that neither counsel is aware of any material misstatement or omission in the prospectus.

Sections 11 and 12 make no distinction between lead and other participating underwriters. As a result, passively participating underwriters that rely on the lead underwriter's due diligence are potentially liable for the lead's investigative failures. [355] While §§ 11 and 12 are silent on the role of participants in the due diligence process, the SEC staff has noted that to succeed on a separate affirmative defense, nonmanaging underwriters must at least take active steps to assure themselves that the manager made a reasonable investigation. [356]

As referenced above, § 12(a)(2) of the Securities Act imposes civil liability on a seller of securities (such as an underwriter) in the case of material misstatements in a prospectus or material omissions that make the statements contained therein misleading. [357] In connection with the Securities Offering Reforms, the SEC promulgated Rule 159 under the Securities Act, which interprets § 12(a)(2) as requiring an assessment of whether there are material misstatements or omissions in a prospectus at the time of sale (including the time of a contract of sale), [358] without taking into account information conveyed after that time. As a result, underwriters have significantly modified their procedures to ensure that information is conveyed to investors no later than the time of the investors' agreement to purchase in the offering. Such information is being conveyed through filing and access to, or electronic or other delivery of, prospectuses or preliminary prospectuses, free writing prospectuses consisting of term sheets or other updating information and, in some cases, oral communications. Electronic communications, including hyperlinks to documents, have become an important element in the conveyance of information. In connection with this new emphasis on conveyance at time of sale (including contract of sale), underwriters have adopted procedures that extend the comfort they receive regarding the material accuracy and completeness of information to specified information available at the time of sale. Conveyance of that information remains the

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responsibility of the seller (and thus issuers must satisfy themselves that underwriters have properly conveyed any such information).

Appropriate processes for performing the due diligence exercise are generally straightforward to integrate with disclosure preparation when the issuer is engaged in an initial public offering. Because a comprehensive disclosure document corresponding to Securities Act requirements is being prepared for the first time, the underwriters will have access to the information and personnel they require for diligence in connection with the drafting process and time to perform a thorough investigation.

Diligence may be more challenging, however, in an offering by an issuer that files reports under the Exchange Act and that qualifies to use a short-form registration statement (Form F-3). An offering using that form is often accomplished on an expedited basis, particularly if the issuer has a shelf registration statement in effect or is eligible to file an automatic shelf registration statement (which becomes effective immediately upon filing, without delay for review). [359] As a result, the underwriters often may have limited time to complete their due diligence exercise. Moreover, in such offerings, a significant amount of disclosure is incorporated by reference from the issuer's annual report on Form 20-F and other Exchange Act filings. [360] The underwriters are unlikely to have participated in the preparation of those filings, but are nonetheless liable for material misstatements or omissions contained in them that are incorporated into the registration statement and prospectus and not corrected.

To address this issue, some issuers using the shelf registration process appoint a law firm as "designated underwriters' counsel" for all offerings conducted using the shelf facility. That firm will likely be involved in the initial preparation of the registration statement and will have an opportunity to conduct further diligence during the life of the shelf registration. This practice potentially allows much of the diligence for offerings under the shelf to be completed in advance, in order to accommodate the rapid offering execution that shelf registration makes possible, and provides continuity (which is particularly important when the underwriters included in the syndicate change from offering to offering).

Rule 176 under the Securities Act, which was promulgated at the time shelf registration was first introduced, specifies certain circumstances that are relevant in determining whether due diligence has been demonstrated, including the type of issuer and security, and whether there was reasonable reliance on officers, employees and others whose duties should give them knowledge of the facts in

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question and responsibility for documents incorporated by reference at the time such documents were filed.

A 1992 report prepared by a task force of the American Bar Association (the "Due Diligence Report") acknowledged that the methods for conducting securities offerings have changed substantially since the liability provisions of the Securities Act were drafted and suggested that additional factors be considered in determining whether the due diligence standard was satisfied. [361] The report took the position that the factors specified by the SEC in Rule 176 were not sufficient to protect underwriters and suggested that factors including the following be taken into account: the likelihood that an investigation will turn up material changes in the existing disclosure; the extent to which potential investors rely on a credit rating; the extent to which potential investors have access to information comparable to that available to the underwriters; and the time available to conduct due diligence.

No action has been taken by the SEC (or Congress) since the adoption of Rule 176 to adopt the suggestions of the Due Diligence Report or otherwise address due diligence standards. Indeed in the *WorldCom* decision, where the motion of defendant underwriters for summary judgment was denied in a case involving an offering off a shelf registration statement of what was at the time investment grade debt, the court pointed out that governmental inaction in the face of requests for modification such as those contained in the Due Diligence Report suggested that the law had not evolved with changing offering practices. [362]

The passage of the Sarbanes-Oxley Act and related rules and SEC initiatives have sharpened the focus during the diligence process on issuers' internal controls, including heightened scrutiny of auditor communications and audit committee proceedings, and on issuer's disclosure controls, including due diligence relating to certification procedures for public disclosure and disclosure committee actions. [363] Underwriters and their counsel also review management's required report on internal control over financial reporting and related

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independent auditor attestation regarding the effectiveness of the issuer's internal control over financial reporting. [364] Additionally, following the *WorldCom* decision, underwriters and their counsel have developed more formalized due diligence procedures (*e.g.*, preparation of a written summary of due diligence activities) for offerings off shelf registration statements.

[8] State Securities Laws

In addition to complying with the federal securities laws, a foreign issuer offering securities in the United States, including to its U.S. employees, must consider the securities laws of the various states where the securities are offered and sold although federal legislation has greatly reduced the significance of such state laws in the case of companies that file reports under the Exchange Act. [365]

[a] State "Blue Sky" Requirements

Nearly every state of the United States requires that securities be registered under its laws prior to sale to the public in that state or be exempt from state registration. The National Securities Markets Improvement Act of 1996 (the "NSMIA") [366] amended the Securities Act to provide for federal preemption of state laws and regulations requiring registration of securities or securities transactions in many cases. As a result, the need to register securities at the state level has been eliminated in connection with most significant securities offerings in the United States, including those by foreign issuers.

As amended by the NSMIA, § 18 of the Securities Act provides exemptions for certain categories of "covered security" (or any security that will be a "covered security" upon completion of a transaction), including:

- securities that are listed, or approved for listing, on the NYSE, Nasdaq or any national securities exchange that the SEC determines has substantially similar listing standards and securities of the same issuer that rank equally with or senior to such listed securities;
- securities issued by an investment company registered under the Investment Company Act;

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- securities offered or sold to "qualified purchasers" as defined by rule by the SEC; [367] and
- securities offered or sold in certain transactions exempt from registration under the Securities Act, including ordinary secondary market transactions (provided the issuer of the security is a reporting issuer under the Exchange Act), [368] certain transactions exempt from registration under § 3(a) of the Securities Act, private offerings under Rule 506 of Regulation D under the Securities Act, private offerings under § 3(b)(2) of the Securities Act, "crowdfunded securities" under § 4(a)(6) of the Securities Act and certain accredited investor transactions pursuant to § 4(a)(7) of the Securities Act. [369]

Such a "covered security" is exempt from all state requirements with respect to (i) registration and qualification of securities or securities transactions, (ii) prohibitions, limits or conditions on the use of any offering document "prepared by or on behalf of the issuer" of the security [370] and (iii) in the case of an

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exchange-listed security, prohibitions, limits or conditions on offers or sales of the security based on the merits of the offering or the issuer. The NSMIA does, however, preserve the states' authority to maintain and enforce their own antifraud laws and to require certain notice filings for "covered securities" that are not listed on an exchange. [371]

In circumstances where the NSMIA does not apply and there is no applicable state law exemption, U.S. legal counsel for the underwriters is typically responsible for arranging compliance with the necessary state securities registration requirements, and the issuer is responsible for paying the fees of such counsel for blue sky work and any state filing fees and for executing individual state registration forms. Generally, the application for registration in any state includes a uniform state application form, a copy of any related Securities Act registration statement and exhibits thereto, a consent to service of process and a check in payment of a fee based on the aggregate dollar amount of securities registered in the state. [372]

The extent of the state regulators' review of the registration or filing materials submitted varies widely. Many states have adopted a standard of review involving the merits of the offering ("merit review") that differs from the SEC's "full disclosure" requirements. In these states, the securities commissioner may deny registration if the offering is determined to be unfair, unjust or inequitable. Generally, these states have adopted regulations and policies that establish standards that an issuer must meet if its offering is to be considered "fair" and appropriate as an investment for the state's residents. These standards include: (i) a prohibition against offering a class of equity securities with no voting rights or rights unequal to other classes of outstanding shares, (ii) limitations on the maximum underwriting commissions and other selling expenses that may be incurred by the issuer in connection with the offering, (iii) limitations on the amount of securities that may be covered by options issued or to be issued to management and underwriters, and (iv) limitations on the price-earnings ratio of the securities offered.

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There do not appear to be merit or fairness standards of special relevance to foreign issuers, other than the requirement of a number of states, including Texas, that the foreign issuer be able to show that it has substantial assets in the United States. This reflects a concern about the unenforceability in the United States of any judgment against the foreign issuer obtained by a U.S. investor.

[b] State "Legal Investment" Laws

There are also state statutory provisions (often called "legal investment" laws) that govern the various types of investments that are permissible for state-regulated financial institutions. These institutions generally include state commercial and savings banks, savings and loan associations, life and casualty insurance companies and public sector pension and retirement systems.

Typically, these provisions list permissible portfolio investments for these institutions, such as government obligations, corporate bonds, preferred stock and common stock, real estate mortgages and notes and similar types of investments. Most states impose quality standards on such investments, *e.g.*, the security may be required to have an investment grade rating. In addition to specified legal investments, most states also permit regulated institutions to invest, under so-called "basket" provisions, a limited portion of funds in any type of security, including those that do not meet the required standards. The legality of investments in securities issued by corporations and governments varies both from state to state and as among different types of regulated financial institutions. However, those states with the largest base of financial institutions usually permit the purchase of foreign securities, subject to certain quantitative limitations and provided the securities meet the same quality standards as those imposed on similar U.S. investment securities. [373] Some legal investment provisions do not specially list foreign securities among those investments that are legal for institutional investors. In those instances, regulated institutional investors may only purchase foreign securities under the basket provisions referred to above.

[c] Global Blue Sky Developments

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Global offerings, in which offers and sales are made both in the United States and into numerous jurisdictions outside the United States, are occasionally undertaken by issuers offering large amounts of securities. [374] Securities offerings made in jurisdictions outside the United States must also be conducted pursuant to such jurisdiction's securities regulations. The U.S. offering documentation, which will take the form of a prospectus in an SEC-registered offering and an offering memorandum in an exempt offering, will include a section that summarizes the selling restrictions of each foreign jurisdiction into which offers or sales will be made (each referred to as a "selling legend"). [375] Ensuring compliance with a jurisdiction's requirements and notifying investors of those requirements in a selling legend may require consultation with counsel in that jurisdiction. [376]

Both the form [377] and the substance of a selling legend depend on the specific requirements of a given jurisdiction's securities regime, and the legend often includes a statement that the securities will not be offered or sold into such jurisdiction except through transactions that do not constitute a public offering within the meaning of such jurisdiction's securities laws. [378]

[9] Market Manipulation and Stabilization

In U.S. public offerings the activities of the underwriters, including any underwriters engaged in a distribution of securities outside the United States,

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and, in certain respects, the issuer (as well as their respective affiliates), are subject to a number of U.S. rules relating to market manipulation and stabilization. These rules are typically implemented through the agreement among underwriters (and, if there are multiple syndicates, also through the intersyndicate agreement) and, with respect to the issuer, through the underwriting agreement. Since 1997, the U.S. rules relating to market manipulation and stabilization in connection with securities offerings have been contained in Regulation M. [379]

[a] Market Manipulation Under Regulation M

Rule 101 and Rule 102 of Regulation M are designed to prevent interested parties from engaging in activities that could artificially raise the price of a security that is the subject of a "distribution" [380] in the United States. Rule 101 regulates bids and purchases by underwriters, prospective underwriters and other distribution participants, and certain affiliates of such persons. Rule 102 regulates bids and purchases by issuers, selling securityholders and certain of their affiliates.

[i] *Rule 101*

Rule 101 applies to "distribution participants," a category that includes underwriters, prospective underwriters, [381] brokers, dealers and others who are participating or have agreed to participate in a distribution of securities. [382] Rule 101 also applies to affiliated purchasers of distribution participants. [383]

Regulation M exempts from the definition of "affiliated purchaser" a separately identifiable department or division of a distribution participant, issuer or

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selling securityholder that regularly purchases securities, whether for its own account or the account of others, or who recommends or exercises investment discretion with respect to the purchase or sale of securities so long as certain conditions are met. [384]

Rule 101 of Regulation M generally prohibits distribution participants and affiliated purchasers from bidding for, purchasing or attempting to induce any person to bid for or purchase (i) any security that is the subject of a distribution (the "subject security") [385] and (ii) any security into which a subject security may be converted, exchanged or exercised (whether immediately or not), or which, under the terms of the subject security, may in whole or significant part determine the value of the subject security (a "reference security"). Thus, during the distribution of an equity-linked security, the underlying security will be subject to Regulation M even if the terms of the equity-linked security provide for cash

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settlement only (assuming that the value of such equity-linked security is determined in significant part by the price of the underlying security, as would generally be the case). [386]

Unless an exemption is applicable, the restrictions contained in Rule 101 apply to distribution participants and affiliated purchasers during a period that commences either one or five business days [387] prior to pricing [388] (or, if later, the time at which such person becomes a distribution participant) and ends upon the completion of such person's participation in the distribution. [389]

Under Regulation M, when a "distribution" occurs in the United States, the restrictions of Rule 101 apply globally, even to activities conducted entirely outside United States by non-U.S. persons. A "distribution" is any offering of securities in the United States that is distinguished from ordinary trading transactions

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by the magnitude of the offering and the presence of special selling efforts and selling methods. [390]

Rule 101 contains a number of exemptions. Securities with a worldwide reported ADTV [391] value [392] of at least $1 million whose issuer has common equity securities with a public float value [393] of at least $150 million are exempt from Rule 101. [394] Rule 101 also includes an exemption for nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities [395] that are rated investment grade by at least one nationally recognized statistical rating organization. [396] This exemption is based on the premise that such securities are

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traded on the basis of their yields and credit ratings as opposed to the identity of the issuer and, therefore, are less likely to be subject to manipulation. [397]

Rule 144A-eligible securities [398] are exempt from Rule 101 if such securities are sold in the United States only to QIBs or persons reasonably believed to be QIBs in transactions exempt from registration under § 4(a)(2) of, or Rule 144A or Regulation D under, the Securities Act. [399] The exemption also applies if the distribution includes certain persons in the United States not deemed to be "U.S. persons" for the purposes of Regulation S under the Securities Act. [400]

Unsolicited brokerage transactions are exempt from Rule 101, as are unsolicited purchases that are not effected from or through a broker or dealer, on a securities exchange or through an inter-dealer quotation system or electronic communications network. [401]

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Rule 101 contains an exemption for the dissemination of research where such research satisfies the conditions of Rule 138 or 139 under the Securities Act. [402] Rule 101 also contains exemptions for certain basket transactions [403] and inadvertent *de minimis* purchases, [404] among others. [405]

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In addition, Rule 103 of Regulation M provides an exemption from Rule 101 to allow "passive market making" during the Rule 101 restricted period in connection with a distribution of securities listed on Nasdaq. The rule is designed to maintain liquidity in situations where a market maker otherwise may be required to withdraw from the market pursuant to Rule 101. Rule 103 limits a passive market maker's bids to the highest current independent bid (unless necessary to comply with an SEC or FINRA rule relating to the handling of customer orders), limits the amount of net daily purchases each passive market maker can make to the greater of 30% of ADTV or 200 shares and contains requirements relating to identification, notification and disclosure of activity pursuant to the rule. [406]

Over the years, the staff of the SEC recognized the intrusive effects of the extraterritorial application of the market manipulation and stabilization rules in effect prior to the adoption of Regulation M and granted relief, principally on a case-by-case basis, from certain of their restrictions. [407] The Regulation M Release noted that, in response to a request from the London Stock Exchange, this relief would be modified and restated under Regulation M. [408] Other exchanges also had obtained similar relief, which could be modified and restated,

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upon request, under Regulation M. [409] To date, however, no other securities exchange has sought the modification and restatement of such relief.

[ii] *Rule 102*

Under Rule 102, it is unlawful for issuers, selling securityholders and their affiliated purchasers [410] to bid for, purchase, or attempt to induce any person to

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bid for or purchase, any covered security during the applicable restricted period. Rule 102 repeats many of the same provisions set forth in Rule 101 and uses many of the same definitions. Accordingly, many of the subjects discussed above, including, for instance, the duration of the restricted periods, the definitions of distribution and affiliated purchaser and the global applicability of the restrictions, if they apply, will apply to both rules. However, certain of the exemptions included in Rule 101 are omitted from Rule 102. [411]

Rule 102 does not include a general exemption for actively-traded securities similar to that set forth in Rule 101. However, in order to allow an issuer of equity-linked securities to hedge the underlying reference security, Rule 102 contains a limited exemption for actively-traded reference securities that are not issued by the issuer of the security in distribution or by any affiliate of the issuer. The exemption covers reference securities with an ADTV value of at least $1 million that are issued by an issuer whose common equity securities have a public float value of at least $150 million. Rule 102 also does not include the exemptions for *de minimis* or basket transactions included in Rule 101.

Rule 102 includes an exemption that permits an affiliated purchaser of an issuer or a selling securityholder to purchase the securities being distributed. [412] Sales of a significant portion of the securities in distribution to affiliates may require disclosure in the prospectus because of the inability of such purchasers to resell such securities freely.

Rule 102 also includes an exemption for two types of plans in respect of an issuer's securities. First, with respect to plans that are available only to employees and shareholders, Rule 102 exempts any distribution pursuant to a plan by or on behalf of an issuer or a subsidiary of the issuer when the distribution is made solely to employees or shareholders or a trustee acting on behalf of such persons. Second, Rule 102 exempts distributions to persons other than employees or securityholders of the issuer, if bids for and purchases of securities pursuant to such plan are effected solely by an agent independent of the issuer and the securities are obtained from a source other than the issuer (*e.g*, from market purchases by the agent). [413] However, a direct issuance plan (*i.e.*, a plan that

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is open to persons other than employees and securityholders and pursuant to which shares are purchased from the issuer or an affiliated purchaser) is not exempt from the provisions of the rule. [414]

Any affiliate of an issuer or a selling securityholder that is acting as a distribution participant has the option of being subject to the less-restrictive Rule 101 rather than Rule 102. [415] The ADTV exemption in Rule 101 is not available, however, in the case of securities issued by the distribution participant or an affiliate of the distribution participant. [416]

[b] Stabilization Under Regulation M

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Rule 104 of Regulation M establishes a flexible framework for stabilization activities conducted in connection with an offering. [417] Rule 104 provides that no person may effect, either alone or with others, any independent transaction to facilitate an offering other than in conformity with the rule's provisions. [418]

In general, under Rule 104, persons stabilizing the price of a security may initiate a stabilizing bid in any market with reference to the independent prices in the principal market for the security wherever located, and maintain, reduce or increase the stabilizing bid to follow the independent bid in the principal market so long as the stabilizing bid does not exceed either the independent bid in the principal market or the offering price of the security.

Under Rule 104, when the principal market for the security is open, the permissible initial stabilizing bid in any market is limited to a price no higher than the last independent transaction price for the security in its principal market, if (i) the security has traded in its principal market on the day stabilizing is initiated or on the preceding business day and (ii) the current asked price in the principal market is equal to or greater than the last independent transaction price. If either of these conditions is not satisfied, stabilizing may be commenced at a price no higher than the highest current independent bid in the principal market.

Generally, if the principal market is closed, but quotations have opened in the market where stabilizing will be initiated, the initial stabilizing bid may not be made at a price in excess of the lower of (i) the price at which stabilizing could have been effected in the principal market for the security at its close or (ii) the last independent transaction price where stabilizing is being initiated. However, if the last independent transaction did not occur on the day stabilizing

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was initiated or on the preceding business day and the current asked price in such market is equal to or greater than the independent transaction price, the price in clause (ii) will be the highest current independent bid price in the market where stabilizing is being initiated.

If the principal market is closed and quotations have not opened in the market where stabilizing will be initiated, stabilizing may be initiated at the lower of (i) the price at which stabilizing could have been effected in the principal market for the security at its close or (ii) the most recent price at which an independent transaction in the offered security has been effected in any market, if the person knows or has reason to know of such transaction.

If no *bona fide* market exists for the security, stabilizing may be initiated at the offering price. If stabilizing is initiated before the offering price is determined, then stabilizing may be continued after the determination of the offering price at the price at which stabilizing could then be initiated.

The maximum caps on the stabilizing price level under Rule 104 are the offering price and the stabilizing bid in the principal market. Once stabilization has been initiated, Rule 104 permits an increase in the stabilizing bid at any time to the highest independent bid price for the security in its principal market, or if the principal market is closed, the highest independent bid in that market at the previous close, so long as the stabilizing bid does not exceed the maximum caps. Rule 104 also provides for adjustment of the stabilizing bid in an amount equal to the value of a dividend, right or distribution when the security being stabilized goes ex-dividend, ex-right or ex-distribution, respectively. If the price of the security is expressed in a currency other than the currency of the principal market, Rule 104 allows adjustments of the stabilizing bid to reflect current exchange rates. [419]

Rule 104 exempts all distributions of Rule 144A-eligible securities to QIBs made in transactions exempt from registration under § 4(a)(2) of, or Rule 144A or Regulation D under, the Securities Act. The exemption also applies if the distribution includes certain persons in the United States not deemed to be "U.S. persons" for the purposes of Regulation S under the Securities Act. Unlike Rules 101 and 102 that exempt both the subject security and the reference security, the Rule 104 exemption is only applicable to the subject security.

Rule 104 permits stabilizing outside the United States during an offering in the United States without compliance with Rule 104, subject to the following conditions: (i) no stabilization is conducted in the United States, (ii) the stabilizing price is not above the U.S. offering price, and (iii) stabilization is conducted only in jurisdictions with regulation of stabilization comparable to that set

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out in Rule 104. [420] For the purpose of this exemption, the Regulation M Release recognized the pre-Market Abuse Directive [421] stabilization regulations of the United Kingdom as comparable to Rule 104 and invited requests for recognition of additional markets having comparable regulations for purposes of the rule. [422] In a no-action letter granted in connection with the 1998 privatization of shares of Nippon Telegraph and Telephone Corporation ("NTT"), [423] the SEC staff clarified its view that Rule 104 permitted stabilization in the United Kingdom under then-applicable U.K. regulations provided that any stabilization in the United States had been terminated, whether or not stabilization had been effected in the United States previously or the U.S. distribution has been completed. The no-action letter also permitted the Japanese underwriters in the NTT offering to conduct stabilizing activities in Japan in accordance with Japanese regulations, even though this involved stabilizing above the U.S. offer price in contravention of Rule 104(f). This relief was required due to the Japanese practice of setting the offering price at a slight discount to the prevailing market price in a secondary offering, and was conditioned on, among other things, the U.S. distribution being complete before Japanese stabilization could begin. The SEC has since granted a class exemption that provides relief similar to the NTT relief described above in connection with all U.S. and Japanese offerings of equity securities by Japanese issuers provided that certain conditions are satisfied. [424] To date, the SEC has granted relief from the application of Rule 104 only in respect of pre-Market Abuse Directive stabilization activities in the United Kingdom (or otherwise in accordance with the U.K. rules) and on the AEX Stock Exchange in Amsterdam, in addition to stabilization activities in Japan, although it did not

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expressly declare The Netherlands' or Japan's stabilization rules to be equivalent to Rule 104 as it had done in the case of the United Kingdom. [425]

Rule 104 requires any person entering a stabilizing bid to notify the market on which the bid is placed. Furthermore, when a person subject to Rule 104 conducts a transaction in securities and the price of those securities may be or has been stabilized, that person is required to notify the purchaser (in a prospectus or confirmation, for example) of that fact. Rule 17a-2 under the Exchange Act also requires managing underwriters to maintain records of syndicate covering transactions and penalty bids (which permit the initial purchasers to reclaim a selling concession from a dealer when the initial purchasers, in covering syndicate short positions or making stabilizing purchases, repurchase securities sold by that dealer), as well as stabilizing activity, [426] and Rule 104 of Regulation M prohibits the imposition of penalty bids in connection with the offering of any security in contravention of such rule. Rule 104 also imposes disclosure and record keeping requirements for certain syndicate aftermarket activities that occur even after stabilization, as such term is used in Rule 104, has ended. Rule 104 requires any person effecting a syndicate covering transaction or placing or transmitting a penalty bid to disclose [427] that fact to the self-regulatory organization that has direct oversight authority over the principal market in the United States for the security for which the syndicate covering transaction is effected or the penalty bid imposed (although public disclosure of such activity is not required). [428]

For a discussion of two customary underwriting practices related to stabilization activities, "overallotment" (whereby the managing underwriter of an

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offering is given the authority by the underwriting syndicate to offer and sell more shares than the underwriters have contracted to purchase from the issuer on a "firm" basis) and the granting of an "overallotment option," *see* § 3.02[5][f].

[c] Prohibited Solicitations and “Tie-in” Agreements for Aftermarket Purchases

The SEC staff has expressed its view that underwriters, broker-dealers and any other distribution participants are prohibited from soliciting or requiring their customers to make aftermarket purchases until the distribution is completed. [429] The staff also described the practice by some underwriters of requiring their customers to agree to buy additional shares in the aftermarket as a condition to being allocated shares in a distribution (so-called "tie-in" arrangements). The staff views these practices as being prohibited by Rules 101 and 102 of Regulation M and possibly violative of other antifraud and antimanipulation provisions of the U.S. securities laws. [430]

[d] Short Selling by Investors in Connection with a Public Offering

Following revisions implemented partly in response to enforcement actions, [431] Rule 105 of Regulation M makes it unlawful, in connection with an

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offering of equity securities for cash pursuant to a registration statement, for any person to sell short a security that is the subject of an offering and to purchase offered securities [432] from an underwriter, broker or dealer participating in the offering if such short sale occurred during the shorter of: (i) the period beginning five business days before the pricing of the offered securities and ending with such pricing, and (ii) the period beginning with the initial filing of such registration statement and ending with the pricing (such period, the "Pre-Pricing Period"). [433]

Rule 105 contains certain exceptions to its prohibition on purchases of offered securities by persons that sold subject securities short during the Pre-Pricing Period. In particular, subject to the requirements detailed in Rule 105 and as further explained in the August 2007 adopting release, exceptions are available to permit purchases of offered securities by (i) persons that offset short positions in subject securities entered into during the Pre-Pricing Period with *bona fide* purchases of such securities made no later than the business day prior to pricing of the relevant offering, (ii) an independent trading unit of a broker-dealer or other separate account of a person where another separately managed trading unit or account had sold the subject securities short during the Pre-Pricing Period, and (iii) an investment company (including a separate fund or fund series) where an affiliated investment company (or another separate fund or fund series) had sold

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the subject securities short during the Pre-Pricing Period. [434] Rule 105 also does not apply to offerings that are conducted on a best-efforts basis, [435] although the SEC has indicated that it may re-evaluate this exception if it becomes aware of potentially manipulative short selling or other concerns in connection with such offerings. [436]

Footnotes

39 § 15(d)(1) of the Exchange Act.

40 § 12(b) of the Exchange Act.

41 The procedures for listing and registering under the Exchange Act securities issued in a public offering are the same as the procedures applicable to listing and registering outstanding securities, as described in § 3.03 and § 4.02. In the case of a public offering of securities to be listed on an exchange, Exchange Act registration proceeds in tandem with Securities Act registration and is accomplished by using Form 8-A, which incorporates the relevant information from the Securities Act registration statement.

42 While under § 5 of the Securities Act sales cannot be made until a registration statement is declared effective, the SEC has permitted, through no-action relief, certain structures whereby conditional offers to buy shares made before the effective date of a registration statement could be accepted following the effective date, and would not be considered preeffective sales violating § 5 of the Securities Act, without the need for investors to reconfirm their preeffective conditional offers to buy. *See*, *e.g.*, *Morgan Stanley Smith Barney LLC* (avail. Nov. 22, 2016) (granting relief under certain circumstances to permit a broker-dealer to accept after the effective date a customer's preeffective conditional offer to buy shares in an IPO if such customer has not withdrawn its offer to purchase prior to the later of one hour after such broker-dealer provides an email notice of effectiveness to such customer and the time of effectiveness, assuming such shares price within 20% of the price range included in the preliminary prospectus delivered to such customer prior to such offer); *Wit Capital Corp.* (avail. July 14, 1999) (granting relief under certain circumstances if the broker-dealer accepts after effectiveness a customer's pre-effective conditional offer to buy shares without affirmatively seeking such customer's reconfirmation of such offer following post-effective pricing, assuming such customer has been given a final opportunity to withdraw prior to

acceptance and has reconfirmed its offer on a pre-effective or post-effective basis).

43 § 2(a)(3) of the Securities Act.

44 The rules contained in Regulation C under the Securities Act govern the preparation of registration statements under the Securities Act, subject to the provisions of any applicable form or any item of Regulation S-K referred to in such form. Rule 400 under the Securities Act. Registration statement forms used by foreign private issuers generally incorporate by cross-reference specific disclosure requirements set forth in Form 20-F (which itself functions as both an Exchange Act registration statement form and the form for annual reports of foreign private issuers). Alternatively, for domestic issuers, including foreign companies that do not qualify as "foreign private issuers," registration statement forms under the Securities Act generally incorporate by cross-reference specific disclosure requirements set forth in Regulation S-K. *See* Regulation S-K, Item 10.

45 § 23 of the Securities Act.

46 Foreign companies that guaranty securities of or co-issue securities with wholly-owned subsidiaries that are not themselves foreign companies are permitted to use an F-series registration statement if the parent and subsidiary are eligible to present condensed consolidated financial information in the parent company's filings. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Forms, Questions 110.03 and 110.04 (Dec. 8, 2016). *See also* § 3.05[1] regarding special rules for foreign governmental and supranational issuers.

47 The Securities Offering Reforms eliminated Form F-2.

48 Under Regulation S-T, all documents filed with or furnished to the SEC by U.S. and, with certain exceptions, foreign issuers must be submitted electronically, using EDGAR. EDGAR filings are accessible by the public through the SEC's website, www.sec.gov. For a description of the documents that foreign issuers may submit by paper, *see* Rule 101(b) of Regulation S-T and Chapter 4, Note 39.

49 *See* the discussion of Exchange Act registration on Form 20-F in §§ 4.04[1] and 4.11.

50 The public offer and sale in the United States of new shares in the form of ADRs technically involve the registration of two securities: the underlying shares and the ADRs. The underlying shares are registered on Form F-1 or Form F-3 registration statements. The ADRs are concurrently registered, as for any ADR program, by filing a Securities Act registration statement on Form F-6, which, as discussed in § 3.04[3], is a simple registration statement describing the depositary arrangements.

51 *See* Form F-1, General Instruction VI.

52 *See* Form F-3, Item 6.

53 *See* § 3.02[2] for a discussion of shelf registration.

54 An offering of securities by a finance subsidiary of a foreign company may, in certain circumstances, be effected on Form F-3 on the basis of the parent's status and reporting history, even if the subsidiary itself would not qualify. The subsidiary must be purely a financing vehicle with no independent operations and the securities being registered (which will generally be debt securities) must be fully and unconditionally guaranteed by the parent. In such instances, the SEC has authorized the filing of a registration statement containing no financial information regarding the subsidiary and has also exempted the subsidiary from the ongoing reporting requirements of the Exchange Act. *See*, *e.g.*, *The Rank Group plc* (avail. Feb. 2, 1998); *CANTV Finance Ltd. and Compañia Anónima Nacional Teléfonos de Venezuela* (avail. Apr. 4, 1997); *WMC Limited and WMC Finance (USA) Limited* (avail. Dec. 17, 1996); *CSR Limited, CSR America, Inc. and CSR Finance Limited, Inc.* (avail. Oct. 25, 1995); *Quebecor Printing Inc., Quebecor Printing Capital Corporation and Quebecor Printing Capital GP* (avail. Mar. 12, 2000). The Securities Offering Reforms expanded majority-owned subsidiary eligibility in Form F-3 to allow majority-owned subsidiaries to use Form F-3 under the same circumstances in which majority-owned subsidiaries may be WKSIs. *See infra* Note 147. For a discussion of other circumstances in which financial statements of guarantors are required to be included in a registration statement, *see* § 4.05[5][c].

55 Form F-3, General Instruction I; SEC Release No. 33-7053 (Apr. 19, 1994). In determining whether a

company meets the public float requirement, nonvoting common stock held by nonaffiliates may be counted along with voting common stock. SEC Release No. 33-7419 (May 8, 1997). Under certain circumstances, nonvoting preferred stock also may be taken into account to satisfy this public float requirement. *See infra* Note 144.

56 Form F-3, General Instruction I.B.5; SEC Release No. 33-8878 (Dec. 19, 2007).

57 Nonconvertible securities, other than common equity, of a majority-owned subsidiary of a WKSI also may be registered if the parent registrant provides a full and unconditional guarantee of the payment obligations on such nonconvertible securities. Form F-3, General Instruction I.C.1.(c)(ii).

58 Form F-3, General Instruction I.B.2; SEC Release No. 33-7053 (Apr. 19, 1994). The Standards used to determine whether the $1 billion threshold is met would be the same as those used in the similar current test for WKSI status. *See* § 3.02[3][a][ii]

59 *See* SEC Release No. 33-7053 (Apr. 19, 1994).

60 Form F-3, Item 5(a) and Form F-1, Item 4A, as applicable if the issuer is eligible to incorporate by reference under General Instruction IV. Such disclosure also may be made by incorporating by reference any form 6-Ks submitted to the SEC by the issuer after its most recent Form 20-F. *See* § 4.02[3][c].

61 Form F-3, Item 5(b)(1). Form F-1, Item 4A(b)(1).

62 *See* § 4.05[2] for a discussion of the timeliness of financial statements. Form F-3, Item 5(b)(2). Although Form F-3 does not technically require an MD&A to accompany the financial statements required by Item 5(b)(2), market practice is to include or incorporate by reference such an MD&A in registration statements on Form F-3.

63 Effective October 1, 2016, the filing fee for Securities Act registration statements is $115.90 per $1 million of securities. *See* Fee Rate Advisory #1 for Fiscal Year 2017 (Aug. 31, 2016). In the case of ADRs, the fee is payable on the registration statement for the securities underlying the ADRs, together with an additional fee on the registration statement for the ADRs. The minimum registration fee applies separately to the registration of the ADRs and the underlying securities.

64 For a further discussion of the "pay-as-you-go" filing fee approach, *see* § 3.02[2][c].

65 Eligible foreign issuers, for their first year of reporting under IFRS, are permitted to file two years rather than three years of income statements, cash flow statements and statements of changes in equity. *See* SEC Release No. 33-8567 (Apr. 12, 2005); *see also* § 4.05[1]].

Form 20-F generally requires that registration statements include audited financial statements no more than 15 months old (and in some cases 12 months old), and that six-month financial statements (which may be unaudited) and U.S. GAAP information, where necessary, be included if the audited financial statements are more than nine months old. In addition, if the issuer has published interim financial information that covers a more current period than is otherwise required, that more current financial information must be included in the filing. *See* Form 20-F, Item 8.A.5; *see also* § 4.02[3][c][i] .

66 *See* § 4.05[1] and § 4.02[3][b][i], Note 40 for a discussion of U.S. GAAP reconciliation requirements. In 2007, the SEC decided to accept financial statements of foreign companies prepared in accordance with IFRS as issued by the IASB without requiring a reconciliation to U.S. GAAP. SEC Release No. 33-8879 (Dec. 21, 2007).

67 Form 20-F Item 3.A. The income statement and balance sheet items required ("selected financial data") include: net sales or operating revenues, income (loss) from operations, income (loss) from continuing operations, net income (loss), net income (loss) from operations per share, income (loss) from continuing operations per share, total assets, net assets, capital stock (excluding long-term debt and redeemable preferred stock), number of outstanding shares, dividends declared per share and diluted net income per share. *See* § 4.05 for a discussion of other financial statement requirements in registration statements.

68 Similarly, the JOBS Act permits an EGC to cover only two years of financial information in the MD&A section of its IPO registration statement. While the JOBS Act provision modifying § 7(a) of the Securities Act to permit the inclusion of only two years of audited financial statements is limited to registration statements for

the initial public offering of the common equity securities of a company and does not extend to registration statements for other or subsequent securities offerings, the SEC has stated that it will not object if in other registration statements an EGC does not present audited financial statements for any period prior to the earliest audited period presented in connection with its initial public offering of common equity securities. *See* Division of Corporation Finance, Jumpstart Our Business Startups Act Frequently Asked Questions, Question 12 (Dec. 21, 2015 (revised)).

69 The SEC has two offices that may be able to assist foreign companies in resolving conflicting accounting requirements and other procedural matters involved in the registration process. The SEC Office of Chief Accountant, while not concerned exclusively with foreign companies, has considerable experience in assisting foreign companies with the accounting requirements of Forms F-1 and F-3. It provides relevant information concerning submissions in its Protocol for Submissions to the Office of the Chief Accountant, which is available on the SEC's website. *See* SEC, Division of Corporation Finance, International Reporting and Disclosure Issues, Part IV(A) (Nov. 1, 2004).

A special staff section for foreign companies, the SEC Office of International Corporate Finance, also often provides guidance to foreign companies and their counsel and investment bankers during the course of public offerings. It is sometimes desirable for a company contemplating a U.S. public offering (particularly if the company has not previously issued securities in the United States) to schedule a preliminary meeting with the SEC staff in advance of filing the registration statement. The company's counsel ordinarily assists the company in scheduling the meeting and usually accompanies the company to the SEC.

70 Shell companies, blank check companies and issuers with no or substantially no business operations are not permitted to use the nonpublic submission procedure.

71 Because staff members are assigned registration statements based on their industry background, it is advisable for issuers to review carefully recent registration statements and comment letters of companies in the same industry sector in order to anticipate and minimize staff comments. In addition to review by the SEC, offering participants that are FINRA members may not participate in an offering absent prior review by FINRA of certain offering documentation addressing underwriting compensation and arrangements (unless an exemption from review applies), pursuant to FINRA rules. *See* § 3.06[4][b]. Registration statements filed by WKSIs are automatically effective upon filing and not subject to SEC review. *See* § 3.02[3][a][ii] for a discussion of WKSIs.

72 The SEC makes staff comment and issuer response letters publicly available via EDGAR. Both foreign and U.S. companies may continue to use the SEC's confidential review procedure for portions of their written responses to staff comments by submitting to the SEC both (i) a complete response letter containing both confidential and nonconfidential information (filed by hand and requesting confidential treatment pursuant to the SEC's FOIA rules) and (ii) a response letter redacted to eliminate all confidential information (filed by EDGAR). *See* SEC, Division of Corporation Finance, Staff Legal Bulletin No. 1 (with Addendum) (Feb. 28, 1997) (setting out the procedures for the SEC staff's handling of confidential treatment requests). With respect to requests for confidential treatment generally, the SEC cautions issuers that they should not be overly broad in their requests and that there must be an appropriate basis for a request for confidential treatment. *See* Press Release, SEC, Staff to Publicly Release Comment Letters and Responses (June 24, 2004).

73 In addition, the SEC attempts to review all registration statements of foreign private issuers engaging in material business transactions with entities subject to OFAC Sanctions, as discussed in greater detail in § 9.08. The SEC's Office of Global Security Risk will likely be involved in staff review of registration statements of issuers with ties to countries that sponsor terrorism and countries linked to human rights violations. The SEC has stated that the office "will function within the traditional disclosure mission of the Commission" including with the objective of obtaining "appropriate disclosure." *See* § 9.08.

74 The length of the comment period can be affected by the volume of capital markets activity at the time of filing.

75 Section 8(a) of the Securities Act provides that the effective date of a registration statement shall be the

twentieth day after the filing. However, in accordance with Rule 473 under the Securities Act issuers include an express provision on the cover of the registration statement delaying effectiveness until such time as the SEC is prepared to declare the registration statement effective.

After responses to comments have been cleared with the SEC staff, the issuer and the managing or principal underwriters may request acceleration of effectiveness of the registration statement pursuant to Rule 461 under the Securities Act. Rule 461 permits such persons to request a date of effectiveness and, upon two business days' notice to the SEC, an hour of effectiveness. Requests must generally be made in writing, but may be oral if certain conditions are met. *See* Rule 461 under the Securities Act. In generally responding to such requests, Rule 460 under the Securities Act provides that the SEC shall have due regard to whether the registration statement has been distributed to underwriters and dealers reasonably anticipated to be invited to participate in the distribution of the subject security. Accordingly, the managing or principal underwriter typically accompanies its request for acceleration with a letter setting out, or the request itself sets out, prospectus distribution details, including breakdowns of recipients and numbers of copies distributed.

76 *See* § 3.02[1][d] discussing the requirement to include the price range and offering size in an IPO preliminary prospectus before distribution.

77 Rule 433 under the Securities Act. *See* § 3.02(3)(c)(iv) for a discussion of free writing prospectuses and § 3.02[3][c][iii][B] for a discussion of electronic road shows.

78 *See* § 3.02[1][e][i] for a discussion of requirement to deliver a preliminary prospectus prior to confirmation of sales.

79 The ability to make up-to-the-minute demand assessments resulting from the bookbuilding process, and the resultant decrease in underwriting risk, has led to a de-emphasis of underwriting commissions in favor of compensation based significantly on selling efforts. *See* 3.02[5][f]. Bookbuilding also facilitates precise allocation of the securities to particular regions and therefore also to the corresponding banks within the underwriting syndicate or syndicates.

In addition to allocations being determined by indications of market interest, it is also shaped by issuers, as they are increasingly playing a part in the allocation process. *See*, *e.g.*, § 3.06[2][b], which describes the FINRA rule that requires a FINRA member acting as the book-running lead manager of an initial public offering to disclose indications of interest and final allocations to an issuer's pricing committee (or board of directors, if no pricing committee has been appointed).

80 Certain websites use transparent order books or auction systems that permit potential investors to view the bookbuilding process. This mechanism raises questions as to whether the information about the order book or about the nature of the auction process must be disclosed in the prospectus and whether information on the computer screen is itself part of the prospectus, or whether such information constitutes a free writing prospectus. Prior to the Securities Offering Reforms, the SEC granted no-action relief whereby auctions of securities by reporting companies were deemed by the staff not to be in violation of § 5(b)(1) of the Securities Act if either a post-effective amendment or final prospectus supplement describing the auction system was filed. *See In Bear Stearns & Co., Inc.* (avail. July 20, 2000) and *Wit Capital Corp.* (avail. July 20, 2000). *See also W.R. Hambrecht & Co.* (avail. July 12, 2000) (delivery of prospectus for debt securities through Hambrecht's website containing a hyperlink to its auction system would comply with § 5(b)(1) and Rule 424 under the Securities Act where the issuer of the debt securities filed material as in *Wit Capital Corp.*). After the Securities Offering Reforms, free writing prospectuses presumably may be used where permitted to provide investors with the auction-related information. Few companies have gone public through Dutch auctions.

In the initial public offering of Google Inc. in 2004, the SEC permitted an electronic auction offering structure to determine the initial public offering price and share allocations. Participants were required to: (i) obtain bidder IDs electronically by registering on an offering website (and, when registering, consent to electronic delivery of communications related to the offering, including amendments to the preliminary prospectus and the final prospectus and notices concerning the effectiveness of the registration statement and acceptance of bids), (ii) submit a bid by one or more of the Internet, telephone, facsimile or in person, depending upon underwriter requirements, setting forth an amount and bid price for shares, which bid could be withdrawn until underwriter electronic notification of acceptance at the time the initial offering price was set and (iii) reconfirm bids upon electronic notification of the occurrence of certain events (including a prospectus recirculation). As in the case of Wit Capital Corp., offers to buy shares made before the effective date of the registration statement could be accepted, if the bid price were at or above the initial offering price, following the effective date of the registration statement without being considered a pre-effective sale in violation of § 5 of the Securities Act and without the need for investors to reconfirm the bid. *See supra* Note 42. In addition, the offering structure provided that, in the instance where the initial public offering price was less than the bottom of the price range or more than 20% above the top of the price range, Google and the underwriters could provide notice on the offering website of the final offering price, issue a press release announcing the final offering price and send an electronic notice to participants who had received a bidder ID notifying them of the final offering price. Under those circumstances, the underwriters would not require bidders to reconfirm bids unless the prospectus were required to be recirculated. If reconfirmation were not required, the underwriters could accept successful bids by sending electronic notices of acceptance in as little as one hour after the final price was set, with withdrawal rights terminating once a bid was accepted.

81 The amount of securities to be offered may be increased by an amendment to the registration statement prior to its effectiveness, but once a registration statement is effective, additional securities (including securities of the same class) can generally be registered only by filing a new registration statement. Pursuant to Rule 462 under the Securities Act, however, a new registration statement may be declared effective immediately upon filing if it relates to no more than 20% of the amount of securities registered on the initial registration statement. *See infra* Note 83 and accompanying text. Other exceptions include the addition of certain securities offered under automatic shelf registration statements. *See* Rule 413 under the Securities Act; § 3.02[2][c].

82 *See* § 3.02[2].

83 Rule 430A under the Securities Act. The omitted information must be included in a final prospectus, which is required to be filed with the SEC within two business days following the earlier of the date of determination of the offering price and the date the final prospectus is first used in connection with the public offering. If, however, the final prospectus is not filed with the SEC within 15 business days after effectiveness, a post-effective amendment must be filed and declared effective before sales are made, and another 15 business-day period will begin to run from the date of effectiveness of the post-effective amendment. Alternatively, the post-effective amendment could contain the pricing information and be declared effective in the manner of a traditional pricing amendment. Rule 430A is available to any issuer, but is limited to offerings of securities for cash.

Although the preliminary prospectus included in the registration statement when it becomes effective must include an estimate of the amount of securities to be offered and the expected price range, any deviations with respect to volume or price will require the filing of a post-effective amended registration statement only if either (i) the aggregate offering price of the offered securities exceeds the specified maximum or (ii) the aggregate offering price of the offered securities is more than 20% lower than the specified maximum and the reductions in volume and/or price giving rise to such lower aggregate offering price would result in a material change in the disclosure contained in the registration statement previously declared effective. *See* General Instructions of Forms S-1, S-3, S-11, F-1 and F-3; Instruction to Rule 430A(a) and Rule 457(o) under the Securities Act. Moreover, if the aggregate offering price of the securities offered exceeds the specified maximum by less than 20%, the required amendment to increase the size of the offering may be accomplished by means of a short-form registration statement that will be effective immediately upon filing. *See* General Instructions to Forms S-1, S-3, S-11, F-1 and F-3; Rule 462(b) under the Securities Act.

84 Rule 159 under the Securities Act, which focuses for liability purposes under §12(a)(2) of the Securities Act on the information conveyed to investors at or prior to the time of an investment decision. Whereas in the past updated disclosure about the issuer and any corrections to the preliminary prospectus would typically have been included in the final prospectus, such an approach is no longer sufficient as a result of adoption

of Rule 159 as part of the Securities Offering Reforms. The adoption of free writing prospectus procedures pursuant to the Securities Offering Reforms has greatly facilitated the ability of issuers and underwriters to address the disclosure liability structure provided by Rule 159, by simplifying the dissemination of updating information to investors prior to an investment decision to purchase the subject securities. *See* discussion of free writing prospectuses in § 3.02[3][c][iv].

85 *See* Rule 10b-10 under the Exchange Act.

86 For a further discussion of settlement in U.S. public offerings, *see infra* Note 489.

87 At a February 2011 conference, a member of the staff of the SEC Division of Corporation Finance stated that the staff understands that economic conditions have created challenges with pricing, and reviewers are trying to be sensitive and flexible. If a registrant wants extra flexibility in the range, it should provide an analysis of the economic conditions that support extra flexibility. It was stated that the staff has granted these requests when it has seen market trends to support them. SEC Filings Insight (CCH, Feb. 24, 2011).

88 A placeholder offering size, often $50 or $100 million, is typically included on the cover page of the registration statement in initial filings since an offering size is required to be included for the payment of fees. That offering size is typically revised in the amendment filed when a price range is added and any additional fees owed are then paid. Press coverage of initial filings sometimes mistakenly identifies the placeholder amount as the expected IPO offering size, although the market generally disregards such reports. First-time registrants had in the past sometimes been permitted to circulate a form of preliminary prospectus that contained information about the issuer, but did not indicate offering size or an estimated price range. The SEC staff, however, subsequently objected to the circulation of preliminary prospectuses that omit price ranges and they are no longer used in initial public offerings.

89 Rule 15c2-8(b) under the Exchange Act.

90 Section 5(b)(2) of the Securities Act.

91 Rule 424 under the Securities Act sets forth time periods for filing prospectuses that disclose information previously omitted or that constitutes a substantive change from or addition to information set forth in a prospectus. In general, Rule 424 provides that a form of prospectus that discloses information previously omitted from the prospectus filed as part of an effective registration statement in reliance on Rule 430A under the Securities Act shall be filed no later than the second business day following the earlier of the date of determination of the price and the date it is first used after effectiveness. Pursuant to Rule 430A, the form of prospectus filed as part of a registration statement for securities offered for cash that is declared effective may omit information with respect to the public offering price, underwriting (including underwriting terms and syndicate composition), underwriting discounts or commissions, amount of proceeds, conversion rates, call prices and other items dependent upon the offering price, delivery dates, and terms of the securities dependent upon the offering date. Pursuant to Rule 430A information omitted but timely filed under Rule 424 is deemed to be part of the registration statement as of the time it was declared effective.

92 Rule 172 under the Securities Act. The prior actual delivery requirement provided only illusory protection for investors because an investment decision had invariably been made, and settlement might have occurred, before the final prospectus reached the investor. Rule 159 is intended to ensure consideration of disclosure liability based on the disclosure record conveyed to the investor at the time of the investment decision. On the other hand, the need to prepare, print and deliver final prospectuses caused inordinate timing and logistical difficulties for issuers and underwriters. Moreover, the sanction for failing to deliver a final prospectus in accordance with the § 5 requirements is draconian and disproportionate—a strict liability right of rescission under § 12(a)(1) of the Securities Act as a result of the § 5 violation.

Rule 173 under the Securities Act requires that for each transaction involving a sale of securities that requires delivery of a final prospectus, each underwriter, broker or dealer participating in such offering (or if the sale is effected by the issuer and not an underwriter, broker or dealer, then the issuer) send to each purchaser, not later than two business days after the completion of the sale (*i.e.*, the closing of an offering), a copy of the final prospectus or, in lieu of the final prospectus, a notice providing that the sale was made pursuant to a registration statement. This notice typically is included in the confirmation of sale required by

Rule 10b-10 under the Exchange Act to be sent to each investor. Rule 173 also permits purchasers to request a physical copy of the final prospectus. Compliance with Rule 173 is not a condition to the exemption from final prospectus delivery under Rule 172, and thus noncompliance with Rule 173 will not result in a violation of § 5 of the Securities Act.

93 Allotment securities include securities acquired in stabilization activities or in an uninterrupted chain of transactions between dealers (as well as securities acquired directly from the issuer or any selling securityholder).

94 As is the case with underwriters, dealers with a prospectus delivery requirement are required to comply with the notice provisions of Rule 173. *See supra* Note 92.

95 *See* April 2000 Release; SEC Release No. 33-7289 (May 9, 1996); SEC Release No. 33-7233 (Oct. 6, 1995) (the "October 1995 Release"). The SEC continues to express concerns as to whether Internet access is sufficiently universal that delivery should be deemed accomplished solely by an issuer's posting a document on the issuer's or a third party's website.

96 The SEC has adopted an "access-equals-delivery" model for delivery of final prospectuses and adopted a "notice-and-access" model for delivery of proxy material; *see supra* Note 92 and accompanying text and § 4.02[3][c][v]; *see also* SEC Release No. 34-55146 (Jan. 22, 2007).

97 Evidence of actual receipt of documents in electronic form can be shown, for example, by an investor's obtaining a different document through a hyperlink from the required document, by an investor's use of forms or other material available only by viewing the required document or by records generated by a system with the capacity to track which users accessed, printed or downloaded those documents.

98 It should be emphasized that general consent to delivery, discussed below, which may be given in advance, does not obviate the need to meet the notice requirement, which requires specific notice of the availability of the required document.

99 For example, documents may be delivered to investors in portable document format ("PDF"), provided investors are informed of the hardware requirements necessary to download PDF files at the time consent to electronic delivery is obtained and are furnished with the required software and technical assistance at no additional cost. PDF is a graphic representation of text provided in a form that cannot be manipulated with word-processing programs. While the SEC has allowed the use of hypertext markup language ("HTML") for EDGAR filings, issuers are still not permitted to file through EDGAR in PDF format, although they may accompany required filings with unofficial copies in PDF format. April 2000 Release.

100 October 1995 Release.

101 October 1995 Release. In the case of a continuous offering, the prospectus should remain available for as long as the issuer will rely on its delivery through the electronic system.

102 October 1995 Release.

103 *See* April 2000 Release. Issuers and broker-dealers may rely on householding (delivery of one document where multiple investors share an address) for prospectus delivery where investors share an electronic address. *See* Rule 154(d) under the Securities Act. However, issuers cannot rely on householding for electronic delivery of proxy material, because Rule 14a-3(e)(1)(ii)(B)(4) under the Exchange Act requires delivery of the relevant document to a post office box or residential street address.

104 Provision of the consent should not be a condition for opening a brokerage account, except in the case of an online-only brokerage firm.

105 SEC Release No. 33-8027 (Oct. 25, 2001) (order declaring registration statement effective); *see also* SEC Release No. 33-8028 (Oct. 25, 2001) (statements of the SEC Commissioners). The importance of this development is highlighted by the fact that the SEC itself, rather than the staff of the SEC, declared the registration statement effective. The staff would normally take this action.

106 The decision was split two to one with a strong dissent filed by then-Commissioner Hunt. Then-Commissioner Hunt expressed concern that American Life would not be providing separate advance notice to investors in connection with website postings. He argued that this SEC decision was "not consistent with

the protection of investors" and exposed investors to significant losses from fraudulent transactions or material changes in the terms of their annuity contracts.

He concluded his dissent by urging the SEC to seek public comment before expanding its decision with respect to this offering.

107 Issuers of annuities and mutual funds are required to update and deliver prospectuses on a more frequent basis than would be required of issuers of other securities as a result of the frequency of changes to the securities underlying these instruments and the ongoing nature of the sales of these instruments by the issuers thereof. This makes the possibility of electronic delivery of required materials particularly relevant to issuers of annuities and mutual funds.

108 Electronic Signatures in Global and National Commerce Act, Pub. L. No. 106-229, 114 Stat. 464 (1999) (codified at 15 U.S.C. §§ 7001–31). This act seeks to promote electronic commerce by providing a consistent national framework for the validity and enforceability of electronic signatures and transactions. With respect to information regarding a transaction that, pursuant to applicable laws or regulations, must be provided to a consumer in writing, the act sets forth conditions that must be satisfied in order for electronic delivery of such information to satisfy the delivery requirements of the applicable law or regulation. The act, for example, sets forth requirements regarding consumer consent to electronic delivery, the right of a consumer to withdraw such consent, the right of a consumer to receive paper copies of electronic records and a consumer's ability to access and retain records that have been delivered electronically.

109 *See* § 3.02[3][c][iv].

110 *But see* § 4.05[2] for a discussion of Item 8 of Form 20-F, which requires that financial statements not be older than a specified period prior to the commencement of an offering and thus effectively imposes certain limitations on when offers may be made off the shelves of foreign companies.

111 Rule 415(1)(a)(x) under the Securities Act. For a discussion of the eligibility requirements of Form F-3, *see* § 3.02[1][b]. Shelf registration is also permitted for continuous offerings by issuers not eligible to use Form F-3 and might therefore be used in connection with continuous offerings such as medium-term note programs by such issuers. Rule 415(a)(1)(ix) under the Securities Act. Such offerings must be "continuous" and not merely "delayed." The updating requirements for registration statements and prospectuses of issuers filing on Form F-1, however, make such an approach cumbersome and difficult.

112 *See* Rule 415(a)(i) under the Securities Act.

113 For seasoned issuers that are not WKSIs, the SEC will permit offers and sales of securities from the old registration statement to be made up to six months after the third anniversary of effectiveness, if a replacement registration statement has been filed but not yet become effective. Rule 415(a)(5)(ii) under the Securities Act. For WKSIs, when an existing shelf registration statement is replaced by a new automatic shelf registration statement, there is no extension of the effectiveness of the registration statement that is being replaced because there is no delay in effectiveness of the replacement registration statement.

114 *See* Rule 457(p) under the Securities Act.

115 Excluding offerings by the registrant's parent or subsidiaries. *See* Rule 415(a)(x) under the Securities Act.

116 *See* Rule 415(a)(5) under the Securities Act. Automatic shelf registration is discussed in § 3.02[2][c].

117 Unallocated shelf procedures have been available to foreign issuers since 1994 (SEC Release No. 33-7053 (Apr. 19, 1994)) but were first made available to U.S. issuers in 1992 (SEC Release No. 33-6964 (Oct. 22, 1992)). Prior to the adoption of unallocated shelf procedures, the shelf registration rules required registration of a specified amount of securities of a given class.

118 *See* § 3.02[4] (discussing the portion of a global offering that includes a U.S. public component that must be registered with the SEC).

119 *See* § 3.02[2][c].

120 *See* § 3.05[4].

121 If omitted information that relates to the terms of the offering, the securities, the plan of distribution or any selling securityholders (as opposed to issuer-related information) is included in an Exchange Act filing, a

prospectus supplement must nonetheless be filed disclosing the specific Exchange Act report or reports in which the information is contained.

122 The Securities Offering Reform Release makes clear that the date of first use is not the date the prospectus supplement is given to a purchaser in connection with a sale, but instead the date the prospectus is first available to an underwriter or any prospective purchaser. *See* Securities Offering Reform Release, 70 Fed. Reg. 44,722, 44,773 (Aug. 3, 2005).

123 Supplements as to which this provision applies include those filed in connection with delayed primary offerings and those containing information regarding selling securityholders omitted from the registration statement. Rule 430B(f)(1) under the Securities Act.

124 Establishing a new effective date will not affect the information that was in the registration statement at the time of any prior sale, and the rights of an investor in a prior sale (with a previous effective date) will remain unaffected by subsequently filed prospectus supplements or Exchange Act reports. The new effective date of the registration statement would not be considered the filing of a new registration statement for purposes of form eligibility.

125 Instead, the effective date would be the date of the issuer's most recent annual report (which updates the prospectus for purposes of § 10(a)(3)) of the Securities Act or, if later, the date that the relevant shelf registration statement initially became effective.

126 For an MTN program, incorporation by reference can be particularly useful as a means of avoiding the cost of preparing and printing a new prospectus supplement each time there is a need to disclose recent developments.

127 Rule 424(b)(2) requires that in any shelf takedown under Rule 415(a)(1)(x), any "information previously omitted" from the prospectus filed with the registration statement under Rule 430B—including MTN final pricing information—must be filed no later than two business days after pricing.

128 *See* § 3.05[1].

129 SEC Release No. 33-6240 (Sept. 10, 1980); SEC Release No. 33-6424 (Sept. 2, 1982). Certain aspects of shelf registration applicable to a Schedule B issuer differ from those applicable to a foreign private issuer, but the procedures are generally the same. *See* Edward F. Greene & Ronald Adee, *The Securities of Foreign Governments, Political Subdivisions and Multinational Organizations*, 10 N.C. J. INT'L L. & COM. REG. 1 (1985); Guy P. Lander, U.S. Securities Law for International Financial Transactions and Capital Markets, 114 U.S. Sec. Law for Financial Trans. § 4:18 (2d ed.) (updated Dec. 2015).

130 *See New South Wales* (avail. Sept. 15, 2009).

131 *See* § 3.02[3][a][ii] for a discussion of WKSIs.

132 Automatic shelf registration cannot be used in connection with business combination transactions or exchange offers on Form S-4 or F-4.

133 Issuers may still avail themselves of the SEC's "novel and unique" process providing for review, upon request and prior to offering, of new securities that may raise substantial regulatory issues. *See* Securities Offering Reform, 70 Fed. Reg. 44,722, 44,781 n.538 (Aug. 3, 2005).

The automatic shelf registration procedures do not allow a WKSI to delay the effectiveness of its automatic shelf registration statement. Instead, the WKSI may use any registration statement form for which it is eligible and, if it uses Form S-3 or F-3, can indicate that it is not an automatic shelf registration statement in order not to go effective immediately. If a WKSI does not use an automatic shelf registration, however, it will not be able to avail itself of the liberalized rules applicable to automatic shelf registration.

134 If the SEC later notifies a WKSI that the use of the automatic shelf registration statement was improper, securities sold prior to such notification will not be deemed to have been sold in violation of § 5 of the Securities Act, and ongoing offerings may continue pending effectiveness of a post-effective amendment or a new registration statement, provided that such offering is permitted by the post-effective amendment or new registration statement. *See* Rule 401(g)(2) under Securities Act.

If an issuer that was a WKSI at the time of initial filing of an automatic shelf registration statement is no longer a WKSI eligible to use an automatic shelf registration statement at the time of the filing of its most recent annual report on Form 10-K or 20-F, it will have to either post-effectively amend its registration statement onto the form it is eligible to use or file a new registration statement. An offering that is ongoing at such time can continue until a post-effective amendment is filed, or where appropriate a new registration statement is timely filed and declared effective, provided that such offering is permitted by the post-effective amendment or new registration statement. To be considered timely, the post-effective amendment or new registration statement would have to be filed within 120 days after the issuer's most recent fiscal year-end.

135 As discussed in § 3.02[2][b], if information that relates to the terms of the offering, the securities, the plan of distribution or any selling securityholders (as opposed to issuer-related information) omitted from the base prospectus is included in an Exchange Act filing, a prospectus supplement must be prepared and filed under Rule 424 under the Securities Act identifying the specific Exchange Act report or reports containing such information.

136 An issuer may include in its registration statement securities to be issued by certain of its majority-owned subsidiaries, including securities (i) that are issued by subsidiaries that are themselves WKSIs, (ii) that are nonconvertible securities, other than common equity, that the parent has fully guaranteed, (iii) that are guarantees of nonconvertible securities, other than common equity, of the parent or another majority-owned subsidiary that is guaranteed by the parent, and (iv) that are nonconvertible securities, other than common equity, of a wholly-owned subsidiary. An issuer may also include in its registration statement securities to be sold by selling securityholders. *See* Form F-3, Instruction I.C.

137 This flexibility is unique to automatic shelf registration statements. Requiring post-effective amendments for these additions is intended to ensure that new issuers and their officers and directors become signatories to the registration statement and that all information, opinions and consents are provided in the registration statement, and for purposes of qualification of any debt securities being added to the registration statement for purposes of the Trust Indenture Act. The Securities Offering Reform Release notes that for automatic shelf registration statements the SEC will permit qualification of a trust indenture at the time of filing of a post-effective amendment adding the related debt securities to the registration statement, whereas for other shelf registration statements the SEC staff will continue to take the view that an indenture must be qualified when the related registration statement first becomes effective.

138 *See* clause (1)(B)(2) of the definition of "Well-known seasoned issuer" in Rule 405 under the Securities Act.

139 Fees deposited in the SEC's "lockbox account" to be withdrawn on a pay-as-you-go basis, as opposed to fees paid in advance in connection with the filing of a registration statement, will be applied based on the fee schedule in effect at the time they are used in connection with a takedown.

140 *See* § 3.02[1][a].

141 *See supra* Note 43 and related text for the definition of "offer."

142 For example, the SEC observes in the Securities Offering Reform Release that the current regulatory system has led to the practice of marketing securities through road show presentations that have not been open to retail investors generally. As a result, small investors generally have not had the same access to information as larger investors.

143 Under the Securities Offering Reforms, limitations on communications disseminated at any time during the offering process have been eliminated for WKSIs, although written communications that qualify as a "free writing prospectus" are in some cases required to be filed. *See* the discussion of free writing prospectuses in § 3.02[3][c][iv].

144 The public float test applies to "voting and nonvoting common equity." In the context of Form F-3 eligibility, this language has in the past presented a problem for some foreign private issuers whose most liquid class of equity is preferred stock. For example, for many Brazilian companies the most widely held and traded equity is a nonvoting preferred stock, which has historically been issued because local corporate law does not contemplate nonvoting common stock. The SEC staff has in the past informally taken the view that such securities could not be used in determining public float for purposes of Form F-3 eligibility. *See* SEC Release No. 33-7419 (May 8, 1997), 62 Fed. Reg. 26,386, 26,387 n.11 (May 14, 1997). In discussing how

public float is calculated, the Securities Offering Reform Release states that, for purposes of both WKSI status and Form F-3 eligibility, the SEC interprets "common equity" to include "a class of participating voting or nonvoting preferred stock of a foreign issuer where the issuance of the preferred stock results from requirements of the applicable foreign jurisdiction or market and where the class of preferred stock has liquidation or dividend preferences and other terms that cause it to be the substantial economic equivalent of a class of common stock." This language allows some foreign registrants to include a class of preferred stock in calculating public float, because (i) the original reason for issuing preferred stock rather than common stock was compliance with a limitation under foreign law, and (ii) the company can reasonably conclude that the preferences are immaterial to the market value of the stock.

145 The Securities Offering Reform Release makes clear that issuers may not include for purposes of the $1 billion test the principal amount of securities that were offered in registered exchange offers (principally as so-called "A/B exchange offers") because a "substantial portion of these offerings involve registered exchange offers of substantially identical securities for securities that were sold in private offerings." Securities Offering Reform, 70 Fed. Reg. 44,722, 44,728 (Aug. 3, 2005).

146 In calculating the $1 billion amount, an issuer generally may include the principal amount of any debt and the greater of the liquidation preference and par value of any nonconvertible preferred stock.

147 A parent issuer may include the aggregate principal amount of such securities issued by its majority-owned subsidiaries that the parent has fully guaranteed. A majority-owned subsidiary of a WKSI may also qualify as a WKSI if the subsidiary satisfies the WKSI criteria. Certain securities of a majority-owned subsidiary of a WKSI that is not itself a WKSI may also be included in a WKSI shelf registration statement. *See supra* Note 136.

148 The Securities Offering Reform Release provides that a seasoned issuer is an issuer that is eligible to use Form S-3 or Form F-3 to register primary offerings of securities pursuant to General Instruction I.B.1 of such Forms or is registering securities in reliance on General Instruction I.B.2, I.B.5, or I.C. of Form S-3 or General Instruction I.A.5 or I.B.2 of Form F-3. The Securities Offering Reforms expanded the majority-owned subsidiary eligibility provisions in Forms S-3 and F-3 to allow majority-owned subsidiaries to use these forms under the same circumstances in which majority-owned subsidiaries may be WKSIs. Asset-backed securities issuers offering securities registered on Form S-3 are also considered seasoned issuers but cannot qualify for WKSI status.

149 Foreign governments (or political subdivisions of foreign governments) that register securities on Schedule B are ineligible to use Form S-3 or F-3. As a result, Schedule B issuers cannot satisfy the WKSI criteria and do not benefit from the communications reforms for WKSIs. While the reforms applicable to seasoned issuers do not by their terms apply to foreign governmental issuers filing on Schedule B under the Securities Act, the original shelf registration rules also did not apply to these issuers. A shelf registration process was later extended to such foreign governmental issuers by interpretation by the SEC's Division of Corporation Finance. Steps to extend the benefits of the communication reforms applicable to WKSIs have yet to be taken by the SEC or the Division.

150 *See* Rule 164 under the Securities Act. In addition, Rule 164 excludes investment companies and business development companies, which are subject to a separate framework governing communications, from using free writing prospectuses. *See* Securities Offering Reform Release.

151 Failure to timely file will not by itself result in an issuer being ineligible to use a free writing prospectus, if the issuer is current at the time of determination of ineligible issuer status.

152 *See* Form S-3, General Instruction I.A.3(b)

153 Ineligibility due to bankruptcy proceedings will terminate once the issuer has filed an annual report with audited financial statements subsequent to its emergence from such proceedings.

154 The "was at the time a subsidiary of an issuer" provision is intended to address concerns about a subsidiary that had been convicted of a felony or misdemeanor described in § 15(b)(4)(B) of the Exchange Act prior to its acquisition disqualifying the acquiring issuer from WKSI eligibility.

155 There is a waiver provision that enables the SEC to waive an issuer's ineligibility if the SEC determines,

upon the "showing of good cause," that it is not necessary to categorize such issuer as an ineligible issuer. Rule 405 under the Securities Act. This authority has been delegated to the Division of Corporation Finance. *See*, *e.g.*, *In the Matter of Tenet Healthcare Corporation* (avail. Apr. 19, 2007) (granting relief from being considered an "ineligible issuer" in connection with a consent decree entered for alleged violations of antifraud provisions of the federal securities laws). In July 2011, the Division of Corporation Finance issued guidance regarding the factors it would consider when granting a waiver and, in March 2014, it updated this guidance. SEC, Division of Corporation Finance, Statement on Well-Known Seasoned Issuer Waivers (July 8, 2011), Revised Statement on Well-Known Seasoned Issuer Waivers (Mar. 12, 2014). Waivers will only be granted if a finding is made that such waiver is consistent with the public interest and the protection of investors. The Division of Corporation Finance's inquiry focuses on whether the conduct involved a criminal conviction or scienter-based violation and whether the violation relates to the issuer's own disclosure about itself or calls into question the issuer's current and future disclosure. If the violation does not involve the issuer's own disclosure, a waiver request is more likely to be granted, even if the violation was intentional or reckless. If the antifraud violation involves the issuer's own disclosure but is not intentional or reckless, the following additional factors will be considered: (i) any remedial steps taken by the issuer, (ii) the pervasiveness and timing of the misconduct, and (iii) the impact on the issuer (and the market as a whole) if the waiver request is denied. A waiver may include conditions or undertakings.

In 2009, the SEC released a Compliance & Disclosure Interpretation ("C&DI") in which it explained how an issuer may continue to offer securities off an automatic shelf registration statement if the issuer will no longer be a WKSI at the time of filing its next annual report on Form 10-K. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 198.06 (Jan. 26, 2009). In order to continue to offer and sell securities using its automatic shelf registration statement, the issuer must, prior to filing its next annual report on Form 10-K, amend the automatic shelf registration statement so that it conforms to the requirements that apply to a nonautomatic Form S-3. Specifically, (i) the issuer must file a post-effective amendment to the automatic shelf registration statement prior to filing the Form 10-K to register a specific amount of securities and to pay the associated filing fee, (ii) the prospectus included in the post-effective amendment to the automatic shelf registration statement may not omit information in reliance on provisions of Rule 430B that are available only to automatic shelf registration statements and instead must contain all information required to be included in a Form S-3, and (iii) the issuer must remain eligible to use Form S-3 at the time of the filing of the Form 10-K. Promptly after filing the Form 10-K, the issuer must file either a post-effective amendment or a new Form S-3 registration statement to convert the prior automatic Form S-3 to a nonautomatic shelf registration statement, which must be declared effective by the SEC staff. Pending effectiveness, the issuer may continue to offer and sell securities using the amended automatic shelf registration statement. Similar procedures apply for foreign private issuers with respect to their Form 20-F and F-3 filings.

156 Rule 164(h) under the Securities Act. Rule 164 also provides that an offering participant other than the issuer benefits from the issuer's status if it has a reasonable belief that the issuer is not an ineligible issuer.

157 Information is released or disseminated by or on behalf of an issuer if the issuer or an agent or representative, other than an offering participant who is an underwriter or dealer, authorizes the communication or approves the release or dissemination before it is made. Rule 168(b)(3) under the Securities Act.

158 *See* Securities Offering Reform Release, 70 Fed. Reg. 44,722, 44,735 n.122 (Aug. 3, 2005).

159 In recognition that foreign issuers that are public companies in other markets though not in the United States regularly disclose factual business information in those other markets, the SEC provided that, for this purpose, reporting issuers include foreign private issuers that (i) meet all of the requirements for eligibility to use Form F-3 other than the reporting history provisions, (ii) satisfy the public float threshold of Form F-3, and (iii) either have had their equity securities traded on a designated offshore securities market for at least 12 months or have a worldwide market value of their outstanding common equity held by nonaffiliates of at least $700 million. The public float requirement is not applicable if at least one class of the issuer's common equity is listed on a national securities exchange and it does not sell more than one third of its public float

over the 12-month period to the date the registrant seeks to rely on the Rule 168 safe harbor.

160 Factual business information that reporting issuers release or disseminate is subject to the applicable requirements of Regulation FD, Regulation G, Item 10 of Regulation S-K and Item 2.02 of Form 8-K. *See* § 4.10[6].

161 The Securities Offering Reform Release clarifies that a customer also may be a potential investor and that the information may be received by other people without affecting the availability of the safe harbor so long as the other conditions of the safe harbor are satisfied.

162 The Securities Offering Reform Release states that releasing a new type of financial information shortly before a registered offering might well be outside the safe harbor. Similarly, if an issuer consistently released certain factual business information on a quarterly basis through ordinary course press releases, it could not satisfy the condition if it instituted an accelerated media campaign right before or during an offering to release that type of factual business information on a different basis or with different timing. Nonetheless, the Securities Offering Reform Release makes clear that "regularly released" does not necessarily pertain only to scheduled releases of information but can also pertain to episodic communications, such as a change in earnings guidance, so long as the issuer has previously provided these communications in that manner. In these situations, the nature of the event triggering the communication will be taken into account.

Issuers also look to apply the safe harbor in Rule 168 when speaking or otherwise publicly participating in industry conferences, where similar level executives have participated in the same or similar conferences in prior periods and that the scope of the discussion will be of similar factual business information. Similarly, the safe harbor in Rule 168 is sometimes relied on to permit certain nondeal road shows, meetings by an issuer with an institutional investor outside an offering context. However, in cases where an offering is planned immediately after participation at a conference or a nondeal road show meeting, careful analysis is necessary to determine whether the safe harbor applies or whether the presentation may be an offer (which may itself be a permissible offer).

163 For example, although an issuer would be able to rely on the safe harbor for an earnings release published consistent with past practice, the Rule 168 safe harbor does not apply to the use of an earnings release by an offering participant as part of the marketing materials to potential investors in the registered offering.

164 *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 256.25 (Aug. 6, 2015).

165 In order to take advantage of the safe harbor for offshore offerings under Regulation S under the Securities Act, an issuer must avoid "directed selling efforts," including the publication of certain advertisements regarding the offering in a publication with a general circulation in the United States. *See* the discussion of directed selling efforts under Regulation S in § 8.02[1][b]. By analogy, if a foreign company avoids "directed selling efforts" in connection with a registered offering, the SEC should not consider the company's activities in its home market to be acts of gun-jumping.

166 The EU prospectus regime, which aims to bring greater regulatory uniformity in Europe to the levels of publicity in the context of offerings and listings of securities, permits an advertisement of a public offering, or admission to trading on a regulated market, of securities within the EU if the advertisement (i) states that a prospectus has been or will be published (and indicates where investors are or will be able to obtain it) and (ii) is clearly recognizable as such, and not inaccurate, misleading or inconsistent with the prospectus.

167 *See* § 11.03[2]. In certain offerings in the United Kingdom, issuers have also sought to encourage investors to purchase shares by offering them bonus shares or vouchers for free services in connection with purchases of minimum numbers of shares. Although U.S. issuers have not generally offered such premiums, similar incentives could be utilized in public offerings in the United States. In a U.S. offering, the Securities Act registration statement would have to disclose the incentives' terms and effect on the share offering and net proceeds. Under § 10(b) of the Exchange Act and § 17 of the Securities Act, it would be unlawful to use such incentives in a fraudulent or deceptive manner. *See* § 11.04[2] and [3].

168 *See*, *e.g.*, § 27A of the Securities Act (providing a safe harbor for certain forward-looking statements) and

Item 303 of Regulation S-K under the Securities Act (requiring forward-looking disclosure about known material trends and uncertainties).

169 In recognition that foreign issuers that are not public in the United States may be public companies in other markets, this safe harbor also is available for certain non-reporting foreign private issuers as described in *supra* Note 159. It is otherwise not available to non-reporting issuers.

170 Regulation FD, Regulation G, Item 10 of Regulation S-K and Item 2.02 of Form 8-K apply to this dissemination of forward-looking information. *See* § 4.10[6].

171 *See* § 3.02[3][b][iv].

172 In 1995, the SEC proposed a rule under which eligible issuers would have been permitted to "test the waters" for a U.S.-registered IPO—that is, to solicit indications of interest from potential investors prior to the filing of any Securities Act registration statement—without being deemed to have "offered" securities for sale in violation of § 5 of the Securities Act. SEC Release No. 33-7188 (June 27, 1995). This would have allowed companies to gauge investor interest before incurring the significant expense of preparing the disclosure documents required for a registered IPO. This proposal was superseded (and substantially narrowed) by an SEC proposal in the Aircraft Carrier Release, SEC Release No. 33-7606 (Nov. 3, 1998), as amended by SEC Release No. 33-7606A (Nov. 13, 1998), that, after some modification, was adopted in 2001 as Rule 155(b) under the Securities Act and permits an issuer to switch from a private placement to a public offering in certain circumstances and provided that certain requirements are satisfied. *See* § 7.02[6].

173 Rule 163A defines "by or on behalf of" an issuer as any communication authorized or approved by an agent or representative of the issuer (other than an offering participant who is an underwriter or a dealer) before the communication is made.

174 For example, the SEC indicates in the Securities Offering Reform Release that if an issuer or its representative gave an interview to the press prior to the 30-day period, the issuer may not be able to rely on the safe harbor if the interview was published during the 30-day period.

The safe harbor is not available to communications relating to certain business combination transactions; offerings registered on Form S-8 (unless the issuer is a WKSI); offerings by issuers that are or were during the past three years blank check, shell or penny stock companies; or communications by issuers that are investment companies or business development companies. Communications falling within the safe harbor are subject to Regulation FD, other disclosure requirements and the antifraud provisions of the federal securities laws.

Communications made outside the 30-day period would not be an "offer" for purposes of § 5(c) of the Securities Act, but such communications are not excluded from the definition of offer for other purposes under the Securities Act, including the definition of "prospectus" in § 2(a)(10) of the Securities Act. Accordingly, while not "offers," communications made outside the 30-day period are subject to disclosure liability under § 12(a)(2) of the Securities Act, which could give purchasers a right to rescind their purchases. A private action under Rule 10b-5 under the Exchange Act would also entitle the plaintiff to recover damages, but a successful action would require the plaintiff to prove the communication contained a false statement or omission made with scienter (that is, an intent to deceive, manipulate or defraud). *See* §§ 11.03[2] and 11.04[2].

175 Rule 135 under the Securities Act. Only the issuer or a selling securityholder (and any person acting on behalf of either of them) may make such an announcement. Rule 135 permits the disclosure of certain additional information in the context of rights offerings, offerings to employees, exchange offers and offerings made under Rule 145(a) under the Securities Act.

176 In the case of an international offering by a foreign issuer, Rule 135e under the Securities Act permits the names of the underwriters (and other information) to be included in a press release outside the United States, and thus as a practical matter the market is informed of the identity of the underwriters. For a discussion of Rule 135e, *see* § 3.02[3][e][vii].

177 *See* Rule 163(c) under the Securities Act. In December 2009, the SEC proposed amendments to Rule 163(c) that would have broadened this exemption. Under the proposed changes, communications made by

underwriters and dealers, and not just those made by issuers, would be covered by the exemption so long as certain conditions were met. The proposal was not adopted.

178 In light of the "automatic shelf registration" process for WKSIs, it was expected that in most cases WKSIs would take advantage of Securities Offering Reforms by having a registration statement on file and would rarely make such offers prior to filing a registration statement. In fact, however, a substantial percentage of WKSIs do not have automatic shelf registration statements on file or do not register common stock on them. WKSIs are permitted to distribute free writing prospectuses before filing a registration statement relating to the securities as long as the free writing prospectus contains a legend prescribed by the SEC regarding the issuer and information about where documents relating to the offering may be obtained upon filing of a registration statement. Such a free writing prospectus need only be filed when and if a registration statement or amendment covering the offered securities is filed. *See* § 3.02[3][c][iv][A] for a discussion of free writing prospectuses.

179 These pre-filing communications will also continue to be subject to the requirements of Regulation FD, since they will not qualify for Regulation FD's exemption for communications made in connection with a registered securities offering by the issuer. *See* § 4.10[6] for a discussion of Regulation FD.

180 *See* § 3.02[3][c][ii] for a discussion of nonbinding indications of interest in connection with "test the waters" communications.

181 SEC, Division of Corporation Finance, Generally Applicable Questions on Title I of the JOBS Act (Apr. 16, 2012), FAQ 3.

182 For a discussion on EGCs' ability to "test the waters" before and after filing of the registration statement, *see* §§ 3.02[3][b][iv] and [c][ii]. For a discussion on pre-deal research *see* § 3.02[3][e]. Deal road shows are considered part of the marketing, not premarketing stage, *see* § 3.02[3][c][iii][B].

183 Investor education initiatives are often supported by sales force presentations given by research analysts to sales personnel in anticipation of investor education, typically a day before investor education meetings begin.

184 *See* § 7.02[4] for a discussion of pilot fishing in the context of exempt private offerings.

185 *See* § 3.02[3][e][i] for a discussion of the use of pre-deal research outside the United States in the context of U.S. registered IPOs that are part of a global offering.

186 *See* § 7.02[6] for a discussion of concerns related to integration of private and public offerings and of Rule 155 under the Securities Act, which provides a nonexclusive safe harbor for a registered offering following an abandoned private offering and for a private offering following an abandoned registered offering.

187 The filing of a registration statement typically is viewed as a solicitation that would foreclose the availability of the exemption for private offerings under § 4(a)(2) of the Securities Act, except insofar as the issuer or its agent approaches prospective investors with which either has a substantive pre-existing relationship. *See* § 7.02[6].

188 EGCs may commence discussions with QIBs and institutional accredited investors prior to the filing or effectiveness of the registration statement and may deliver freely-tradable shares to them if they do not commit to purchase the securities prior to effectiveness of the registration statement.

189 Although the securities offered to cornerstone investors are generally not part of the registered offering, disclosure of a cornerstone investor should be considered in light of the policy underlying Item 9.B.3. of Form 20-F, which requires an issuer to identify any group of targeted potential investors to whom the securities are offered. *See also* Form F-1, Item 7, which requires disclosure of recent sales of unregistered securities.

190 Offering participants might conclude that an anchor investor should be identified because its ownership position will be material to investors following the offering. Absent such a determination, we do not believe the requirement in Item 9.B.2 of Form 20-F to disclose that a prospective investor intends to purchase more than 5% of the offering should dictate disclosure, since such disclosure is not required of a domestic issuer.

191 The term "oral" is not defined in the Securities Act or the SEC's rules, but the term "written" is defined very

broadly in § 2(a)(9) of the Securities Act to include, among other modes of communication, "graphic communication," which in turn is defined in Rule 405 under the Securities Act. Essentially, any communication other than an in-person or telephonic communication (not in any way preserved for retransmission) will be treated as a written communication. Materials, including slide presentations, that accompany a nonrecorded, in person or telephonic communication are not considered written communications as long as they are not retained by investors or otherwise able to be printed or saved after the time of the communication.

192 A WKSI that communicated information that constituted an offer (*i.e.*, a free writing prospectus) prior to filing a registration statement would rely on Rule 163 under the Securities Act rather than Rule 134 to avoid a gun-jumping violation.

193 Rule 134 is available without regard to whether the statutory prospectus includes a price range, except in the case, such as an IPO, where a price range is required in a statutory prospectus circulated to investors, and where the Rule 134 communication includes pricing or related information. *See* Securities Offering Reform Release.

194 In July 2011, pursuant to § 939A of the Dodd-Frank Act, the SEC amended Rule 134 to remove the safe harbor for credit ratings assigned or expected to be assigned by a nationally recognized statistical rating organization ("NRSRO") to the applicable securities. *See* SEC Release No. 33-9245 (July 27, 2011). The SEC noted that removing credit rating references from the Rule 134 safe harbor "would not necessarily result in a communication that included this information being deemed to be a prospectus or a free writing prospectus." *See* Securities Ratings, 76 Fed. Reg. 46,603, 46,612 (Aug. 3, 2011). However, the result would be that if the credit rating information were included, the entire communication would lose the safe harbor's protection and need to be evaluated under more uncertain facts-and-circumstances criteria. Given the risks of such an exercise, especially in light of the relatively extensive and detailed offering-related information that a Rule 134 communication could otherwise contain, issuers and underwriters typically exclude rating information from deal-related press releases.

195 *See* § 3.02[3][e].

196 SEC, Division of Trading and Markets, Jumpstart Our Business Startup Act—Frequently Asked Questions About Research Analysts and Underwriters (Aug. 22, 2012), FAQ 1.

197 *See* § 3.02[3][b][v][A] for a discussion of premarketing during the quiet period and, more generally, of certain types of activities that constitute premarketing.

198 *See* § 3.02[3][c][iii][B] for a discussion of road shows, the principal type of marketing activity following launch.

199 *See* § 3.02[3][b][v][A] for a discussion of investor education generally and investor education meetings during the quiet period.

200 *See* § 3.02[3][b][v][A] for a discussion of pilot fishing generally and, in particular, to the limited extent permitted during the quiet period.

201 *See* § 3.02[3][e][vi] for a discussion of pre-deal research in respect of EGCs. *See* 3.02[3][e][ii], more generally, for a discussion of research reports in the context of U.S. registered offerings by U.S. reporting companies or seasoned foreign private issuers.

202 *See* § 3.02[3][e][i] for a discussion of the use of pre-deal research outside the United States in the context of U.S. registered IPOs that are part of a global offering.

203 Rule 433(h)(4) under the Securities Act defines a road show as "an offer (other than a statutory prospectus or a portion of a statutory prospectus filed as part of a registration statement) that contains a presentation regarding an offering by one or more members of the issuer's management … and includes discussion of one or more of the issuer, such management, and the securities being offered."

204 Rule 433(d)(8) under the Securities Act and Rule 405 under the Securities Act (excluding certain forms of communication from the definition of "graphic communication" and thus from the definition of "written communication").

205 Rule 433(d)(8)(i) under the Securities Act.

206 Rule 405 under the Securities Act.

207 Rule 405 under the Securities Act.

208 A *bona fide* electronic road show is a road show transmitted by graphic means that is a written communication and contains a presentation by some members of management and includes discussion of the issuer, management or securities being offered, and, if more than one road show that is a written communication is used, covers the same general areas as in the other versions. The *bona fide* electronic road show need not: (i) cover the exact same material as in the other versions; (ii) have the same management present; (iii) include all projections contained in the other versions; or (iv) provide for Q&As. If there is more than one version of the road show that is a written communication, the *bona fide* electronic road show must be made available no later than the other versions. Rule 433(d)(8)(ii) under the Securities Act.

209 *See* § 11.03[2] discussing liability under § 12(a)(2) of the Securities Act and § 11.04[2] discussing liability under Rule 10b-5 under the Exchange Act. Liability under § 11 of the Securities Act does not apply to a road show, unless it is explicitly incorporated by reference into the registration statement, which would be very unusual.

210 However, liability concerns have substantially limited the use of free writing prospectuses that could be construed as having a marketing purpose, and free writing prospectuses have been used most often to describe the terms of offered securities and the offering and occasionally to communicate late-breaking developments.

211 A written communication constituting an offer circulated at the same time as or after delivery of a final prospectus (such as sales confirms)—a so-called “free writing—does not constitute a prospectus under the Securities Act. These communications would not be subject to the rules governing free writing prospectuses. In addition, Rule 134 notices, Rule 135 communications, regularly released factual business information and forward-looking information falling within Rules 168 and 169, and research reports satisfying the requirements of Rule 137, Rule 138 or Rule 139 under the Securities Act, do not constitute free writing prospectuses because they are by rule not offers or prospectuses for purposes of the gun-jumping provisions.

212 Rule 433(h)(3) under the Securities Act defines a written communication or information as prepared or provided "by or on behalf of" a person if the person or agent or representative of the person authorizes the communication or information or approves the communication or information before it is used. Rule 433(h)(3) also makes clear that an offering participant will not be an agent or representative of the issuer solely by virtue of its acting as an offering participant.

213 For a discussion of "ineligible" issuers, *see* § 3.02[3][a][ii]. In addition, Rule 164 excludes investment companies and business development companies, which are subject to a separate framework governing communications, from using free writing prospectuses.

214 WKSIs are permitted to use free writing prospectuses prior to the filing of a registration statement pursuant to Rule 163 under the Securities Act. *See* § 3.02[3][b][iv].

215 Rule 164(e)(ii) under the Securities Act.

216 The required legend indicates how to obtain a prospectus and recommends that potential investors read the prospectus (including Exchange Act documents incorporated by reference). The legend also advises investors that they can obtain the registration statement, including the prospectus and any incorporated Exchange Act documents, through the SEC's website, and that they may request the prospectus from the issuer or any underwriter or dealer by calling a toll-free number. The legend may be a generic one with a toll-free number of the underwriter (or the issuer) for an investor to call to obtain the prospectus.

Disclaimers of responsibility or liability that would be impermissible in a statutory prospectus or registration statement would also be impermissible in free writing prospectuses (*e.g.*, disclaimers regarding accuracy or completeness or that the communication is not a prospectus).

217 Rule 433 requires issuers and offering participants to retain for three years any free writing prospectus used from the date of the initial *bona fide* offering of the securities, but only if the free writing prospectus was not filed with the SEC.

In order to ensure sufficient oversight of the content and usage of a free writing prospectus, Rule 418(a)(8) gives the SEC authority to request production of any free writing prospectus used in connection with an offering.

218 Rule 164 provides, under certain circumstances, a cure provision for failures to file a free writing prospectus, to include the required legend or to comply with the record retention requirements. *See* § 3.02[3][c][iv][C].

219 *See* §§ 11.03[2], 11.04[1] and 11.04[2] for a discussion of the liability standards under § 12(a)(2) of the Securities Act and Rule 10b-5 under the Exchange Act.

220 Rule 433(c)(2)(i) under the Securities Act.

221 As a result, in practice, a free writing prospectus could be used in an offering by a non-reporting or unseasoned issuer without prior or concurrent delivery of a statutory prospectus only in the case of a free writing prospectus published or disseminated by the media as to which neither the issuer nor an offering participant provided consideration for such publication or dissemination. The delivery or availability condition also applies if consideration has been or will be given by the issuer or an offering participant for the dissemination (in any format) of the free writing prospectus or § 17(b) of the Securities Act requires disclosure that consideration has been or will be given by the issuer or any offering participant in connection with the free writing prospectus. Section 17(b) requires disclosure of consideration received or to be received from an issuer, underwriter or dealer for the circulation or publication of a communication describing a security, even if the communication purports not to offer a security for sale.

222 *See* SEC Release No. 33-7856 (Apr. 28, 2000) for the prior guidance.

223 The date of "first use" is the date the free writing prospectus is available to the managing underwriter, syndicate member or any prospective purchaser—not when an underwriter first delivers it to investors.

224 This condition only requires that the issuer information contained in the free writing prospectus be filed and not necessarily the free writing prospectus itself.

225 Most issuers, even if they are ineligible issuers, are permitted to use free writing prospectuses that consist solely of descriptions of the terms of the securities or the offering pursuant to Rule 164. Although a free writing prospectus that contains the final terms of an offering benefits from a later filing deadline, a free writing prospectus that also contains other information that if distributed separately from the final terms would be required to be filed no later than the date of its first use will not benefit from the later filing deadline— *i.e.*, it cannot "piggyback" on the later filing deadline for a free writing prospectus containing only the final terms.

226 The conditions to be met in Rule 433 are (i) the free writing prospectus is filed in accordance with Rule 425 (including the filing timeframe), (ii) the material filed pursuant to Rule 425 indicates on the cover page that it is also being filed pursuant to Rule 433 and (iii) the material filed pursuant to Rule 425 includes the legend required by Rule 433.

227 For example, this filing condition would be triggered where an underwriter included a free writing prospectus on an unrestricted website or sent out a press release regarding the issuer or the offering that would constitute a free writing prospectus. On the other hand, the Securities Offering Reform Release states that a free writing prospectus on a website with access restricted to an underwriter's investors or an e-mail by an underwriter to its customers that are potential investors, regardless of the number of such customers, will not require filing. If an issuer distributes a free writing prospectus prepared by an offering participant, however, the free writing prospectus would become an issuer free writing prospectus as a result of this distribution and require filing by the issuer.

228 Rule 164 does not provide a cure mechanism for failure to include a hyperlink to the statutory prospectus in an electronic free writing prospectus of an unseasoned or nonreporting issuer. Similarly, a free writing

prospectus that includes a hyperlink to a prospectus that does not contain a price range when required would constitute a § 5 violation.

229 There may be situations where it will not be clear how to communicate the proper legend to the same prospective purchasers because information as to recipients of the original unlegended communication is not available, in which case it will be necessary to err on the side of overinclusiveness.

230 Pursuant to Rule 433(f) under the Securities Act, an independently prepared media publication would be considered a free writing prospectus prepared on behalf of an issuer or any other offering participant if the issuer or any other offering participant (or any person acting on its behalf) provided, authorized or approved the information that is prepared and published or disseminated by a person that is in the business of publishing, radio or television broadcasting and is unaffiliated with the issuer or any other offering participant.

231 Rule 433(f) also provides that such a free writing prospectus (i) does not need to be filed if the substance of the free writing prospectus has previously been filed, and (ii) may include information that the issuer or offering participant reasonably believes is necessary or appropriate to correct information in the communication, and that the issuer or offering participant may file a copy of the materials provided to the media (so long as it contains all the information provided to the media) in lieu of filing the actual written communication as published or disseminated.

In cases where an issuer or other offering participant prepared, paid for or gave consideration for the preparation, publication or dissemination of or uses or refers to a published article, television or radio broadcast or advertisement, the issuer or other offering participant would have to satisfy the general conditions for use of the free writing prospectus at the time of publication. In other words, for non-reporting issuers and unseasoned issuers, a statutory prospectus would have to accompany or precede the communication, which would have the practical effect of prohibiting such issuers from publishing or broadcasting written advertisements, "infomercials" or broadcast spots that included information beyond that permitted by other safe harbors (*e.g.*, Rule 134). For seasoned issuers, the most recent statutory prospectus would have to be on file with the SEC and the issuer or offering participant would have to file the free writing prospectus no later than the date of first use.

Rule 433 also allows an issuer that is in the media business to be able to rely on the media condition if the issuer (i) is the publisher of a *bona fide* newspaper, magazine or business or financial publication of general and regular circulation, or a *bona fide* broadcaster of news, including business and financial news, (ii) has established policies and procedures for the independence of the content of the publications or broadcasts from the offering activities of the issuer, and (iii) publishes or broadcasts the communication in the ordinary course.

232 As a result, issuers and underwriters that use a free writing prospectus to convey the final terms of an offering to investors for Securities Act § 12(a)(2) purposes typically file both the free writing prospectus and a prospectus supplement that includes the same description of the final terms as the free writing prospectus (as well as any terms omitted from the free writing prospectus).

233 *See* § 4.10[6] for a discussion of Regulation FD.

234 Regulation FD provides that secondary offerings will be excluded from the regulation's requirements if the offering also includes a registered capital formation transaction for the account of the issuer. Regulation FD makes clear, however, that inclusion of a capital formation transaction for the account of the issuer as part of the offering for the purpose of evading the requirements of Regulation FD will not exclude the secondary portion from its requirements. The exclusion for registered business combination transactions remains available.

235 *See* § 4.10[6] for a discussion of Regulation FD.

236 *See* SEC Release No. 33-5180 (Aug. 16, 1971).

237 *See* § 3.02[1][e] for a discussion of the prospectus delivery requirement.

238 While arguably "publicity," so-called "bell ringing" ceremonies at the NYSE or Nasdaq are generally thought

to be permitted.

239 *See* discussion of Rules 168 and 169 under the Securities Act, which provide a nonexclusive safe harbor for certain factual and forward-looking information in § 3.02[3]a][iii].

240 For a discussion of a reporting issuer's ongoing communications with financial analysts and related disclosure issues, including the duty to correct or update previous communications, Regulation FD, selective disclosure to analysts and management participation in the preparation of analysts' reports, *see* § 4.10.

241 *See* § 14.07[5][b], which discusses limitations that both European and U.S. underwriters may impose on the distribution of pre-deal research in certain circumstances in light of the Global Research Settlement, as well as certain FINRA rules.

242 *See* § 3.01.

243 *See* § 3.02[3][b] and [c] for discussions of impermissible offers during the quiet period and waiting period, respectively. *See* § 3.02[3][e][vi] for a discussion of liability concerns in connection with the preparation and distribution of research reports.

244 If the lead managers of an offering determine that research should not be distributed in the United States, even in accordance with Rule 139 (as discussed below), this prohibition generally is imposed on all members of the syndicate to level the playing field and avoid any concern about imputed liability among the members. If an underwriter nonetheless distributes research in violation of the prohibition, the underwriter could well be expelled from the syndicate.

245 The 25-day period generally coincides with the 25-day period following an IPO registration statement effective date set forth in Rule 174(d) under the Securities Act during which broker-dealers must deliver a prospectus in connection with transactions in the IPO security. *See* § 3.02[1][e][i]

246 *See* § 3.02[3][e][vii] for a discussion on the distribution of research reports outside the United States in the context of global offerings. *See also infra* Note 266 for discussion of blackout periods with respect to research distributed other than in the context of IPOs.

247 Special difficulties may arise in connection with spin-offs and similar transactions involving the disposition by a parent company of some or all of the shares in a subsidiary or investee company. There will likely be some flexibility for the publishers of research reports about the parent (but not initiators of such coverage) to continue to reflect information about the subsidiary or investee in such research reports to the same degree as in the past, although special care will need to be taken with respect to potentially sensitive or material information about the subsidiary or investee or information about the spin-off or similar transaction.

248 Rule 139 under the Securities Act defines a research report as "a written communication, as defined in Rule 405 under the Securities Act, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision." Rule 139(d) under the Securities Act.

249 The issuer (or any of its its predecessors) must not be or have been during the preceding three years a shell company (other than a business combination related shell company), blank check company or penny stock issuer. Rule 139(a)(1)(ii).

250 *See* Rule 139(a)(1)(i)(B) under the Securities Act.

251 *See* Rule 139(a)(1)(iii) under the Securities Act. Rule 139 permits a broker or dealer participating in a distribution of securities to initiate coverage on a new class of an issuer's securities as long as research reports about the issuer or its securities, including a different class of securities, have been published or distributed previously or at least one such report has been distributed or published following the discontinuation of coverage.

252 The issuer (or any of its predecessors) must not be or have been during the preceding three years a shell company (other than a business combination related shell company), blank check company or penny stock issuer. Rule 139(a)(1)(iii) under the Securities Act.

253 Rule 139(a)(2) under the Securities Act. Rule 139(a)(2) also requires that any projections must:

- have been published previously on a regular basis;
- be included with respect to either a substantial number of companies in the issuer's industry or subindustry or substantially all companies covered in the report; and
- cover the same periods with respect to such other companies.

The industry research report may include a more favorable recommendation than the one included in the last report, provided the report contains "similar types of information about the issuer or its securities as contained in prior reports."

254 The issuer (or any of its predecessors) must not be or have been during the preceding three years a shell company (other than a business combination related shell company), blank check company or penny stock issuer. Rule 138(a)(4) under the Securities Act.

255 As with Rule 139 under the Securities Act, Rule 138 under the Securities Act defines a research report as "a written communication, as defined in Rule 405 under the Securities Act, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision." Rule 138(d) under the Securities Act.

256 Rule 138 under the Securities Act. Rule 138 is applied on an offer-by-offer basis for issuers that use the SEC's shelf registration procedures. Thus, having an effective shelf registration statement in place that covers both debt and equity (either allocated or unallocated) will not, in itself, preclude the availability of the rule. *See* SEC Release No. 33-7132 (Feb. 1, 1995).

257 Rule 138(a)(3) under the Securities Act. *See* § 3.02[3][e][iii].

258 Rule 137 under the Securities Act. As with Rules 138 and 139, Rule 137 defines a research report as "a written communication, as defined in Rule 405 under the Securities Act, that includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision." Rule 137(e) under the Securities Act.

259 In addition, the issuer (or any of its predecessors) of the securities being offered must not be (or have been during the preceding three years) a blank check company, a shell company (other than a business combination related shell company) or a penny stock issuer. Rule 137 under the Securities Act.

260 JOBS Act § 105.

261 Although distribution of research outside the United States in connection with an offering by a non-U.S. issuer should not raise issues under § 5 of the Securities Act, it does raise certain issues under Regulation M under the Exchange Act, which, as described in § 3.02[9][a], generally prohibits, both inside and outside the United States, the solicitation, commencing with a one- or five-business day restricted period before the offering price is determined, of offers to buy securities of the same class as the securities that will be distributed in the offering, in order to avoid manipulation of the price of such securities. Rule 101 of Regulation M provides certain exemptions for research distribution, principally where the research satisfies the conditions of Rules 138 or 139 under the Securities Act or where it relates to certain actively traded securities. The exemption for certain actively traded securities, the relatively brief period during which distribution of research would be affected and the current practice of many issuers to adhere to a blackout period that would, in any event, exceed the Regulation M restricted period have resulted in Regulation M having minimal impact on most global offerings by non-U.S. issuers.

An additional concern is that information, particularly forward-looking information, not required to be included in a registration statement under Securities Act requirements but included in research reports, may be required by the SEC to be included in the registration statement if that information is published in the United States, including in media reports based on research reports obtained outside the United States, notwithstanding that neither the issuer nor any underwriter had any involvement in those media reports. *See infra* Note 299. In an offering by a Chinese company in 2000, for example, information derived from a research report, including financial projections, was published in various U.S. newspapers. The research report was distributed only outside the United States, and the information was published without the consent of the company or of the underwriter that had prepared the report. The issuer nevertheless was required to include a risk factor in its prospectus that stated the assumptions on which the projections were based and urged investors not to rely on the projections. *See* PetroChina Company Limited, Prospectus (Mar. 30, 2000); *see also* LG. Philips LCD Co., Ltd., Prospectus (July 15, 2004). As a result of the SEC's focus on this area, some underwriters consider avoiding the inclusion of projections or forecasts in pre-deal research in SEC-registered offerings, even though published exclusively outside the United States.

262 The legend could read as follows: "Neither this document nor any copy of it may be taken or transmitted into the United States or distributed in the United States or to any U.S. person (within the meaning of *Regulation S* under the Securities Act)." While it is not strictly necessary for the legend to refer to U.S. persons in the case of most offerings that fall into Category 1 of Regulation S, a restriction on distribution to U.S. persons is often included regardless of the Regulation S category of the issuer in order to decrease the likelihood that research reports will make their way inappropriately into the United States (*e.g.*, through distribution by a U.S. person resident abroad to an affiliate in the United States). For a discussion of the different Regulation S categories, *see* § 8.02[1][c].

263 If a research report satisfies the requirements of Rule 138 or Rule 139 under the Securities Act, its distribution, even in the United States, will not constitute directed selling efforts under Regulation S and will not be inconsistent with the offshore transaction requirement for the Regulation S offering. As a result, such research report need not be isolated from the United States. Rules 138(c) and 139(c) under the Securities Act.

264 *See* § 11.04.

265 Concern that issuers may be held liable for the contents of research reports that they participate in preparing was heightened by a 1997 SEC enforcement action, *In the Matter of Presstek, Inc.*, SEC Release No. 34-39472 (Dec. 22, 1997). *See* § 4.10[1], which discusses concerns arising from issuer involvement in the preparation of research reports, including a discussion of *Presstek*.

In addition to these liability concerns, issuer involvement in reviewing research reports may be further constrained by FINRA rules. Pursuant to these rules, U.S. broker-dealers may not submit a research report to an issuer prior to publication, except to review certain sections of the draft report (not including those sections that contain the research summary, research rating or price target) for factual accuracy. *See* FINRA Rule 2241(b)(2)(N) and Supplementary Material .05. We understand that many firms have extended this prohibition globally so that it applies also to non-U.S. broker-dealer affiliates within the same holding company structure. However, NASD Rule 1050(f) allows a foreign research analyst employed by a foreign affiliate of the FINRA member to contribute to a "globally branded" research report without having to be registered with FINRA. The research report must prominently disclose (i) each affiliate that contributed to the report, (ii) the names of any foreign research analysts employed by any contributing affiliate, (iii) that such research analysts are not registered or qualified as research analysts with FINRA, and (iv) that such research analyst may not be an associated person of the FINRA member and therefore may not be subject to FINRA restrictions on communications with a subject company, public appearances and trading securities held by a research analyst's account.

266 Blackout periods, during which the dissemination of research by syndicate members is prohibited, were developed by European banks as a way of reducing these liability concerns. Their imposition subsequently became routine in global offerings. In the past, blackout periods typically ran four weeks or longer. However, in recent years, many offerings have imposed a blackout period shorter than this, or in some cases even eliminated it altogether, on the theory that it may not in fact be very useful in protecting against liability for research reports.

Lead managers typically interpret the blackout periods they impose on the syndicate to apply even to research reports previously published by underwriters and included on electronic systems operated by third parties. Agreements with third parties sometimes do not permit authors to have such reports deleted upon request. A syndicate member may therefore need to seek permission from the global coordinator to allow a corresponding departure from the blackout restrictions for the offering in question.

In addition to self-imposed blackout periods, FINRA rules may impose research quiet periods following U.S. public offerings for non-EGCs. *See* § 14.07[5].

267 Changes to the U.S. securities laws, intended to encourage issuers to include such forward-looking information in offering documents, have not met with great success. *See* § 4.06[1][a].

268 *See* § 3.02[1][e] for a discussion of aftermarket prospectus delivery requirements.

269 Information on an issuer's website should be regularly and frequently updated, not only during a public offering and in the immediate run-up and aftermath, but outside the offering context as well. Generally, material should be checked to ensure its accuracy and currency. The SEC has cautioned that "[i]n effect, a statement may be considered to be 'republished' each time that it is accessed by an investor or … each day that it appears on the website." April 2000 Release, Use of Electronic Media, 65 Fed. Reg. 25,843, 25,855 (May 4, 2000). During an offering, material other than the prospectus also should be vetted to ensure conformity with the prospectus.

270 *See* § 3.02[3] for a discussion of press releases issued pursuant to Rules 134, 135, 168 and 169.

271 The prospectus should be in the form most recently filed with the SEC and should be removed or properly archived at the end of the prospectus delivery period.

272 SEC Release No. 33-7856 (Apr. 28, 2000) (the "April 2000 Release"); *see* § 3.02[3].

273 In the past, the securities of both U.S. and non-U.S. issuers sold outside the United States were registered only to cover the possible flowback of such securities into the United States, not the initial sales themselves. However, following amendments in 1998 to Regulation S, it is generally necessary as a practical matter to register both U.S. and non-U.S. sales of equity securities of a U.S. issuer in the initial distribution, rather than attempt to rely on Regulation S with respect to the non-U.S. sales of such securities. Such registration is generally required because Rule 905 of Regulation S under the Securities Act provides that equity securities of U.S. issuers acquired from the issuer, a distributor or any of their respective affiliates in a transaction in compliance with Regulation S are deemed to be "restricted securities" as defined in Rule 144 under the Securities Act, meaning that such securities may not be freely traded in the United States unless they are registered under the Securities Act, satisfy the requirements of Rule 144 or are sold under another exemption from the registration requirements of the Securities Act. *See* § 8.02[2].

274 The number of shares to be registered must also include those subject to the underwriters' "overallotment option," which is discussed in § 3.02[5][f].

275 WKSIs may file a post-effective amendment to an effective automatic shelf registration statement to increase the number or add a class of securities not previously included in the relevant registration statement or to add securities of a majority-owned subsidiary otherwise permitted to be included in an automatic shelf registration statement. *See* Rule 413 under the Securities Act. WKSIs may also register an indeterminate number of securities of any class on an automatic shelf registration statement without specifying whether the securities are being sold in primary offerings or secondary offerings on behalf of selling securityholders. Classes of securities registered also do not need to be allocated between the issuer, its eligible subsidiaries or selling securityholders. Registration fees may be paid on a pay-as-you-go basis and additional information with respect to any particular offering may generally be provided by a prospectus supplement. An issuer that is a WKSI based only on its registered nonconvertible securities may only register nonconvertible securities (other than common equity) on an automatic shelf registration statement unless it is eligible to use either Form S-3 or F-3 for a primary offering because it has a public float of $75 million or more. *See* § 3.02[2][c] (discussing automatic shelf registration statements).

For issuers not eligible to use automatic shelf registration statements, a new registration statement must be filed to increase the number or add a new class of securities being offered. Under Rule 462 under the Securities Act, a new registration statement may be declared effective immediately upon filing if it relates to no more than 20% of the amount of securities registered on the initial registration statement, provided that certain conditions are satisfied. *See* Rule 462 under the Securities Act. In addition, Rule 416 under the

Securities Act permits certain additional securities arising from stock splits, stock dividends and related occurrences to be offered under effective registration statements under certain circumstances. *See* Rule 416 under the Securities Act.

276 *But see supra* Note 273, noting the possible need to register non-U.S. sales of equity securities of a U.S. issuer. U.S. issuers offering equity securities outside the United States using a prospectus that is different from that used in the United States will need to consider whether that prospectus will be required to be filed with the SEC as a free writing prospectus (and whether the prospectus used in the United States will need to be delivered to the recipients of any such free writing prospectus prior to or with the delivery of the free writing prospectus), or whether the same prospectus should be used in all jurisdictions, with any different or alternative pages used outside the United States filed as part of the U.S. registration statement with the SEC. *See* also Rule 433(d) under the Securities Act; § 3.02[3][b]iv].

277 The reason for making this clear is to reduce the risk that the issuer and the underwriters of the international offering will be exposed to liability, mainly under § 11 or § 12(a)(2) of the Securities Act, in respect of the international offering (a risk that may also be mitigated by the limitations on the extraterritorial application of the U.S. securities laws as a result of the Supreme Court's decision in *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010), as discussed in § 11.10[3]). The statement, which should be added to the cover page of the registration statement, could read as follows: "The shares being registered include [insert number] shares that are to be offered outside the United States but that may be resold from time to time in the United States while a registration statement is required to be in effect or a prospectus is required to be delivered." It would also be advisable to add the following sentence to the underwriting section of the U.S. prospectus (or to the single prospectus when only one is being used in and outside the United States): "This Prospectus may be used in connection with [securities] initially offered outside the United States in the [international offering] insofar as such [securities] are resold from time to time in the United States in transactions that require registration under the Securities Act."

In order to buttress the argument that these liability provisions do not apply to purchases outside the United States, additional text along the following lines should also be included in the prospectus used outside the United States (or in the single prospectus when only one is being used in and outside the United States):

> The [securities] being offered outside the United States pursuant to the [international offering] have not been registered under the Securities Act for offer or sale as part of their initial distribution. Each [international underwriter] has represented and agreed that it has not offered or sold and will not offer or sell such [securities] as part of its initial distribution within the United States. The [securities] being offered outside the United States have been registered under the Securities Act for resale from time to time in the United States in transactions that require registration under the Securities Act. Terms used in this paragraph have the meanings given to them by Regulation S under the Securities Act.

If a separate prospectus is being used for the offering outside the United States, it would also be advisable not to include in the international prospectus any paragraph in the U.S. prospectus relating to the enforceability of judgments by U.S. persons and the section of the U.S. prospectus that typically refers to the SEC registration statement and the exhibits thereto.

278 In global offerings where the only public offering is in the United States, typically one prospectus can cover the whole global offering.

279 U.S. issuers in U.S. public offerings will need to consider whether a prospectus used outside the United States will be required to be filed with the SEC as a free writing prospectus (and whether the prospectus used in the United States will need to be delivered to the recipients of any such free writing prospectus prior

to or with the delivery of the free writing prospectus). *See* Rule 433(d) under the Securities Act; § 3.02[3][c][iv]. Alternatively, offering participants may seek to use a single prospectus that meets the requirements of all relevant regulators and file as part of the U.S. registration statement any different or alternative pages that may be necessitated by the requirements of the non-U.S. regulators.

280 In certain cases, a company may prepare both home-country GAAP financial statements and U.S. GAAP or IFRS financial statements, such as where it is required by outstanding bond covenants to do so or because home-country GAAP is not familiar to the international community. In such instances, the issuer may choose to use the U.S. GAAP or IFRS financial information in its international offering documents and its local GAAP financial information only in its home-market retail offering.

281 The SEC staff has insisted, in certain circumstances, that projections and other information released offshore be included in the prospectus. *See infra* Note 299.

282 Information included in a prospectus in a U.S. registered offering could give rise to liability under, among other provisions, § 11 of the Securities Act. *See* § 11.03[1]. Regarding the duty to update, *see* § 4.10[4]. Domestic issuers similarly seek to avoid liability under § 11 through incorporation by reference of earnings releases that include earnings guidance by electing to submit the earnings guidance information pursuant to Item 7.01 of Form 8-K. Unlike information filed pursuant to Item 8.01, information in a report furnished pursuant to Item 7.01 is not automatically incorporated by reference into a filing under the Securities Act. *See* § 4.10[8] Note 621.

283 If included, steps can be taken in the United States to attempt to minimize the potential liability associated with the forward-looking information in prospectuses. *See* § 11.03[5]. Offering participants may be more willing to include this type of information in offering memoranda in Rule 144A offerings, where liability under § 11 of the Securities Act is not an issue, but even in Rule 144A offerings, consideration should be given to the impact of including the projections on a potential claim under Rule 10b-5 under the Exchange Act.

284 If sales are made in one market before they can be made in another, premature secondary market trading in that market, and uncontrolled resales into other markets, could adversely affect the distribution as a whole.

285 *See* Rule 159 under the Securities Act.

A written confirmation of sale may be delivered to investors as long as the final prospectus is filed with the SEC by the required filing date or the issuer has made a good faith and reasonable effort to file such a prospectus within the required time under Rule 424 and, if the issuer has not timely filed the prospectus, the issuer files the prospectus as soon as practicable thereafter. Rule 172 under the Securities Act; *see also supra*, Note 92 and accompanying text.

286 For example, U.S.-style diligence typically includes interviews with key officers of the issuer and access to the issuer's significant documents, including minutes of the meetings of the board of directors and all material contracts. In the United Kingdom, a similar "verification" process is conducted in connection with disclosure in the relevant offering documents; moreover, extensive "verification notes," identifying the basis for each disclosure in the prospectus, are often produced particularly in the context of a premium listing in the United Kingdom.

287 *See* Rule 433 under the Securities Act for the limited circumstances under which a non-reporting issuer may use a free writing prospectus. For a discussion of free writing prospectuses, *see* § 3.02[3][c][iv].

288 Although it may be possible to get such publications to agree not to publish advertisements in specified jurisdictions, they generally will not agree to restrict ordinary articles to certain editions, and these too can raise questions under the U.S. rules against publicity.

289 *See* §§ 3.02[3][b][ii] and 3.02[3][c][i].

290 *See* § 3.02[3][a][iii].

291 *See* the definitions of "directed selling efforts" and publication "with a general circulation in the United States" in Regulation S, both of which are discussed in § 8.02[1][b].

292 SEC Release No. 33-7356 (Oct. 10, 1996), 61 Fed. Reg. 54,518, 54,518 n.9 (Oct. 18, 1996).

293 In the privatization of the electricity distribution companies of England and Wales, for example, rebates on electricity bills were offered to individuals who purchased shares.

294 Preliminary Note 9 to Regulation S under the Securities Act.

295 We understand that some issuers have taken the view, which we believe is reasonable, that the Rule 135e safe harbor should be available even though some of the issuer's officers participating in the press conference are physically located in the United States, provided certain conditions, such as the following, are met: (i) the members of the press all are physically present outside the United States, (ii) the officers participate through a video- or audio-conference facility set up at a closed location in the United States, (iii) the conference facility is linked for transmission only to the press conference offshore and not to any other location or person, and (iv) U.S. journalists are invited to participate offshore, but no journalist is allowed to participate while physically located in the United States.

296 In proposing the safe harbor, the SEC indicated that the safe harbor would not be available in connection with offerings conducted solely in the United States because there would be no "apparent reason for conducting offshore press activities." *See* SEC Release No. 33-7356 (Oct. 10, 1996), 61 Fed. Reg. 54,518, 54,522 (Oct. 18, 1996). This limitation may create difficulties for offerings by non-U.S. issuers wishing to conduct offers exclusively in the United States while also conducting press activities in their home jurisdictions or elsewhere outside the United States. Such circumstances may arise where the issuer's home market is not large enough to accommodate a sizeable offering or does not have a sufficiently liquid

securities market for trading purposes. The adoption of Rules 168 and 169 under the Securities Act as part of the Securities Offering Reforms, however, has eased this tension for ordinary course business communications consistent with past practice. *See* § 3.02[3][a][iii][A].

297 In general, the legend must include statements to the effect that (i) the materials are not an offer for sale of the securities in the United States and (ii) the securities may not be sold in the United States absent registration or an exemption from registration and that any public offering will be made by means of a prospectus containing detailed information regarding the company and its management, as well as financial statements. The materials also must not include any purchase order or coupon that could be returned indicating interest in the offering. In addition, if the issuer or selling securityholder intends to register any part of the offering in the United States, the legend must include a statement to that effect.

Under Rule 135e under the Securities Act, research reports can form part of a press package distributed to members of the U.S. press in reliance on the safe harbor. SEC Release No. 33-7470 (Oct. 10, 1997). Generally, however, offering participants have elected not to take advantage of this option.

In circumstances in which Rule 135e is not available (*e.g .*, with respect to press contacts in the United States), the relief granted by the SEC staff in the 1996 Deutsche Telekom offering (which predated Rule 135e) may be helpful in understanding the publicity activities that the SEC has deemed permissible in exceptional circumstances. The 1996 Deutsche Telekom offering, which ultimately yielded proceeds of over $12 billion, attracted intense public interest in both the general and financial press. To ensure that the company was able to maintain an appropriate flow of information to the marketplace during the months leading up to the offering, the company sought and was granted no-action relief that allowed certain press activities in the United States in the period up until one month before the first filing of the U.S. registration statement with the SEC, and set forth certain guidelines for publicity activities during the remainder of the offering process. *See Deutsche Telekom AG* (avail. June 13, 1995 *)*. Following the implementation of the Securities Offering Reforms, entities that qualify as WKSIs may release communications that reference a securities offering at any time, although those communications would likely be classified as free writing prospectuses that would need to be filed with the SEC. *See* Rule 163 under the Securities Act; § 3.02[3][b][iii].

298 *See* SEC Release No. 33-7470 (Oct. 10, 1997). In 2000, the SEC staff tightened its standards with respect to the availability of press-related materials on the Internet (*see* SEC Release No. 34-42728 (Apr. 28, 2000), though it has indicated some flexibility in the context of Regulation S-only offerings. *See* § 8.02[1][d].

299 In a number of U.S.-registered transactions, members of the SEC staff questioned the availability of Rule 135e, even when all its conditions appear to have been met. In these transactions, press articles found their way into the United States, including by way of the Internet. The staff seriously considered delaying at least one of these offerings, but stepped back from this draconian measure. The staff has, however, required the inclusion in the prospectus of statements made at press conferences or in other communications protected by Rule 135e. For example, in a public offering of an Italian issuer involving a registered offering in the United States, the issuer's chairman conducted an interview during the offering on CNN International in which the offering was discussed, and the issuer disclosed certain projections to the Italian press that were not included in the issuer's preliminary U.S. prospectus. Although the SEC staff ultimately accepted that the interview was permissible under Rule 135e, the issuer was required to amend its final U.S. prospectus to include the projections released to the Italian press, expressly subjecting the issuer to Securities Act liability for them. In a subsequent U.S. public offering by a Korean bank, the SEC staff required the inclusion in the U.S. prospectus of statements, including projections made during the offering, by the bank's senior officers abroad and reported by various news services.

Although the SEC rules for registration statements do not require the inclusion of all "material" information unless the registration form in question otherwise requires it or the omission of material information would make the information contained therein misleading, the staff has nonetheless insisted on inclusion of information it deems material based on the policy that all investors should have equivalent information when making investment decisions, a concern that goes beyond SEC rules and appears to run counter to the safe harbor from the registration requirements that Rule 135e expressly affords. By requiring the prospectus to contain Rule 135e communications, the staff has sought to put U.S. investors on the same footing as those outside the United States. The staff has even pressed these views where third parties, including members of the media, have improperly or without authorization from the issuer published in the United States information derived from research reports or other information regarding the issuer distributed outside the United States. *See supra* Note 261. It seems less defensible in such circumstances to force the issuer to include in its prospectus information prepared and circulated improperly by third parties. Following implementation of the Securities Offering Reforms, such research reports could potentially be made to fit into the free writing prospectus rules in order to resolve potential publicity questions arising under § 5 of the Securities Act, although offering participants may not be willing to accept prospectus liability on such reports. *See* § 3.02[3][c][v].

Because the staff has the power to accelerate the effectiveness of a registration statement, it essentially has the ability as a practical matter to force the inclusion in a prospectus of any information released abroad, whether or not the staff has a legitimate basis in the SEC's rules for its demands. Where, however, the registrant is prepared to include the Rule 135e statements in its statutory prospectus or as a separate free writing prospectus if the staff insists, threats to delay the offering, in order to allow for a "cooling-off" period, are particularly unwarranted and inconsistent with the safe harbor Rule 135e purports to grant.

300 If the information is included in the prospectus after being reported in the United States, or is released as a free writing prospectus, ordinary prospectus liability would attach to such information. Otherwise, only the general U.S. antifraud rules would apply.

301 *See* § 7.02[4] for a discussion of publicity in private offerings in the United States. Following the 2012 change to Rule 144A under the Securities Act to eliminate the prohibition on offers to nonQIBs, there has been some limited relaxation related to publicity in the United States in the context of private offerings in the United States. While issuers and underwriters remain cautious because of Rule 10b-5 liability concerns, they have been willing to include underwriters' names and other limited factual information that is outside the scope of the Rule 135c under the Securities Act nonexclusive safe harbor.

302 The issuer could argue that there is no offer of securities being distributed if the offering is "all sold."

303 For purposes of an independently prepared media free writing prospectus for which no payment or other consideration has been made by the issuer or another offering participant, the statutory prospectus included in the registration statement would not be required to include a price range otherwise required by rule. *See* Rule 433(b)(2)(ii) under the Securities Act. *See* § 3.02[3][c][v][A].

304 *See* § 3.02[1][a]; *see also supra* Note 84 (discussing Rule 159).

305 Access is generally limited through electronic "gateposts." Gateposts vary in the degree of restriction they impose. At the most restrictive end are password-protected mechanisms, through which only those established to be non-U.S. persons are granted passwords in advance permitting access to the site. The party dispensing passwords typically uses the same means of self-certification and independent verification as to residence as have historically been used in the nonelectronic context. Somewhat less restrictive are gateposts requiring the entry of a post code or other address indicator, which is electronically compared to an existing database of post codes or addresses outside the United States (typically in one or a handful of countries in which the offering is concentrated), and restricts access where the information does not provide assurance that the user resides outside the United States. The least restrictive gateposts ask the user to certify that he or she is not a U.S. person by clicking "yes" or "no" in response to a question to this effect, and only permits access to those users who certify that they are not U.S. persons. Such gateposts involve no independent verification by the party posting the materials on the website.

306 The legend should be similar to the one required by Rule 135e under the Securities Act, although the relief from publicity restrictions provided by Rule 135e is not available for information posted on a website (even if posted on a server located outside the United States), except for press-related materials of foreign issuers where access to the website is limited as described above.

307 The several liability of underwriters in a U.S. offering contrasts with the joint and several liability of underwriters that sometimes applies in offerings outside the United States. The U.S. practice is that if one

or more underwriters default with respect to less than a specified portion (typically either 1/10th or 1/11th) of the underwritten securities, the remaining underwriters will assume the obligations of the defaulters *pro rata*. If, however, the amount exceeds the specified percentage, the agreement may be terminated by the other underwriters.

308 In the multiple syndicate context, allowing the foreign syndicate to proceed on a joint and several liability basis (as is sometimes done outside the United States) while the U.S. syndicate proceeds in the customary manner (*i.e.*, several liability only) is generally not desirable because it is invariably the case that the closing of each offering is conditioned on the closing of the other: if the obligations of the U.S. underwriters are several, and the obligations of the underwriters in the other syndicate are joint and several, a default by a single U.S. underwriter that releases the other U.S. underwriters from their obligations to carry out the U.S. offering could, in effect, vitiate the joint and several character of the obligations of the underwriters in the other syndicate. One solution to this problem is to allow the U.S. underwriters to agree severally, and the other underwriters to agree jointly and severally, and to condition the closing of each offering on the closing of the other, but not to allow the underwriters outside the United States to escape from their obligations if the U.S. offering fails to close solely by reason of a default by one or more U.S. underwriters. Another approach is to require the U.S. offering to go forward on a reduced basis (*i.e.*, without the shares that had been allocated to the defaulting U.S. underwriter) in cases in which the default relates to an agreed percentage of the offering, typically between 10% and 15%.

On the related question of contribution, U.S. and non-U.S. underwriters, particularly in the context of multiple syndicates, sometimes negotiate regarding the contribution to be made by foreign underwriters to losses suffered by U.S. underwriters in connection with claims by U.S. investors, as the U.S. market is the most prone to litigation and the most likely to result in claims against underwriters. Non-U.S. underwriters not offering securities in the United States may therefore seek to obtain a limitation on their contribution liability to losses arising out of claims made by investors who purchased securities from their syndicate (or in the case of single syndicate offerings, their selling region).

309 Regardless of whether a single international syndicate or multiple syndicates are used, any sales in the United States by a non-U.S. syndicate member generally must be effected through an SEC-registered broker-dealer (which often is an affiliate of the non-U.S. syndicate member). *See* § 15 of the Exchange Act and Rule 15a-6 thereunder. Although the SEC proposed amendments to Rule 15a-6 that would have permitted foreign broker-dealers not registered with the SEC to effect transactions with qualified investors in the United States, subject to the terms and conditions specified in Rule 15a-6, as proposed to be amended, those amendments have not been adopted. SEC Release No. 34-58047 (June 27, 2008). All other applicable local rules would also have to be observed by the relevant syndicate. For example, a single syndicate in a distribution that includes U.S. sales must comply with FINRA requirements. *See* § 3.06.

310 An agreement among underwriters governing these and other matters is also typically entered into by the underwriters in each syndicate.

311 In some cases, the underwriters in the non-U.S. tranche may agree to allocate among themselves the responsibility for making offers and sales in particular countries.

312 In offerings by foreign issuers conducted wholly or primarily outside the United States, the period between signing and closing is more variable.

313 SEC Release No. 34-78962 (Sept. 28, 2016), proposing an amendment to Rule 15c6-1(a).

314 The SEC has not proposed any change to the standard settlement cycle for underwritten offerings of equity securities that price on a customary timetable, but has requested comment as to whether a change should be made. SEC Release No. 34-78962 (Sept. 28, 2016).

315 A typical provision reads as follows:

> This Agreement shall be subject to termination in the absolute discretion of the

> Representatives … if prior to such time (i) trading in the Company's Common Stock shall have been suspended … or trading in securities generally on the New York Stock Exchange shall have been suspended or limited or minimum prices shall have been established on such Exchange, (ii) a material disruption in securities settlement, payment or clearance services in the United States shall have occurred, (iii) a banking moratorium shall have been declared either by Federal or New York State authorities or (iv) there shall have occurred any outbreak or escalation of hostilities, declaration by the United States of a national emergency or war or other calamity or crisis the effect of which on financial markets is such as to make it, in the judgment of the Representatives, impracticable to market the Securities.

316 *First Boston Corp.* (avail. Sept. 3, 1985).

317 Rules 15c2-4 and 10b-9 under the Exchange Act.

318 *Force majeure* clauses have increasingly less significance as settlement periods continue to shorten. *See* SEC Release No. 34-78962 (Sept. 28, 2016) (proposing a shortened standard settlement cycle as described above).

319 In certain privatizations, the right to terminate by reason of *force majeure* was eliminated, or could only have been invoked by the sellers and the underwriters jointly, marking a major departure from U.S. practice.

320 Following the terrorist attacks in the United States on September 11, 2001, many investment banks expanded their *force majeure* provisions to include references to (i) material disruptions in commercial banking, securities settlement and clearance services and (ii) the occurrence of any other calamity or crisis.

321 The International Capital Markets Association recommends the following *force majeure* provision, which is widely used and representative of such provisions in Euromarket underwriting agreements generally:

> Notwithstanding anything contained in this Agreement, … the [Joint] Lead Manager[s]… on behalf of the Managers may by notice to the Issuer … terminate this Agreement at any time before the time on the Closing Date when payment would otherwise be due under this Agreement to the Issuer in respect of the Securities if, in the opinion of the Lead Manager, there shall have been such a change in national or international financial, political or economic conditions or currency exchange rates or exchange controls as would in their view be likely to prejudice materially the success of the offering and distribution of the Securities or dealings in the Securities in the secondary market …
>
> ICMA PRIMARY MARKET HANDBOOK at A9-3, International Capital Market Association (2016).

This provision grants much more discretion than its counterpart in a typical underwriting agreement for a U.S. transaction. If there is a U.S. syndicate as part of a dual-or multi-syndicate global offering, and if it is a condition that each tranche must close for any to close, and if the *force majeure* clause in the underwriting agreement follows the IPMA recommendation, then, in practice, the scope of the U.S. *force majeure* clause is much less important, even if narrower, because if the international tranche fails to close, so will the U.S. tranche.

322 Certain private issuers have been able to moderate, although not eliminate, *force majeure* clauses in the context of offerings of their securities. Changes to *force majeure* clauses in this context have generally taken three forms, though all of them are unusual. First, some private issuers have been successful in requiring underwriters to consult them before terminating the offering. Second, some private issuers have

been able to eliminate one or more of the conditions that may constitute *force majeure .* Finally, some private issuers have required underwriters to exercise reasonable judgment before terminating the offering, as opposed to leaving the termination decision to the underwriters' sole discretion. (If reference is made simply to the underwriters' judgment or discretion, without qualification as to whether it must be reasonable, a reasonableness qualification would be implied in any event if the underwriting agreement is governed by New York law.)

In addition, in the context of privatizations, sovereigns have been successful in resisting *force majeure* provisions in underwriting agreements. This result has been due both to the large size of most privatizations and to their high profile in the public eye; underwriters have apparently been willing to accept this additional risk in light of the potential rewards.

While practice in the United States varies, some agreements provide that the issuer must pay the underwriters' out-of-pocket expenses if the *force majeure* clause is invoked. In Europe, it is typical for the issuer to agree to pay all the underwriters' expenses (sometimes subject to a cap), whether the offering proceeds to completion or not.

323 Because underwriters of an offering in the United States may be subject to civil liabilities under federal or state law, they will customarily require indemnification by the issuer with respect to all liabilities arising out of material misstatements or omissions in the registration statement (including the prospectus, any preliminary prospectus, any road show and certain free writing prospectuses), excluding certain minor portions for which the underwriters assume responsibility.

For decades, however, the SEC has stated that it believes indemnification for liabilities arising under the Securities Act is against public policy and thus may be unenforceable. If such indemnification is sought for officers, directors or controlling persons of an issuer, the SEC has long required issuers (as a condition to acceleration of the effectiveness of a Securities Act registration statement) to agree to submit to a court the issue of enforceability of such indemnities and to be governed by such court's decision. Item 512(h) of Regulation S-K under the Securities Act.

While this undertaking does not apply to undertakings to indemnify underwriters, the policy considerations are the same (*see*, *e.g.*, *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970)), and underwriting agreements for offerings in the United States usually provide that if indemnification is held by a court to be unavailable, the issuer and the underwriters will share aggregate losses (through a procedure known as "contribution") in such proportions that the issuer will pay a much greater share of such losses than the underwriters as a group.

It is also customary for an issuer to agree in the underwriting agreement for a U.S.-registered offering to make generally available to its securityholders an earnings statement covering a period of at least 12 months beginning after the effective date of the registration statement. Section 11(a) of the Securities Act provides that a person who purchases securities after such an earnings statement has been made available must prove that he or she acquired the securities in reliance on a materially false or misleading statement in the registration statement in order to have a right to recovery under § 11. Before that time, he or she need only show that the security was included in a registration statement that contained an untrue statement of a material fact or made a material omission. The filing of an annual report on Form 20-F is one method of satisfying the requirements of § 11(a) of the Securities Act. *See* Rule 158 under the Securities Act; *see also* § 11.03[1][a].

324 This issue frequently arises where local corporate law limits the ability of the issuer to give financial benefits or assistance to shareholders. In Germany, for example, stock corporations are prohibited from granting any benefit to a shareholder other than on the basis of arm's-length commercial dealings, the distribution of a validly declared dividend or distributions in a liquidation proceeding. Outside these circumstances, payments or other transfers of benefits to shareholders constitute an unlawful repayment of capital by the issuer. In its so-called "DT 3" decision of May 31, 2011, the highest German court in civil matters (Bundesgerichtshof, the "BGH"), held that the assumption of prospectus liability by an already public issuer in connection with a pure secondary offering constitutes an unlawful repayment of capital to the selling

shareholder(s), unless the issuer receives compensation for the assumption of prospectus liability in the form of a specific, measurable benefit reflected in the issuer's balance sheet. BGH, II ZR 141/09, *available at* http://openjur.de/u/168086.html. According to the BGH, absent such compensation, an issuer may only assume prospectus liability in such an offering if the selling shareholders fully indemnify the issuer for any losses it may incur as a result of the assumption of prospectus liability. The BGH did not address the question of whether the indemnification of the underwriters by the issuer in a pure secondary offering raises similar issues. Neither did it deal with the question of whether the analysis is different if an issuer assumes prospectus liability in connection with an initial public offering and first-time listing of its shares where no new shares are offered, although there are strong arguments that the principles of the "DT3" decision apply *mutatis mutandis* in such a scenario. If the selling shareholders indemnify the issuer for any losses it may incur in connection with the assumption of prospectus liability in the context of a pure secondary offering, including losses arising from the indemnification of the underwriters by the issuer, the issuer should be permitted to indemnify the underwriters for prospectus liability. If the selling shareholders do not so indemnify the issuer, the underwriters should make sure that they get full indemnification from the selling shareholders. Where there are no such local law constraints, the indemnity is typically provided by the issuer, as well as by the selling shareholders.

325 *See* § 3.06[1] (discussing the obligation of FINRA members to include certain mandatory provisions in lock-up arrangements) and § 3.06[4][b] (discussing the lock-up of securities received by members of the underwriting group as underwriting compensation or otherwise).

326 The term "green shoe option" arises from an offering in 1963 by the Green Shoe Manufacturing Company, the first offering to include an overallotment option.

327 In March 2005, Ernst & Young (since renamed "EY") circulated an accounting alert taking the position that, among other things, an overallotment option exercisable after the closing date of an offering should be treated as a call option that "will likely meet the definition of a derivative under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities." EY's On Call Advisory Services Accounting Alert: Overallotment (Greenshoe) Provisions Evolve into FAS 133 Derivatives (Mar. 23, 2005). Although the alert speaks generally about overallotment options, we understand that EY's interpretation is not intended to relate to overallotment options on the issuer's own stock, but does include options over its debt securities, including convertible debt securities. The alert was not predicated on any recent change in the interpretation of the accounting statement by the SEC or otherwise, and we understand that certain firms may not share EY's views. Moreover, subsequent to the alert, EY clarified that its position regarding FAS 133 treatment is limited to so-called "free" options—namely, those options that may be used for any purpose, and not solely to cover overallotments.

328 Historically, the option granted to underwriters in U.S.-registered offerings to acquire additional securities at the offering price could be exercised solely to cover overallotments, if any. As a result of the 1997 implementation of Regulation M, however, the option granted to the underwriters need not be restricted to covering overallotments in transactions to which Regulation M does not apply (*e.g.*, U.S.-registered offerings benefiting from the ADTV exemption or Rule 144A offerings). Thus, technically, underwriters may now receive "free" options in connection with offerings in which the underwriters are not subject to Regulation M, allowing them to exercise the option at any time, whether or not to cover a short position. However, to the extent underwriters continue to sell securities throughout the period during which such an option could be exercised, the issuer, any selling shareholders and their affiliated purchasers would be subject to the longer Regulation M restricted period because they cannot benefit from the ADTV exemption.

Free options also raise other regulatory considerations. To the extent the distribution of securities is ongoing in the United States, the underwriters will continue to have prospectus delivery obligations with respect to those sales. The underwriters also, as a practical matter, may be deterred from selling the shares acquired on exercise of a free option at more than the issue price, as doing so would require amendment of the underwriting compensation disclosure in the prospectus. *See* Items 501 and 508 of Regulation S-K. The additional underwriting compensation resulting from sales of such shares at prices above the original issue price also could implicate FINRA review requirements and rules relating to underwriting compensation. *See* § 3.06[4] (describing FINRA's Corporate Financing Rule).

FINRA rules also affect the structure of the overallotment option in a U.S.-registered offering. *See* § 3.06[4][a] (discussing FINRA constraints on the size of such an option in a U.S.-registered offering). In addition, overallotment options in offerings subject to EU regulations are subject to certain limitations pursuant to the EU Market Abuse Regulation and its implementing measures. These limitations constrain the green shoe option in a number of ways, including by restricting it to 15% of the number of shares initially offered, capping a naked short position resulting from overallotment not covered by a green shoe option at 5% of the original offering size and providing that the exercise of the option be used solely to cover overallotments. *See* Commission Delegated Regulation (EU) 2016/1052 with regard to regulatory technical standards for the conditions applicable to buy-back programs and stabilization measures.

329 One issue that issuers occasionally raise is whether the commissions payable on shares obtained through exercise of the overallotment option should be the same as the commissions paid on underwritten securities. Because shares obtained on exercise of the overallotment option are not underwritten, a few issuers have successfully argued that only the selling, and not the underwriting, component of the commissions should be paid. It is very unusual, however, for underwriters to accept this.

330 A syndicate's short position is created at the time the securities are priced and allocated (following effectiveness of the registration statement in an offering registered with the SEC). The short position is typically at least as large as the number of securities available to the underwriters through the overallotment option. The lead manager's decision as to the size of the short position at any given time during the typical period during which the overallotment option can be exercised (30 days) primarily depends upon its perception of the aftermarket trading of the securities in question. In the case of an offering that trades at a significant premium in the immediate aftermarket, the overallotment option may be exercised immediately and the short position closed out at the same time. A lead manager might not establish a naked short position unless it is concerned about the potential for supply to exceed demand in the aftermarket, with the consequent negative pressure on price. It will assess the situation based on, among other factors, market conditions and the level of interest expressed in the securities being offered during the marketing process. *See* SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects (Nov. 14, 2000) (setting out the views of the SEC staff on certain issues relating to syndicate short sales).

The SEC staff takes the view that securities sold in any naked short sales must be registered with the SEC together with the securities registered for sale on a firm-commitment basis or pursuant to the exercise of the overallotment option. A specific number of shares to cover naked short sales does not, however, need to be included on the cover of the registration statement in order to register such sales. The registration statement is deemed by the SEC staff to include an indeterminate number of naked short securities. *See* SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects (Nov. 14, 2000). The effect of this staff position is to impose §§ 11 and 12(a)(2) liability with respect to naked short sales, but no additional registration fee is required.

331 The SEC staff takes the view that the underwriters must disclose in the prospectus the possibility that they will make short sales and engage in short covering transactions. It has stated that the disclosure should also describe what short sales are, distinguishing between covered and naked short sales, explain how short positions may be covered and how underwriters determine the method for closing out such sales, explain when a naked short position may be created and outline the potential effects (*e.g.*, raising or maintaining the market price of the securities in question or preventing or retarding a decline in their market price) of such transactions). The staff provided model language that may be used verbatim, or adapted, to address the required points. *See* SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects (Nov. 14, 2000). Private offerings under Rule 144A typically include similar disclosure. The SEC has also promulgated Rule 10b-21 under the Exchange Act, an antifraud rule aimed at abusive naked short selling by sellers that deceive broker-dealers or other specified persons regarding the ability of the sellers to deliver securities in time for settlement and that in fact fail to deliver securities by settlement. *See* SEC Release No. 34-58774 (Oct. 18, 2008).

332 If the overallotment option is to be exercised and settled after the closing of the offering of the underwritten

securities, the issuer is generally expected to "bring down" its representations, warranties and officers' certificates to the time of the overallotment closing, and bring-down 10b-5 letters regarding the absence of material misstatements or omissions in the offering materials, as well as bring-down accountants' comfort letters on the financial information contained in such materials, are generally required. Where the overallotment option is limited to covering short positions generated in connection with the initial placement of securities in an offering, the overallotment securities were actually sold to investors at the time of the closing for the firm securities. Notwithstanding the view of practitioners that a bring-down of diligence documentation is not necessary from a legal standpoint under such circumstances, underwriters generally insist on the receipt of bring-down 10b-5 letters and comfort letters at the option closing for commercial reasons.

333 As an alternative to formally borrowing securities, the underwriters may arrange with a portion of the initial investors to delay delivery of the securities. In connection with making these arrangements, the underwriters should consider the restrictions on the regulation of credit in connection with distributions in § 11(d) of the Exchange Act, as well as Regulation T (discussed in § 9.05[11]).

334 *See infra* Note 389.

335 As noted in *infra* Note 417, Regulation M should not be deemed to restrict non-U.S. purchases or inducements to purchase the subject securities after the U.S. distribution is completed (even if the ADTV exemption is not applicable). This view is consistent with the views expressed in a no-action letter under Rule 10b-6 under the Exchange Act, one of the predecessor rules to Regulation M. *See Williams, William J., Jr.* (avail. Nov. 27, 1996). That letter was granted in the context of a request by the syndicate to increase the number of shares for which the overallotment option could be exercised to cover syndicate short sales in excess of the syndicate short position at the time of completion of the initial distribution. The staff confirmed that so long as the further sales by the syndicate occurred outside the United States, the U.S. distribution would not be deemed to continue for purposes of Rule 10b-6.

336 *See supra* Note 327.

337 *EBC I, Inc. v. Goldman Sachs & Co.*, 832 N.E.2d 26 (N.Y. 2005).

338 *See EBC I, Inc. v. Goldman Sachs & Co.*, 832 N.E.2d 26 (N.Y. 2005).

339 *See HF Mgmt. Services LLC v. Pistone*, 818 N.Y.S.2d 40, 42, 43 (N.Y. App. Div. 2006) (noting that the decision in EBC I was "the exception that proves the rule" and that "a fiduciary aspect [is] absent from the majority of underwriting relationships").

340 Notwithstanding the apparently clear limitation on liability in § 11(e), the U.S. District Court for the Southern District of New York has suggested in *dictum* that, in light of the broad definition of "underwriter" under the Securities Act, the amount of securities "underwritten" by a lead underwriter in an offering may be greater than the amount formally allocated to it. *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. Rep. (CCH) ¶93,139 (S.D.N.Y. Mar. 14, 2005); *see* § 11.03[1][b], Note 39.

341 This solution may not work if the issuer wishes to reserve to itself the discretion to direct the underwriters how to allocate the commissions among themselves, rather than having fixed arrangements set out in the agreement among underwriters.

342 *See* Telis Demos, Alibaba IPO Will Have 'Friends and Family' Share Program, WALL ST. J. Sept. 5, 2014, noting that while use of directed share programs has declined, several large IPOs in recent years, including that of Alibaba Group Holding Ltd., have implemented such programs. Separately, in recent years the idea of selling to "friends and family" has expanded some as issuers that want to include marketing to specific investor groups have sold a small portion of shares in an IPO to groups of fans, customers and other constituencies of investors through electronic platforms, like Loyal3.

343 *See* § 3.02[1] for a discussion of "gun-jumping."

344 *See* Rule 134 under the Securities Act. *See* § 3.02[3][c][i] for a discussion of Rule 134.

345 Although FINRA's rules are applicable only to its members, which generally will include all the U.S. broker-dealer participants in the offering, the rules require those participants in certain circumstances to obtain the

agreement of foreign members of the underwriting syndicate and selling group to comply with the rules as well. *See* § 3.06[2].

346 FINRA Rule 5130 defines a "new issue," in general, as any IPO of an equity security as defined in § 3(a)(11) of the Exchange Act made pursuant to a registration statement or offering circular (regardless of whether the securities are so-called "hot issues" that immediately trade at a premium in the secondary market). FINRA Rules, Rule 5130(i)(9), FINRA MANUAL.

347 In order to establish a parent-subsidiary relationship, the parent must have either (i) the right to vote 50% or more of a class of voting security of the subsidiary or (ii) the power to sell or direct 50% or more of a class of voting security of the subsidiary. FINRA Rules, Rule 5130(d)(1)(B), FINRA MANUAL.

348 FINRA Rules, Rule 5131(d)(2)(A) FINRA MANUAL. The NASD and NYSE initially proposed these rules in response to concerns raised by a special advisory committee convened in 2002 by the NYSE and NASD at the request of the SEC in the wake of concerns regarding IPO allocation abuses by certain investment firms. Notably, the special advisory committee recommended that the SEC and self-regulatory organizations adopt restrictions regarding directed share programs beyond those set forth in the NASD's and NYSE's proposed rules on the topic. Specifically, the committee recommended that directed share programs be limited to 5% of an IPO. In addition, the committee recommended that issuers include more detailed disclosure on directed share programs in prospectuses by including, for example, disclosure on total size of programs, number and nature of participating individuals or institutions, amounts purchased, minimum percentages of shares allocated to employees and allocations to participants exceeding a specified threshold. The committee further recommended that each listed company be required to include, in its code of business conduct and ethics, a policy regarding receipt of shares in a company's IPO by directors and executive officers. *See NYSE/NASD IPO Advisory Committee Report and Recommendations* (May 2003); *see also* SEC Release No. 33-8565 (Apr. 7, 2005) (providing guidance on activities that are prohibited in connection with IPO allocations); *cf*. Press Release, SEC, Voluntary Initiative Regarding Allocations of Securities in "Hot" Initial Public Offerings to Corporate Executives and Directors (Apr. 28, 2003) (stating that directed share programs would be exempt from the voluntary initiative regarding IPO allocations agreed to by several large investment banking firms in connection with the global research settlement entered into among such firms and the SEC, NYSE, NASD and other regulators); *see also* § 14.07[5][b].

349 FINRA Rules, Rule 5131(d)(2)(B), FINRA MANUAL.

350 § 11(b)(3) of the Securities Act.

351 *But see* Note 53 in § 11.03[1][c] for a discussion of litigation concerning, among other matters, underwriter reliance on WorldCom, Inc.'s audited (and therefore expertized) financial statements, where the court held that the existence of "red flags" regarding the accuracy of expertized information, including audited financial statements, can create a duty to investigate.

352 While historically meetings with accountants were sometimes conducted without management present, accountants have generally instituted policies requiring the attendance of company management at diligence sessions with accountants.

353 Privilege issues sometimes play a role in determining which counsel communications are made available in connection with due diligence.

354 The guidelines for accountants' comfort letters are set forth in Auditing Standard ("AS") 6101 (Letters for Underwriters and Certain Other Requesting Parties) ("AS 6101"). AS 6101 became effective December 31, 2016, succeeding AU 634 (Letters for Underwriters and Certain Other Requesting Parties), which in turn had succeeded Statement on Auditing Standards ("SAS") No. 72 (Letters for Underwriters and Certain Other Requesting Parties) (1998), and comfort letters are still sometimes referred to as SAS 72 letters. AS 6101 states that accountants may provide negative assurance in a comfort letter with respect to changes during a period subsequent to the date of the latest financial statements included in the prospectus, but may only provide such assurance as of a date that is less than 135 days from the end of the last period for which the accountants have performed an audit or an interim review in accordance with AS 4105 ("AS

4105") (Reviews of Interim Financial Information). AS 4105 succeeded AU 722 (Interim Financial Information, which in turn had succeeded SAS No. 100 (Interim Financial Information) and a review of interim financial information for comfort letter purposes is still sometimes referred to as a SAS 100 review. As a result of this 135-day rule, and depending on the timing of preparation and review of its interim financial statements, an issuer effectively may be precluded from making an offering during certain periods of the year. "Negative assurance" in this context generally refers to the language in a comfort letter to the effect that nothing came to the attention of the auditor that would cause it to believe that (i) any material modifications should be made to the relevant financial statements for them to be in conformity with GAAP, (ii) unaudited interim financial statements contained in the prospectus were not prepared on a basis substantially consistent with the audited financial statements contained in the prospectus, or (iii) there were certain changes in specified financial statement line items after the date of the financial statements included in the prospectus as compared to the comparable prior-year period (in the case of line items in the income or cash flow statement) or to the most recent balance sheet contained in the prospectus (in the case of balance sheet line items) from what is stated in the prospectus except for changes that the prospectus discloses have occurred or may occur (so-called "stub period comfort"). In addition, in U.S. registered transactions, negative assurance would typically also include language to the effect that nothing came to the attention of the auditor that would cause it to believe the financial statements contained in the registration statement do not comply as to form in all material respects with the applicable accounting requirements of the Securities Act and the rules and regulations thereunder.

Initially, review under AS 4105's predecessor provision was only applicable to the interim financial statements of SEC registrants and companies making regulatory filings with certain other U.S. government agencies. Effective for reviews of financial information for interim periods beginning after December 15, 2009, such review has also been permitted for interim financial statements of an entity (i) that meets certain conditions related to the auditor and financial reporting framework applicable to the interim financial information as compared to the audited annual financial statements, and (ii) when the interim financial information is condensed information, such condensed interim financial information purports to comport with an appropriate reporting framework and other content and financial information availability conditions are met. Appropriate reporting frameworks may include FASB ASC 720 and Article 10 of Regulation S-X with respect to U.S. GAAP or IAS 34 with respect to IFRS issued by the IASB. Comfort letters delivered in Rule 144A/Regulation S offerings regularly include customary negative assurance in respect of interim periods where the financial statements for such interim periods are included in the offering memorandum.

355 *See*, *e.g.*, *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (Participating underwriters "who did nothing and relied solely on [lead underwriter]" were bound by their failure to conduct a reasonable investigation).

356 *See* "New High Risk Ventures," Exchange Act Release No. 34, 9671 (July 26, 1972), 1972 WL 125474, at *6 (July 27, 1972) ("[The participant] must satisfy himself that the managing underwriter makes the kind of investigation the participant would have performed if he were the manager.").

357 Section 12(a)(2) also applies to oral statements. *See* § 11.03[2] for a general discussion of § 12(a)(2).

358 Oral contracts of sale of securities are generally valid and binding under state law. Therefore, a contract of sale is commonly entered into in a phone call with a customer immediately following pricing of an offering.

359 With shelf registration, certain qualifying issuers can register securities that may then be offered in a single transaction or a series of transactions. *See* the discussion of shelf registration, including automatic shelf registration, in § 3.02[2][c].

360 *See* § 3.02[2][c].

361 Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws, as submitted to the A.B.A., Section of Business Law, Committee on Federal Regulation of Securities (July 10, 1992).

362 *See In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 671 (S.D.N.Y. 2004). In the Aircraft Carrier Release, SEC Release No. 33-7606 (Nov. 3, 1998), as amended by SEC Release No. 33-7606A

(Nov. 13, 1998), the SEC proposed amendments to Rule 176 under the Securities Act to clarify further factors to be considered by underwriters in the determination of whether a reasonable investigation had been conducted. The proposed rules, which were seen as largely codifying current practice by major underwriters, were never adopted. For a discussion of the impact of the WorldCom on diligence standards, *see* § 11.03[1][c].

363 *See generally* Chapters 4 and 5 for a discussion of the Sarbanes-Oxley Act.

364 *See* § 5.04.

365 *See* § 7.09.

366 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

367 While the SEC proposed a definition of "qualified purchaser" that is the same as the definition of "large accredited investor" included in its 2007 proposal to revise Regulation D, the proposal has not been adopted. However, all states have laws or regulations in place under which offers and sales of securities to certain classes of institutional investors are exempt from state registration requirements. Although the breadth of the exemption varies from state to state, in most cases it covers financial institutions generally, including broker-dealers and other institutional purchasers of securities. *See* § 7.09. In connection with amendments to Regulation A adopted in 2015, the SEC adopted a limited definition of "qualified purchaser" that includes purchasers and offerees of securities in Tier 2 Regulation A offerings. *See* Rule 256 of the Securities Act.

368 The practical result of this provision of the NSMIA is to preempt blue sky laws with respect to secondary trading in securities issued by an SEC-reporting issuer (in addition to all transactions in NYSE or similarly listed securities). This preemption would not extend to secondary trades in all types of securities; for example, state registration requirements with respect to unlisted securities of a foreign issuer that furnishes information pursuant to Rule 12g3-2(b) under the Exchange Act are not preempted under this provision of the NSMIA.

369 The NSMIA provides preemption for all transactions exempt from registration pursuant to regulations promulgated by the SEC under § 4(a)(2) of the Securities Act (but not for transactions exempt under Rule 144A). Transactions meeting the requirements of Rule 506 of Regulation D accordingly qualify for preemption; transactions under Rules 504 and 505 of Regulation D do not. *See* § 7.02, Note 31. The preemptive treatment accorded to Rule 506 transactions pursuant to the NSMIA is of no practical significance with respect to large underwritten private placements to institutional investors in the United States, both because such placements are generally not made in technical reliance on Rule 506, *see* § 7.02[2], Note 40 and accompanying text, and because Rule 506 provides a registration exemption only to the issuer of the security (and not the underwriters of the placement), *see* § 7.02[2], Note 32 and accompanying text. These private placements are often conducted under state law self-executing exemptions for offers and sales to specified types of institutional investors. *See* § 7.09, Note 309.

370 An offering document is deemed "prepared by or on behalf of the issuer" if "the issuer or its agent or representative" (i) authorizes the document's production and (ii) approves the document before its use. SEC Release No. 33-7418 (Apr. 30, 1997), Definition of "Prepared By or On Behalf of the Issuer" for Purposes of Determining if an Offering Document is Subject to State Regulation, 62 Fed. Reg. 24,572, 24,573 (May 6, 1997).

371 In addition, the NSMIA would not preempt state legislation adopted in response to accounting scandals and corporate governance abuses. The California Corporate Disclosure Act, for example, requires a publicly traded corporation incorporated or qualified to do business in California to include additional information in its annual information statement including disclosure of, among other things, the company's independent auditor, annual compensation of each member of the board of directors and executive officers, and any loans made to a member of the board of directors or any executive officer at preferential rates. CAL. CORP. CODE §§ 1502.1, 2117.1 (West 1990 & Supp. 2008). Although additional states may be considering adopting similar provisions, none to date has passed equivalent legislation.

372 Certain state disclosure and other requirements may also need to be satisfied.

373 For example, California insurers may to a limited extent make investments in foreign securities that are substantially of the same type and investment grade as eligible domestic investments, subject to concentration limits both on total foreign investments and total investments from a single foreign jurisdiction. CAL. INS. CODE § 1241 (West 2011). Similarly, New York life insurers are permitted to invest up to 10% of their "admitted assets" in Canadian investments and up to 20% of their "admitted assets" in foreign investments that are of the same types as eligible domestic investments including, among others, government obligations, corporate bonds, real estate mortgages and corporate stock. N.Y. INS. LAW § 1405(a)(7)(A) and (C) (McKinney's 2015). Certain other restrictions generally apply and vary with the type of investment, including concentration limits on total investments from a single foreign jurisdiction and ratings and exchange listing requirements. Similar provisions also govern foreign investments of New York property and casualty insurers. N.Y. INS. LAW § 1404 (McKinney's 2015).

374 The first equity offerings made by General Motors and AIG following their receipt of funds under the Troubled Asset Relief Program ("TARP") were examples of such global offerings.

375 It is common for offerings to include selling legends relating to "professional" exemptions in the countries that are most commonly marketed in (including Canada, EEA countries, Switzerland, the UK, Japan, Hong Kong, Singapore, the Dubai International Financial Centre, and Australia). These more regularly used selling restrictions are commonly provided by counsel to the underwriters based on forms kept by the underwriters internal legal departments. Global Blue Sky typically refers to inclusion of additional jurisdictions; for example, in the AIG offering mentioned in the note above, selling legends were included for 40 jurisdictions.

376 In most cases, foreign counsel will provide the selling legend that will be included in a U.S. issuer's offering document. Generally, counsel to the underwriters reviews such information because it is the underwriters that are responsible for offers and sales of securities to investors. Underwriters' U.S. counsel should be sure to review such disclosure with foreign counsel to ensure, among other things, not only the restrictions, but also the exemption under which the offers and sales will be made, is included in such disclosure.

377 Counsel in some jurisdictions advise that portions of a legend be in bold text or capitalized due to the requirement that such information be prominently placed.

378 Such statements generally also include a reference to the fact that the offer and sale of securities will be made pursuant to an exemption from such jurisdiction's filing and registration requirements.

379 SEC Release No. 34-38067 (Dec. 20, 1996) (the "Regulation M Release"); *see* § 7.10 for further discussion of Regulation M (in the context of private placements).

380 In the case of securities registered on a shelf, Rules 101 and 102 require each takedown off the shelf to be analyzed independently to determine whether it constitutes a distribution and, if it does, as of when the relevant rule applies to that takedown. *See* SEC, Division of Market Regulation, Staff Legal Bulletin No. 9, Frequently Asked Questions About Regulation M (Oct. 27, 1999) (revised Sept. 10, 2010), Fed. Sec. L. Rep. (CCH) ¶60,009 ("Staff Bulletin No. 9").

381 The term "prospective underwriter" includes any person who (i) submits a bid to participate in a distribution and knows or is "reasonably certain" that such bid will be accepted or (ii) has reached, or is "reasonably certain" to reach, an understanding with an issuer, selling securityholder or managing underwriter that such person will become an underwriter. In either case, such person will be considered a prospective underwriter regardless of whether the terms of the underwriting have been agreed upon. Rule 100 of Regulation M.

382 A broker-dealer that performs only ministerial duties and receives a fixed fee consistent with its limited role (*i.e.*, its compensation is not based on the success of the offering and is a customary amount) will not be deemed a distribution participant. *See* Staff Bulletin No. 9.

383 For purposes of Regulation M, "affiliated purchaser" includes an affiliate of a distribution participant, issuer or selling securityholder that, directly or indirectly, controls "the purchases of any covered security by a distribution participant, issuer or selling securityholder, whose purchases are controlled by any such person, or whose purchases are under common control with any such person." Rule 100 of Regulation M.

384 Such persons will not be considered "affiliated purchasers" if: (i) the distribution participant, issuer or selling

securityholder maintains and enforces written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate that might result in a violation of Rule 101, 102 or 104 of Regulation M, (ii) the distribution participant, issuer or selling securityholder obtains an annual independent assessment of the operation of such policies and procedures, (iii) the affiliate has no officers (or persons performing similar functions) or employees (other than clerical, ministerial or support personnel) in common with the distribution participant, issuer or selling securityholder that direct, effect or recommend transactions in securities, and (iv) the affiliate does not, during the applicable restricted period, act as a market maker (other than as a specialist in compliance with the rules of a national securities exchange) or engage, as a broker or dealer, in solicited transactions or proprietary trading, in covered securities. *See* Rule 100 of Regulation M.

Certain aspects of the "affiliated purchaser" definition are derived from and intended to codify various exemptive and no-action positions taken by the staff of the SEC under the market manipulation and stabilization rules in effect prior to the adoption of Regulation M.

385 The Regulation M Release clarifies that, in the case of debt securities, an issuer's outstanding securities will not be deemed to be the same as the security in distribution unless they are identical (*i.e.*, feature the same coupon rate, maturity date and other terms). By contrast, outstanding shares that differ only in voting rights from the shares being distributed are deemed to be the same security as the shares in distribution.

The SEC staff has also clarified that where a company is concurrently making a distribution of the same securities in two different offerings, an inducement to purchase securities in one offering should not constitute an impermissible inducement with respect to the second offering. For example, where a company offers its shares to the public for cash while concurrently offering its shares to shareholders of an acquisition target in connection with a merger, *bona fide* offers to sell or the solicitation of offers to buy shares distributed in one distribution would not be impermissible inducements with respect to the concurrent distribution of the same securities. However, sales efforts that go beyond *bona fide* offers to sell or the solicitation of offers to buy securities may result in a finding of impermissible inducements to purchase. *See* Staff Bulletin No. 9.

386 Conversely, activities in respect of a derivative security (*e.g.*, a convertible bond, warrant or option (including a short position in a put option)) related to a security in distribution (*e.g.*, the underlying common stock) will not be subject to the rule, so long as the price of the derivative security is not used to determine the price of the security in distribution under the terms thereof.

387 The restricted period commences one business day prior to pricing if the subject security has an average daily trading volume ("ADTV") value of at least $100,000, and the issuer has a public float value of at least $25 million. *See infra* Note 391 (explaining the calculation of ADTV value). In all other cases, the restricted period commences five business days prior to pricing. As used in Regulation M, the term "business day" is defined as a 24-hour period that includes an entire trading session for the security in the principal market for the security being distributed. Thus, for example, if pricing occurs at the close of trading in the principal market on Tuesday and a one-business day restricted period applies, the restricted period will begin at the close of trading in the principal market on Monday. If, however, pricing occurs prior to the close of trading on Tuesday, the restricted period would begin prior to the opening of trading in the principal market on Monday. *See* Staff Bulletin No. 9; *see also* Rule 100 of Regulation M.

388 Pricing occurs when the parties agree on the price, regardless of whether the agreement has yet been (or will ever be) memorialized in writing. *See* Staff Bulletin No. 9.

389 An underwriter will be deemed to have completed its participation in a distribution when its participation has been distributed and after any stabilization arrangements and trading restrictions in connection with the distribution have been terminated. *See* Rule 100 of Regulation M. For a selling group member that is not part of the underwriting syndicate, its participation in a distribution is completed when the selling group member has sold its entire allotment. *See* Staff Bulletin No. 9. A distribution participant's participation in a distribution will not be deemed completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of exercise. *See* Staff Bulletin No. 9. In this case, any

purchases made prior to the exercise of the option would constitute a violation of Regulation M. *See* § 3.02[5][f] for a discussion of overallotment options and syndicate short sales. Securities acquired by a distribution participant for investment purposes, that is, securities placed in an underwriter's investment account, will be considered distributed for purposes of Regulation M. *See* Regulation M Release. It is prudent for securities placed in such an investment account to be retained for a reasonable period of time. In addition, pursuant to FINRA requirements, any FINRA member acting as a manager (or in a similar capacity) of a distribution of a subject security, reference security or actively-traded security under Rule 101 must send a notice to FINRA, generally required no later than the close of business the next business day following the pricing of the distribution, providing the date and time of the pricing of the offering and the offering price. *See* FINRA Rules, Rule 5190(d), FINRA MANUAL.

390 Rule 100 of Regulation M. Neither the existence of exercisable warrants (or convertible securities) nor the approaching expiration date of such securities would itself cause the issuer of the warrants or convertible securities to be deemed to be in distribution. *See* Staff Bulletin No. 9. Special selling efforts, such as the solicitation of warrant exercises or conversions, a temporary reduction of the warrant exercise or conversion price or the payment of a soliciting dealer's fee, might cause a distribution to be deemed to be present. *See* Staff Bulletin No. 9.

391 ADTV may be calculated based on the two calendar months preceding the offering or on a 60-day rolling period ending within ten days of the filing of the related registration statement or, if there is no registration statement or the offering is being made pursuant to a shelf registration statement, ending within ten days of the pricing.

In the context of a security convertible into an actively-traded security, the SEC staff has clarified that the ADTV of the reference security does not affect the restricted period of the subject security; rather, the ADTV of the subject security (*i.e.*, the convertible security) determines the restricted period. *See* Staff Bulletin No. 9.

ADTV is calculated based on "worldwide" trading volume of common equity securities (per the definition found in Rule 100) and the SEC staff has clarified (in Staff Bulletin No. 9) that "[t]he phrase 'common equity securities' includes the equivalent type of stock of a foreign issuer. As a result, a foreign issuer with an existing exchange listing outside the United States may already have ADTV for purposes of Regulation M at the time of its U.S. initial public offering.

392 According to the Regulation M Release (text at note 42), "a distribution participant should have flexibility in determining a security's ADTV value from information that is publicly available, if such participant has a reasonable basis for believing that the information is reliable. [Footnote omitted.] Furthermore, in calculating the dollar value of ADTV, any reasonable and verifiable method may be used. For example, it may be derived from multiplying the number of shares by the price in each trade, or from multiplying each day's total volume of shares by the closing price on that day."

393 Public float value is defined as the aggregate amount of common equity securities held by nonaffiliates and is disclosed, in the case of U.S. issuers, in annual reports on Form 10-K filed with the SEC under the Exchange Act. *See* Rule 100 of Regulation M.

394 The SEC staff has granted exemptions to underwriters to engage in market making where the actively traded security exemption was not met, particularly in the context of noninvestment-grade sovereign debt issuances.

395 Regulation M's definition of "asset-backed security" comes from Item 1101 of Regulation AB, and is used to describe a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the securityholders.

396 Pursuant to § 939A of the Dodd-Frank Act, the SEC was charged with removing from SEC regulations all references to or requirements of reliance on credit ratings. Accordingly, the SEC has attempted to identify the characteristics of securities that make the markets for investment grade securities difficult to manipulate

and has indicated that its goal is to implement the requirements of the Dodd-Frank Act without necessarily changing the substantive results under the various rules and forms or imposing undue additional burdens on market participants. SEC Release No. 34-64352 (Apr. 27, 2011). The proposed approach would remove the references to credit ratings in Rules 101(c)(2) and 102(d)(2) and would instead exempt nonconvertible debt and preferred stock and asset-backed securities from Regulation M if they (i) are liquid relative to the market for that asset class (as indicated by the daily trading volume and number of market makers, among other things), (ii) trade in relation to general market interest rates and yield spreads (rather than in relation to issuer-specific factors), and (iii) are relatively fungible with securities of similar characteristics and interest rate yield spreads (for trading purposes). The determination of whether these factors are met would be required to be made using reasonable factors of evaluation and then verified by an independent third party, which could not be counsel to the underwriter or issuer or an affiliate of theirs. The SEC requested comment on what the qualifications of such a third party should be, and whether for example an entity eligible to be a "qualified independent underwriter" in the distribution should be required. Although the SEC, in the context of eliminating credit rating references in other rules in 2013, indicated it would address the proposed removal of such references from Rules 101 and 102 separately at a later time, it has not yet done so. *See* SEC Release No. 34-71194 (Dec. 27, 2013).

397 Rule 101 also includes exemptions for "exempted securities," as defined in § 3(a)(12) of the Exchange Act (including certain government and municipal securities), face-amount certificates issued by a face-amount certificate company and redeemable securities issued by an open-end management investment company or a unit investment trust.

398 For a discussion of the requirements of Rule 144A, *see* § 7.02[3].

399 This exemption does not cover private placements of Rule 144A-eligible securities to accredited investors that are not QIBs.

400 For a discussion of the requirements of Regulation S, *see* Chapter 8.

401 The staff of the SEC has clarified that market transactions would be deemed solicited where an indication of interest has been solicited by a syndicate member from a client to purchase in the distribution, but the client instead wishes to buy immediately in the market. *See* Staff Bulletin No. 9.

In connection with Rule 10b-6 under the Exchange Act, one of the predecessor rules to Regulation M, the SEC indicated that the dissemination of research to particular customers by sales personnel (in contrast to the dissemination of research continuously through the use of routine distribution systems such as mailing lists) would render a transaction solicited, and thus outside the scope of permissible transactions under Rule 10b-6. The SEC also noted that research transmitted orally must be evaluated in the context of the entire oral presentation, including whether the broker-dealer or the customer initiated the contact, the sophistication of the customer and the normal course of dealings with the customer, and further noted that, in most cases, the oral transmission of positive research by sales personnel on their own initiative would constitute a solicitation and an inducement to purchase. *See* SEC Release No. 33-6550 (Sept. 19, 1984); *see also supra* Note 261 (discussing certain exceptions to Regulation M for the distribution of research that is in compliance with Rule 138 or 139 under the Securities Act). Although Rule 10b-6 is no longer in force, the SEC has indicated that interpretations under the rules in effect prior to the adoption of Regulation M remain relevant to interpretations of similar terms and concepts used in Regulation M. *See* the Regulation M Release.

402 For a discussion of Rules 138 and 139 under the Securities Act and the dissemination of research in connection with a global offering, *see* §§ 3.02[3][e][iii] and [iv].

In the case of research reports not meeting the conditions of Rule 138 or 139, the SEC declined to codify an exemption based on existing market practice, which often involved the distribution of such noncomplying research reports outside the United States in a manner consistent with local market practice when the securities being offered were those of a non-U.S. issuer. *See* SEC Release No. 33-7375 (Dec. 20, 1996). The SEC noted, however, that there might be circumstances in which the distribution outside the United States of such noncomplying research reports might be appropriate during a global offering.

The issue has become less important since the adoption of Regulation M because of the frequent availability of exemptions under Regulation M (in particular, the actively-traded securities exemption) and the relatively brief restricted periods under Regulation M (which are shorter than the typical research blackout periods imposed by lead managers). Many practitioners are of the view that prohibiting the distribution outside the United States of noncomplying research reports in the context of global offerings by non-U.S. issuers would be an inappropriate extra-territorial exercise of U.S. authority.

403 This exemption codifies certain no-action relief granted by the staff of the SEC under Rule 10b-6 under the Exchange Act (which was, as mentioned above, one of the predecessor rules to Regulation M). *See Basket Trading During Distributions* (avail. Aug. 6, 1991). Rule 101 exempts *bona fide* basket transactions in covered securities in the ordinary course of business if (i) the security being distributed constitutes 5% or less of the value of the basket being purchased and (ii) the basket contains at least 20 securities. The exemption also permits the adjustment of an existing basket position related to a standardized index if such adjustment is made in the ordinary course of business as a result of a change in the composition of the relevant index.

404 The de minimis exemption exempts purchases that in the aggregate total less than 2% of the security's reported ADTV and unaccepted bids. The de minimis exemption is limited to persons who maintain and enforce written policies and procedures reasonably designed to achieve compliance with Rule 101. Once inadvertent transactions are discovered, subsequent transactions are not covered by the exemption. In addition, even if a trade subsequently is broken, it must be considered a purchase for the purpose of the exemption.

405 Rule 101 exempts from its coverage transactions among distribution participants in connection with a distribution, and purchases of securities from an issuer or selling securityholder in connection with a distribution, in either case that are not effected through an exchange, as well as transactions complying with the passive market making and stabilization provisions contained elsewhere in Regulation M and bids and purchases of odd-lots. In addition, Rule 101 exempts the exercise of any option, warrant, right or conversion privilege set forth in the instrument governing a security, as well as offers to sell or the solicitation of offers to buy the securities being distributed (including securities acquired in stabilizing) or securities offered as principal by the person making such offer or solicitation. *See* Regulation M Release, Anti-Manipulation Rules Concerning Securities Offerings, 62 Fed. Reg 520, 532 n. 95 (Jan. 3, 1997); *see also* Staff Bulletin No. 9.

406 A Nasdaq market maker that is affiliated with the issuer or selling securityholder but is not acting as a distribution participant may not rely on Rule 103. *See* Staff Bulletin No. 9.

407 *See Distributions of Certain United Kingdom Securities and of Certain Securities Traded on SEAQ International* (avail. Jan. 10, 1995). This letter restated and expanded similar relief first granted in the late 1980s and permitted passive market making in connection with offerings by certain issuers listed on the London Stock Exchange's Stock Exchange Automated Quotation System ("SEAQ") or quoted on the London Stock Exchange's Stock Exchange Automated Quotation International system ("SEAQI").

The SEC staff recognized that Rule 10b-6, one of the predecessor rules to Regulation M, would have interfered with the London Stock Exchange rules intended to preserve the integrity of London's trading market. These rules were designed to prohibit "fair-weather" market making by effectively preventing a member firm from resuming market making activities in a security for three months after the firm ceased to make a market in that security. Market makers in London thus do not withdraw from the market when they or their affiliates participate in an offering, as they would be required to do, absent an exemption, by Rule 10b-6 (as well as by Rule 101 of Regulation M). *See* L. E. Bergmann, *Selected Trading Practices Developments*—1987, ALI-ABA Course of Study—Broker Dealer Regulation (Jan. 21–22, 1988).

408 *See London Stock Exchange* (avail. Aug. 5, 1997). The London Stock Exchange's revised relief under Regulation M permits broker-dealers that are members of the London Stock Exchange to engage in "passive" market making activities in connection with offerings by certain issuers when such broker-dealers would otherwise be prevented from making a market by Regulation M. "Passive" market making refers to

the ability of the U.K. firms to provide depth and liquidity in the U.K. securities market by continuing to act as market makers without leading the market in price or size of quotations. Without the relief granted by the SEC, the London Stock Exchange was concerned that, in the case of securities that did not qualify for the actively-traded securities exemption of Rule 101, Regulation M would impede the normal functioning of the U.K. securities market when members of the London Stock Exchange (or their affiliates) participated in a distribution of covered securities while making a market in such securities on the London Stock Exchange.

In substance, the SEC relief permits members of the London Stock Exchange and certain affiliates to bid for, purchase, or solicit the purchase of securities that are the subject of a U.S. distribution (or a reference security), notwithstanding the application of Rule 101, when such securities are listed on SEAQ or, in certain cases, SEAQI. This relief is applicable during the period commencing (i) one business day before the determination of the offering price and ending upon completion of participation in the distribution in the United States in the case of securities with an ADTV value of $100,000 or more that are issued by an issuer whose common equity securities have a public float value of $25 million or more or (ii) five business days before the determination of the offering price and ending upon completion of participation in the distribution in the United States in the case of all other securities. The relief is subject to a number of conditions, including that members of the London Stock Exchange not enter any bids for or make any purchases of covered securities at a price higher than the highest bid, and that no bids be made for a quantity of covered securities greater than the largest quoted bid size currently displayed on SEAQ or SEAQI by an independent member of the London Stock Exchange not participating in the distribution. These restrictions do not apply to purchases following unsolicited inquiries or unsolicited brokerage transactions.

Under the relief, London Stock Exchange members are also required to reduce their bids if such bids subsequently become higher in price or larger in size than any independent bid. Disclosure of the passive market making activities must also be included in the prospectus filed under the Securities Act in connection with the U.S. distribution.

409 *See*, *e.g.*, *Rhone-Poulenc S.A.* (avail. Jan. 25, 1993) (SEAQI and Marché des Options Négociables de Paris ("MONEP"), which also included exemptions for concurrent exchange offers by the French government (the selling shareholder) and the company); *TOTAL* (avail. June 23, 1992) (SEAQI and MONEP, which also covered a concurrent exchange offer); *TOTAL* (avail. Oct. 18, 1991) (SEAQI and MONEP); *Novo Nordisk A/S* (avail. June 18, 1991) (Copenhagen Stock Exchange); *Société Nationale Elf Aquitaine* (avail. June 10, 1991) (SEAQI and MONEP); *Trans Canada Pipelines Limited Equity Offering* (avail. June 10, 1991) (Montreal Stock Exchange); *Norsk Hydro a.s.* (avail. May 6, 1988) (Oslo Bors).

410 An affiliated purchaser of an issuer or selling securityholder that is acting as a distribution participant may, however, comply with the provisions of Rule 101 rather than Rule 102 if the affiliated purchaser is not itself the issuer or selling securityholder (although the ADTV exemption in Rule 101 will not be available to an affiliated purchaser, as that exemption is unavailable for securities issued by an affiliate of a distribution participant). *See also infra* Note 414 (examining certain no-action relief that has been granted under Regulation M to affiliated purchasers of issuers and certain other parties that are not acting as distribution participants).

411 According to the Regulation M Release, these exemptions are omitted because issuers and selling securityholders have a direct stake in the proceeds of the offering and thus may have a greater incentive to manipulate the price of covered securities. The release also notes that transactions by issuers and selling securityholders generally are not monitored by self-regulatory organizations and that issuers and selling securityholders generally do not engage in the same type of market activities as part of their business as those persons subject to Rule 101. *See* Regulation M Release.

412 *See* the Regulation M Release, Anti-Manipulation Rules Concerning Securities Offerings, 62 Fed. Reg. 520, 522 n.95 (Jan. 3, 1997); *see also* Staff Bulletin No. 9.

413 An agent will not be considered independent of the issuer in cases where the issuer exercises any direct or indirect control or influence over the timing, manner, price or amounts of purchases or selects the broker or dealer through which purchases may be exercised. Such control or influence will be deemed not to exist if

the issuer, not more than once in any three-month period, revises the basis for determining its contributions to a plan or the frequency of its allocations to a plan, or revises the formula that determines the amount or timing of purchases by the agent.

414 The SEC staff has granted no-action relief from Rule 102 to an open-end investment fund that, by its nature, engaged in continuous offers to sell and repurchase securities. *See Popular High Grade Fixed-Income Fund* (avail. Sept. 10, 2002); *see also ING Senior Income Fund* (avail. Oct. 17, 2002) (granting relief from Rule 102 to an investment fund for purposes of a rescission offer to purchase its securities while engaged in a distribution of shares subject to Rule 102); *accord Oppenheimer Senior Floating Rate Fund* (avail. Aug. 31, 2005).

415 An affiliated purchaser of an issuer or selling securityholder that is not acting as a distribution participant would be subject to the more restrictive Rule 102. However, the SEC staff has granted no-action relief to affiliated purchasers of the issuer of the securities being distributed that were not, themselves, acting as distribution participants to allow the affiliated purchasers to conduct certain market making and other transactions in the subject securities. *See*, *e.g.*, *UBS AG* (avail. Sept. 22, 2000). Relief has been granted subject to compliance with certain conditions, and has been premised on certain factors, including that the subject securities would have qualified as actively-traded securities under Rule 101(c)(1) of Regulation M, that the relevant activities were being undertaken in the ordinary course of business and that the withdrawal of the affiliated purchasers from the market could have had possible "serious harmful effects" both in the home market and in the United States or create disruptions for customers or conflict with fiduciary duties of the affiliated purchasers. *See Deutsche Bank Aktiengesellschaft* (avail. Sept. 16, 2010); *see also Bank of Montreal* (avail. Apr. 8, 2011); *Shinhan Financial Group Co., Ltd.* (avail. Mar. 5, 2009); *ABN AMRO Holding N.V.* (avail. Aug. 7, 2007); *Allianz SE* (avail. Mar. 23, 2007); *Banca Intesa S.p.A.* (avail. Nov. 1, 2006); *Sanpaolo IMI S.p.A.* (avail. Nov. 1, 2006); *Allianz AG* (avail. Apr. 10, 2003); *UBS AG* (avail. Sept. 22, 2000). The SEC staff has also granted no-action relief under Rule 102 to permit an issuer to engage in a share repurchase program while engaged in a distribution of its securities, subject to numerous conditions. *See Barclays Bank PLC* (avail. Aug. 2, 2007).

416 The issuer's ADTV will still be significant under such circumstances because it is used to determine whether the restricted period relating to the issuer's or its affiliate's market activities will begin one business day or five business days prior to pricing. For example, a distribution participant that is an investment banking subsidiary of a global investment bank that is the issuer of securities in an offering will be subject to the restrictions of Regulation M and therefore must be out of the market one business day before the pricing date in that offering.

417 It is worth noting that the term "stabilization" has different meanings within and outside the United States. Rule 104(a) of Regulation M refers to stabilization "in connection with an offering" and applies to market interventions that precede the completion of a distribution (but generally do not extend beyond such completion). *See infra* Note 420. Outside the United States, stabilization is a more general term, often referring to market activities of underwriters occurring during a specified period following the closing of an offering. Non-U.S. jurisdictions may require that a global offering of securities also comply with the stabilization rules of that jurisdiction. Interesting issues therefore arise in trying to apply Regulation M in the context of aftermarket activities called "stabilization" abroad. For example, stabilization in accordance with European Union rules is permitted for a limited period after an offering. Regulation M should not be deemed to restrict non-U.S. purchases or inducements to purchase the subject securities after the U.S. distribution is completed. The Rule 104 restrictions also would not need to be followed because the offering in the United States has been completed. This view is consistent with the views expressed in a no-action letter under Rule 10b-6, one of the predecessor rules to Regulation M. *See Williams, William J., Jr.* (avail. Nov. 27, 1996), which is discussed in *supra* Note 335.

418 Rule 104, unlike Rules 101, 102 and 103, applies to all "offerings" and not merely to "distributions" within the meaning of Rule 100. *See* Staff Bulletin No. 9.

419 The term "current exchange rate" is defined as the current rate of exchange between two currencies, which is obtained from at least one independent entity that provides or disseminates foreign exchange quotations

in the ordinary course of its business. Rule 100 of Regulation M.

420 Rule 104 regulates stabilization activities only so long as the U.S. component of a global offering is continuing or if the stabilization activities "facilitate the offerings in the United States" even though the U.S. distribution is completed. *See Nippon Telegraph and Telephone Corp.* (avail. Nov. 8, 1999). It should thus be the case that in general, once the U.S. distribution is completed, and assuming no U.S. purchases or sales are being made in connection with syndicate stabilization activities, Rule 104 is no longer applicable and only local regulations apply. *See supra* Note 417.

421 The Market Abuse Directive was the predecessor to the current Market Abuse Regulation.

422 The staff of the SEC has approved reliance on the pre-Market Abuse Directive U.K. stabilization regulations even outside the United Kingdom provided that: (i) the stabilization activities are conducted subject to and in compliance with the U.K. stabilization regulations, (ii) at least a portion of the international offering is or will be conducted in the United Kingdom, (iii) the stabilization activities will be conducted by or under the management of an "authorized person" (any underwriter or other financial services firm that is an authorized person under the U.K. Financial Services Act 1986 (or any successor law) as in effect from time to time, whether the firm is acting for its own account or for the accounts of others (*e.g.*, as an agent of an underwriting or other selling group)), and (iv) the stabilization activities will occur at a time when no stabilization is being conducted in the United States. *See Nippon Telegraph and Telephone Corp.* (avail. July 28, 2000).

423 *Nippon Telegraph and Telephone Corp.* (avail. Dec. 11, 1998).

424 *See Nippon Telegraph and Telephone Corp.* (avail. Nov. 8, 1999).

425 *See supra* Note 422 and accompanying text; *ING Group N.V.* (avail. June 10, 1997). The SEC has not determined that the post-Market Abuse Directive (or post-Market Abuse Regulation) stabilization rules of the United Kingdom, The Netherlands or any other member of the European Economic Area are equivalent to Rule 104. Such a determination may in any case be of limited utility, because Rule 104 relates to stabilization activities during a distribution, whereas stabilization safe harbors and related activities in jurisdictions outside the United States often apply only during a specified period following the closing of an offering. *See supra* Notes 417 and 420.

426 *See also* Items 508 of Regulation S-K under the Securities Act (requiring that the "plan of distribution" section describe any prospective stabilizing and aftermarket activity, including syndicate covering transactions and penalty bids).

427 The SEC has granted an exemption from this notification requirement for nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities that in each case are rated investment grade. *See The Bond Market Association* (avail. Dec. 10, 1997). *But see infra* Note 546 for a discussion of the removal from SEC regulations of all references to or requirements of reliance on credit ratings.

428 Notice of a penalty bid should be submitted to FINRA when the penalty bid will be assessed. If notice of a penalty bid is given at the time of pricing because the agreement among underwriters contains a penalty bid provision but no penalty bid is in fact imposed, the staff of the SEC has stated that an amended notice should be filed to reflect that no such assessments were made. *See* Staff Bulletin No. 9. As a practical matter, penalty bids are rarely used.

429 SEC, Division of Market Regulation, Staff Legal Bulletin No. 10, Prohibited Solicitations and "Tie-in" Agreements for Aftermarket Purchases (Aug. 25, 2000), Fed. Sec. L. Rep. (CCH) ¶60,010.

430 In January 2005, the SEC announced the filing of settled civil injunctive actions in federal court against Morgan Stanley & Co. Incorporated and Goldman, Sachs & Co. The actions related to the firms' allocations of stock in initial public offerings they underwrote in 1999 and 2000, where it is alleged, among other things, that they attempted to induce certain customers who received allocations to place purchase orders for additional shares in the aftermarket. In settlement of this matter, both banks consented, without admitting or denying the allegations of the complaint, to final judgments that permanently enjoined them from violating Rule 101 of Regulation M, and ordered each of them to pay a $40 million civil penalty. *See SEC v. Morgan Stanley & Co. Incorporated*, SEC Litigation Release No. 19050 (Jan. 25, 2005); *SEC v. Goldman, Sachs &*

Co., SEC Litigation Release No. 19051 (Jan. 25, 2005). Similar cases were also brought against other investment banks, including J.P. Morgan Securities, Inc. and Credit Suisse First Boston Corporation, alleging allocation abuses in initial public offerings carried out during the same period. *See SEC v. J.P. Morgan Securities, Inc.*, SEC Litigation Release No. 18385 (Oct. 1, 2003); *SEC v. Credit Suisse First Boston Corporation*, SEC Litigation Release No. 17327 (Jan. 22, 2002).

FINRA has adopted rules that, among other things, prohibit its members from engaging in certain "*quid pro quo*" allocation arrangements in connection with initial public offerings. *See* § 3.06[2][b] for a discussion of FINRA Rule 5131.

431 Prior to revisions adopted in August 2007, Rule 105 had only prohibited covering short sales of securities made during the Pre-Pricing Period (as defined below) with offered securities purchased from an underwriter, broker or dealer participating in the offering. Under the prior rule, however, the SEC had brought a number of enforcement actions for violations of Rule 105. *See*, *e.g.*, *In re GLG Partners, LP*, SEC Release No. 34-55956 (June 26, 2007); *Amaranth Advisors L.L.C.*, SEC Release No. IA-2601 (May 9, 2007); *In re Goldman Sachs Execution & Clearing L.P.*, SEC Release No. 34-55465 (Mar. 14, 2007); *SEC v. Solar Group S.A.* (S.D.N.Y. Nov. 6, 2006), SEC Litigation Release No. 19899 (Nov. 6, 2006); *SEC v. Compania Internacional Financiera S.A.* (S.D.N.Y. Dec. 20, 2005), SEC Litigation Release No. 19501 (Dec. 20, 2005). Certain of these enforcement actions involved trading activities intended to conceal the fact that shares acquired in offerings were being allocated to cover short sales entered into during the Rule 105 Pre-Pricing Period. *See* SEC Release No. 34-54888 (Dec. 6, 2006). As a result, the SEC has amended Rule 105 of Regulation M to prohibit, subject to certain exceptions, all purchases of offered securities by persons making short sales of the securities that are the subject of the offering during the Rule 105 Pre-Pricing Period, irrespective of whether the acquired securities were used to cover the short position.

432 In connection with offerings of convertible or exchangeable securities, the underlying security is not deemed to be an offered security for purposes of Rule 105. As a result, Rule 105 does not prohibit a person that shorted common stock in the Pre-Pricing Period from purchasing securities that are convertible into or exchangeable for such common stock. The SEC has noted, however, that it would continue to monitor the convertible offering market and may re-evaluate the treatment of these offerings under Rule 105. *See* SEC Release No. 34-56206 (Aug. 6, 2007).

433 The prohibition is based on the price distortion that can result when pre-pricing short sales are covered with shares sold in the offering, thereby undermining the market's ability to work as an independent pricing mechanism and thus the integrity of the offering price. Short sales by traders aware of their ability to cover short sales with offering shares do not involve the same market risk as short sales that are intended to be covered with open market shares, and this can upset price discovery and the efficiency of the pricing process. *See* SEC Release No. 34-56206 (Aug. 6, 2007).

434 Rule 105(b) of Regulation M. The SEC has indicated that it will also consider on a case-by-case basis specific requests for exemptive relief from entities that may not otherwise qualify for the separate account exception of Rule 105. *See* SEC Release No. 34-56206 (Aug. 6, 2007).

435 The prohibition originally did not apply to offerings filed under Rule 415 under the Securities Act on the grounds that shelf offerings of equity securities were not common when Regulation M was adopted, and it was the SEC's understanding at that time that potential investors generally were not aware of shelf takedowns until just before they took place, meaning that pre-pricing short sales were arguably not focused on any prospective offering. However, in light of the evolution of shelf offering techniques to include many of the features of nonshelf offerings, *e.g.*, road shows and other special selling efforts, thereby giving investors advance notice of the offering before it occurs, and because shelf offerings of equity securities have become commonplace, in 2004 the SEC amended Rule 105 of Regulation M to extend the prohibition to shelf takedowns. *See* SEC Release No. 34-50103 (July 28, 2004); *see also supra* Note 433, which describes the pricing disruption concerns pre-pricing short sales can raise.

436 The SEC has also indicated that it will continue to monitor whether trading patterns in debt securities raise manipulative concerns in connection with debt offerings. In addition, the SEC has stated that it will continue

to monitor the use of derivative strategies that may replicate the economic effect of the activity that Rule 105 is designed to prevent. *See* SEC Release No. 34-56206 (Aug. 6, 2007).

U.S. Regulation of the International Securities and Derivatives Markets, § 3.03, LISTING EQUITY SECURITIES IN THE UNITED STATES

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 § 3.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

A foreign company that lists securities on a U.S. exchange must register under the Exchange Act the class of securities to be listed. As a consequence, the issuer will become subject to the periodic reporting and other requirements of the Exchange Act, including the corporate governance, accountability, auditor independence and other requirements of the Sarbanes-Oxley Act and the Dodd-Frank Act. [437] In addition, listing on the NYSE or Nasdaq will subject the issuer to the ongoing rules of the exchange including various corporate governance, notice and other requirements. [438]

[1] Registration Under § 12 of the Exchange Act

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[a] Section 12(b)

As discussed in § 4.02, a class of securities, whether newly issued or already outstanding, that is listed on a national securities exchange (such as the NYSE or the Nasdaq [439]) must be registered under § 12(b) of the Exchange Act. [440] The SEC must declare the registration statement effective before such securities may be listed. [441]

[b] Core Disclosure Document—Form 20-F

The statutory disclosure requirements set out in the Securities Act and the Exchange Act are substantially identical. Over time, beginning in the early 1980s, the SEC developed the view that the information necessary for investors purchasing in a distribution should be the same as the information necessary for investors to make informed secondary market trading decisions (which was the primary rationale for imposing periodic reporting in the Exchange Act).

This recognition led to two important developments. First, the accounting and disclosure requirements for a registered public offering were made substantially identical to the accounting and disclosure requirements for registration of

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a class of securities under the Exchange Act or for periodic reporting thereunder. [442] Second, an integrated disclosure system was developed, important consequences of which were shelf registration and later automatic shelf registration. [443] Under that system, for many issuers, information filed under the Exchange Act need not be repeated in prospectuses prepared subsequent to the Exchange Act filing, but may simply be incorporated by reference, thus reducing the size of the prospectus and the time necessary for its preparation.

Under the integrated disclosure system, the accounting and disclosure requirements for foreign issuers under the Securities Act and the Exchange Act now derive from the same form: Form 20-F. Form 20-F is used both for original registration and for annual reports subsequently filed under the Exchange Act, and is the source of requirements for company disclosure to be included in registration statements under the Securities Act. [444]

In 1999, the SEC adopted a complete revision of Form 20-F that replaced most of its issuer-related disclosure requirements, other than financial statement requirements, with international disclosure standards adopted by the International Organization of Securities Commissions ("IOSCO"). [445] The adoption of Form 20-F based on the IOSCO standards did not change the requirement that financial statements be prepared in accordance with, or reconciled to, U.S. GAAP, which can be a significant obstacle for foreign issuers seeking access to U.S. markets. In 2007, however, the SEC adopted amendments to Form 20-F that now allow foreign private issuers to file financial statements prepared in accordance with IFRS, as issued by the IASB, without reconciliation to U.S. GAAP. [446]

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The changes to Form 20-F based on IOSCO standards also did not affect the supplementary disclosure requirements provided for in the SEC's industry guides, which can be another significant obstacle for foreign banks, insurance companies and mining companies in particular. [447] In addition, although much in the IOSCO standards was clearly inspired by the previous Form 20-F and by U.S. disclosure practices, there are extensive differences in wording between the IOSCO standards and previous Form 20-F. The SEC staff is likely to interpret the IOSCO standards, where the wording differs but is ambiguous, in light of analogous provisions of Regulation S-K.

Substantial revisions were also made to Form 20-F pursuant to the Sarbanes-Oxley Act and the rules adopted by the SEC thereunder. In particular, new disclosure requirements were established with respect to off-balance sheet transactions, contractual obligations, non-GAAP financial measures, conclusions on the effectiveness of an issuer's disclosure controls and procedures and internal control over financial reporting, management's responsibility for establishing and maintaining internal control over financial reporting and the related accountants' attestation report, audit committee financial experts, codes of ethics and auditor fees and services. [448] Certain of the rules implementing the Sarbanes-Oxley Act mandate disclosures in periodic reports filed under the Exchange Act, but do not impose those requirements in Securities Act registration statements. [449]

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Substantial changes have also been made to Form 20-F since the passage of the Sarbanes-Oxley Act, including additional disclosure requirements relating to corporate governance practices; [450] ADR fees; [451] changes in auditors; [452] and a shortening of the reporting deadline, with annual reports on Form 20-F required within four months of the issuer's fiscal year end. [453]

Most recently, changes have been made to the Form 20-F disclosure requirements as a result of implementation of the disclosure mandates of the Dodd-Frank Act, including the following:

- the requirement that every reporting company that is an operator or has a subsidiary that is an operator of coal or other mines in the United States make certain health- and safety-related disclosures. These provisions apply to foreign issuers that operate or have subsidiaries that operate mines in the United States. [454]
- the requirement that any reporting company, including a foreign issuer, that manufactures or contracts to manufacture products for which conflict minerals are necessary to those products' functionality or production disclose whether or not its conflict minerals originate in the Democratic Republic of the Congo and adjoining countries (collectively, the "DRC Countries"). If a

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  company is unable to conclude that its conflict minerals did not originate in any DRC country (or the minerals came from recycled or scrap sources), it is required to file a "Conflict Minerals Report" as an exhibit to the annual report that provides, among other things, detailed disclosure regarding measures taken by the company to exercise due diligence with respect to its supply chain, including an independent private sector audit. [455]
- the requirement that any reporting company, including a foreign issuer, that engages in the commercial

development of oil, natural gas, or minerals disclose payments made to governments for such development.

- the commercial development of oil, natural gas or minerals. [456]

[2] Obtaining a Listing in the United States

[a] Application for Listing

In selecting a market on which to list their securities, issuers should consider not only fees and applicable rules for listed companies, but also the different market structures and types of trading in each market. For example, the NYSE is a hybrid market combining features of auction markets and automated trading. Historically, the NYSE operated principally as an auction market— *i.e.*, a market in which the prices at which securities are bought and sold are generally established and trades executed in electronic or face-to-face contacts at a single electronic or physical location between floorbrokers of buyers and sellers. In addition, a member of the exchange (a "designated market maker," formerly called "specialists") is selected for each listed security and is responsible for maintaining a fair and orderly market in that security, even if it must to a limited extent trade for its own account in order to meet public demand. The NYSE has expanded its automated trading platform in response to technological advances and regulatory demand. [457] Nasdaq markets are "dealer markets"— *i.e.*, markets in which market-makers agree to quote bid and offered prices for standard small transactions in particular securities and to execute trades at those prices. Executions can be placed at a multiplicity of market-makers and electronic market centers.

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In each of these exchanges, immediate reporting of transactions provides real-time price information. Proponents of each of these markets claim particular advantages of their trading and market-making procedures (*e.g.*, cost of trading, price improvement, liquidity, *etc.*), as well as the prestige of a listing on that market. [458]

Once a decision to list on the NYSE or Nasdaq has been made, an application must be submitted to the exchange. In connection with an IPO, the exchanges typically request two months to complete work on the application, whereas secondary listings of equity or debt securities typically can be accomplished more quickly. Trading will commence on a date chosen by the issuer in consultation with the exchange and after the related registration statement has been declared effective. The listing application contains various certifications and undertakings from the issuer and upon listing the issuer will become subject to numerous continued listing requirements. Key NYSE and Nasdaq listing standards are set out in the next two sections.

[b] New York Stock Exchange Listing Standards

In order to make the U.S. equity markets more accessible to foreign companies, the NYSE has special standards and procedures for listing shares [459] or ADRs [460] of foreign companies where there is a broad, liquid market for a company's shares in its home country. [461] The principal criteria include distribution and size standards that require the foreign issuer to have, worldwide, a minimum of 5,000 holders of 100 or more shares (determined on the basis of beneficial ownership, if known, in addition to holders of record), and a minimum of 2.5 million publicly held shares [462] having a market value of at least $100 million. [463]

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The alternate listing standards for foreign companies also require the issuer to meet one of the following three alternative financial standards (determined under U.S. GAAP or IFRS) based on earnings, operating cash flow or global market capitalization: [464]

- to have pre-tax earnings from continuing operations, after minority interest, amortization and equity in the earnings or losses of investees and as adjusted for certain specified items, of at least $100 million in the aggregate for the last three years (with a minimum of $25 million in each of the most recent two years); [465] , [466]

- for companies with a total worldwide market capitalization of not less than $500 million and revenues (in the most recent 12-month period) of $100 million to have aggregate operating cash flow (calculated in accordance with NYSE specifications) for the last three years of at least $100 million in the aggregate (with a minimum of $25 million, as adjusted for certain specified items, in each of the two most recent years); [467]
- to have not less than $750 million in total worldwide market capitalization (with not less than $75 million in revenues in the most recent fiscal year). [468]

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Foreign companies may also rely on the "affiliated company" standard, the principal criteria for which are (i) global market capitalization of at least $500 million, (ii) minimum of 12 months of operations (although there is no requirement to have been a separate corporate entity for such period), (iii) a parent or affiliated company being a listed company on the NYSE in good standing and (iv) such parent or affiliated company retaining control over the foreign company or being under common control with the foreign company (with control presumed to exist when the parent or affiliate holds directly or indirectly 20% or more of the foreign company's voting stock). The affiliated company must have a market value of publicly held shares worldwide of at least $60 million. [469]

NYSE MKT, formerly NYSE Amex Equities, has a focus on small-cap companies and less stringent listing standards. A foreign issuer can qualify for listing under the NYSE MKT domestic listing standards [470] or the more relaxed

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foreign company standards: distribution and size standards that require the foreign company to have, worldwide, a minimum (i) 800 round-lot holders, (ii) 1,000,000 publicly held shares [471] and (iii) market value of publicly held shares of $3,000,000. [472] The NYSE also operates NYSE Arca, an all-electronic exchange that primarily lists exchange-traded notes, funds and other products.

Prior to submitting an application for listing, a company must undergo a confidential eligibility review in which the NYSE will consider whether the company satisfies the listing standards. [473] The NYSE charges companies listing fees at the time their shares are listed and on an ongoing basis annually. The initial listing fee and the annual listing fee are charged on a per-share basis. [474] The issuer may list any additional shares issued after the initial listing by filing with the NYSE a subsequent listing application and required opinions of counsel and paying all necessary listing fees. [475] Upon listing, the issuer is required to enter into a listing agreement with the NYSE, which sets out the continuing obligations of the issuer to implement certain NYSE policies. [476] The NYSE permits foreign private issuers to follow home country practice in lieu of certain corporate governance provisions and may, on a case-by-case basis, waive or modify obligations that relate to financial reporting or certain other corporate governance matters, other than corporate governance obligations imposed by the Sarbanes-Oxley Act and related NYSE rules. [477]

[c] Nasdaq Listing Standards

Effective July 2006, Nasdaq [478] created a new listing tier—the Nasdaq Global Select Market ("Nasdaq/GSM"), with financial and liquidity requirements higher than those of the NYSE or other Nasdaq markets (the Nasdaq Global

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Market and the Nasdaq Capital Market). [479] The current listing requirements for the inclusion of securities in all three markets are based on the distribution of the issuer's stock and the size of the issuer. [480] The requirements to list on the Nasdaq Global Market and Nasdaq Capital Market are considerably less difficult to meet than current NYSE requirements, especially with respect to the requirements for inclusion of shares of common stock (or ADRs representing such shares) of foreign issuers in the Nasdaq Capital Market.

For shares of common stock (or ADRs representing such shares) of an issuer to be eligible for initial inclusion in Nasdaq Capital Market, the issuer must satisfy one of three alternative sets of criteria ("entry standards"). Under each of these, the issuer must meet the following criteria: (i) at least one million publicly held shares or ADRs worldwide, [481] (ii) 300 round lot holders of record of the shares or ADRs, (iii) three registered market-makers for the shares or ADRs, and (iv) the initial Nasdaq bid price must be at least $4 per share. In addition to such criteria:

- under the first entry standard, the issuer must have (i) stockholders' equity of at least $5 million, (ii) a market value of publicly held shares or ADRs of $15 million, and (iii) an operating history of at least two years;
- under the second entry standard, the issuer must have (i) stockholders' equity of at least $4 million, (ii) a market value of listed securities [482] of $50 million, and (iii) a market value of publicly held shares or ADRs of $15 million; and
- under the third entry standard, the issuer must have (i) stockholders' equity of at least $4 million, (ii) net income from continuing operations of $750,000 in the most recently completed fiscal year (or in two of the last three fiscal

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years), and (iii) a market value of publicly held shares or ADRs of $5 million. [483]

The requirements for initial inclusion of securities in Nasdaq Global Market are similar to but more stringent than those for Nasdaq Capital Market. There are three entry standards that may be satisfied as a basis for inclusion of common stock (or ADRs representing such stock) in Nasdaq Global Market. Under each of these, there must be at least 1.1 million publicly held shares or ADRs worldwide and 400 round lot holders of record of the shares or ADRs, and the initial Nasdaq Global Market bid price must be at least $5 per share. In addition to such criteria:

- under the first entry standard, (i) the market value of publicly held shares or ADRs must be at least $8 million, (ii) there must be at least three registered market-makers for the security and (iii) the issuer must have stockholders' equity of at least $15 million and pre-tax income of at least $1 million in its most recently completed fiscal year (or in two of three of its most recently completed fiscal years);
- under the second entry standard, (i) the market value of publicly held shares or ADRs must be at least $18 million and (ii) the issuer must have stockholders' equity of at least $30 million and a two-year operating history; and
- under the third entry standard, (i) the market value of publicly held shares or ADRs must be at least $20 million, (ii) there must be at least four registered market-makers for the security and (iii) the issuer must have either a market capitalization of $75 million or total assets and total revenues of at least $75 million each in its most recently completed fiscal year (or in two of the last three fiscal years). [484]

Nasdaq/GSM has three entry standards that may be satisfied as a basis for inclusion of common stock (or ADRs representing such stock) in it. Under each of these, there must be at least three registered market-makers for the security and the initial Nasdaq/GSM bid price must be at least $5 per share. In addition to such criteria:

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- under the first entry standard, the issuer must have pre-tax income of at least $11 million in the prior three fiscal years (in the aggregate) and pre-tax income of at least $2.2 million in each of the two most recent fiscal years and positive pre-tax income in each of the prior three fiscal years. If the issuer does not have three years of publicly reported financial data, it may qualify under the first entry standard if it has reported aggregate pre-tax income of at least $11 million and positive pre-tax income in each reported fiscal year;

- under the second entry standard, the issuer must have (i) cash flows of at least $27.5 million in the prior three fiscal years (in the aggregate) and positive cash flows in each of the prior three fiscal years, (ii) an average market capitalization of at least $550 million over the prior 12 months (in the case of an initial public offering, compliance with the market capitalization requirement will be based on the issuer's market capitalization at the time of listing) and (iii) revenue in the previous fiscal year of at least $110 million; and
- under the third entry standard, the issuer must have an average market capitalization of at least $850 million over the prior 12 months (in the case of an IPO, compliance with the market capitalization requirement will be based on the issuer's market capitalization at the time of listing) and revenue of at least $90 million in the previous fiscal year.

Additionally, issuers must meet each of the liquidity requirements, or the applicable alternatives, in their specific category. The categories fall into the following groups: new company listings, seasoned companies, closed-end management investment funds and business development companies. Each category is required to have at least 1.25 million publicly held shares or ADRs worldwide. The required number of beneficial holders ranges from 450 to 2,200 depending on the category of issuer, and the market value of publicly held shares or ADRs ranges from $35 million to $110 million depending on the category of issuer. [485]

Issuers with securities listed on any of the three markets must comply with maintenance listing standards in order to retain their listing. [486] The maintenance standards are similar to, but less stringent than, the initial listing standards.

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Upon listing, the issuer is required to enter into a listing agreement with Nasdaq, which sets out the continuing obligations of the issuer to implement certain Nasdaq policies. [487] Nasdaq allows a foreign issuer to choose to follow home-country practice in lieu of certain corporate governance provisions and may, on a case-by-case basis, waive or modify obligations that relate to financial reporting or certain other corporate governance matters, other than corporate governance obligations imposed by the Sarbanes-Oxley Act and related Nasdaq rules. [488]

Footnotes

437 This section specifically addresses the listing of foreign companies' equity securities. *See* § 3.05 regarding special issues relating to the issuance of debt securities.

438 *See* § 5.02[1] regarding listed company audit committee requirements and § 5.05 discussing corporate governance requirements applicable to listed companies.

439 Prior to becoming a national securities exchange, Nasdaq rules required registration under § 12(g) of the Exchange Act for the quotation of securities, even though § 12(g) itself would only require registration if the total assets and number of shareholders of the issuer exceeded the thresholds specified in § 12(g). *See* § 12(g) of the Exchange Act and Rule 12g-1 thereunder. As a result of Nasdaq's transition to a national securities exchange, the Nasdaq-listed securities previously registered under § 12(g) of the Exchange Act have become registered under § 12(b) of the Exchange Act. *See* SEC Release No. 34-54240 (July 31, 2006). OTC Bulletin Board rules generally require the issuer to be subject to the reporting requirements of the Exchange Act. *See* FINRA Rules, Rule 6530, FINRA MANUAL. *See supra* Note 33 (discussing OTC markets).

440 The exemption from Exchange Act registration provided by Rule 12g3-2(b) is not available for listed securities.

441 The relevant exchange must, as a condition to the SEC's making the related Exchange Act registration statement effective, certify its approval and request that the SEC accelerate the effective date of the registration statement. *See* § 12(d) of the Exchange Act. In circumstances where exchange listing is

concurrent with a registered equity offering, the effectiveness of the Securities Act registration and the Exchange Act registration is coordinated.

Rule 12g-3 under the Exchange Act provides a limited exception to the requirement that the registration statement be declared effective where securities of an issuer not already registered pursuant to § 12 of the Exchange Act are issued, in connection with a succession by merger, consolidation, exchange of securities, acquisition of assets or otherwise, to the holders of any class of securities of another issuer registered pursuant to either § 12(b) or § 12(g) of the Exchange Act. *See* § 4.02[3][a][iii].

442 *See* SEC Release No. 33-6437 (Nov. 19, 1982).

443 *See* SEC Release No. 33-6499 (Nov. 17, 1983); SEC Release No. 33-6459 (Mar. 18, 1983); SEC Release No. 33-6383 (Mar. 3, 1982); SEC Release No. 33-6423 (Sept. 2, 1982); Securities Offering Reform Release. Shelf registration is discussed in § 3.02[2][c].

444 Previously, because of certain compromises made at the time the integrated disclosure system was adopted for foreign issuers, *see* SEC Release No. 33-6437 (Nov. 19, 1982), certain accounting requirements for financial statements prepared for most Securities Act registration statements were more rigorous than the accounting requirements for financial statements prepared for an Exchange Act filing. The SEC has now eliminated this differentiated treatment, and the more complete financial statements are required for foreign issuers in both Securities Act and Exchange Act filings. *See* SEC Release No. 33-7745 (Sept. 28, 1999); *see also* SEC Release No. 33-8959 (Sept. 23, 2008). For fiscal years ending on or after December 15, 2011, all financial statements included in annual reports on Form 20-F or in Securities Act registration statements must comply with Item 18 of Form 20-F, other than for Canadian Multi-Jurisdictional Disclosure System ("MJDS") filers. SEC Release No. 33-8959 (Sept. 23, 2008).

445 *See* SEC Release No. 33-7745 (Sept. 28, 1999) (the "20-F Release"). Corresponding changes were also made to the forms for the registration of offerings under the Securities Act.

446 Foreign issuers using U.S. GAAP or IFRS are required to provide their financial statements to the SEC in Extensible Business Reporting Language ("XBRL"), an interactive data format, when they file annual reports on Form 20-F. SEC Release No. 33-9002 (Jan. 30, 2009). Interactive data files are filed as exhibits that supplement, but do not replace, the financial statements otherwise required to be filed under Form 20-F. Foreign issuers are not required to include an interactive data file when using Forms 20-F to register securities under the Exchange Act, but are required to present financial statements in this format in connection with their first annual report on Form 20-F. Rule 405(g) of Regulation S-T requires that a foreign issuer subject to the interactive data requirement provide the same information on its corporate website, if it has one. Interim financial data reported on Form 6-K is not subject to the interactive data requirements, although revisions of annual financial statements do require interactive data exhibits, even if filed on Form 6-K. *See* Form 6-K, General Instruction C.6.

447 An industry guide had been in effect for oil and gas companies. However, on or after January 1, 2010 and for Exchange Act annual reports for years ending on or after December 31, 2009, a detailed set of substantially revised disclosure rules replaced the industry guide but remain applicable to foreign oil and gas companies. In a 2016 concept release, the SEC requested public comment on whether the industry guides improve disclosure or should be revised and whether industry guide requirements should be codified in Regulation S-K. *See* SEC Release No. 33-10064 (Apr. 13, 2016). Additionally, the SEC has proposed certain changes to Industry Guide 7 relating to mining companies. *See* SEC Release No. 33-10098 (June 16, 2016).

448 *See generally* Chapters 4 and 5.

449 *See generally* Chapters 4 and 5. For example, certifications by principal executive officers and principal financial officers and disclosure regarding internal controls, codes of ethics and audit committee financial experts, required by §§ 302, 404, 406 and 407 of the Sarbanes-Oxley Act, respectively, and the rules issued by the SEC thereunder, are required to be included in annual reports filed under the Exchange Act but not in Securities Act registration statements. This distinction may well be based on the greater liability under Securities Act registration statements to which issuers, their directors and those members of senior

management required to sign the registration statement are subject. It may also be based on an SEC conclusion that it was appropriate in some cases not to impose additional requirements in connection with initial public offerings registered under the Securities Act.

450 *See* Form 20-F, Item 16G; SEC Release No. 33-8959 (Sept. 23, 2008). Such disclosure became required by the SEC in December 2008 and was already required under NYSE and Nasdaq rules.

451 ADR disclosure, including (i) the fees and charges that holders of ADRs pay for general depositary services (particularly those that must be paid on an annual basis), (ii) whether the depositary has the right to collect fees and other charges by offsetting them against dividends or against deposited securities and (iii) information concerning any payments made from the depositary to the issuer; *see* Form 20-F, Item 12D.3 and Item 12D.4. Additionally, disclosure of the fees and charges that holders of ADRs may have to pay must now be included in an annual report, not only in registration statements as previously required.

452 *See* Form 20-F, Item 16F. This disclosure must include any indication that the auditor will not stand for reelection and any change in any subsidiary auditor on which the principal auditor has expressed reliance in its report. Because part of the purpose of Item 16F is to require disclosure of opinion shopping, this item requires disclosure of adverse, disclaimed or qualified opinions; disagreements with the prior auditor; specified types of audit-related problems of which the prior auditor had advised the issuer; and certain kinds of pre-engagement consultations with the new auditor. Item 16F also requires that the prior auditor provide a letter to the SEC stating whether it agrees with the disclosure in Item 16F, which must be filed as an exhibit to the annual report or registration statement containing such disclosures.

453 *See* SEC Release No. 33-8959 (Sept. 23, 2008).

454 *See* SEC Release No. 34-63549 (Dec. 15, 2010) (the "Mine Safety Release"). *See also* § 4.07[4].

455 *See* SEC Release No. 34-67716 (Aug. 22, 2012). *See also* § 4.08.

456 *See* SEC Release No. 34-78167 (June 27, 2016). *See also* § 4.08.

457 The SEC adopted Regulation NMS under the Exchange Act. Regulation NMS addresses four main topics: (i) order protection (or prohibitions on "trade-through"), (ii) aftermarket access, (iii) sub-penny pricing, and (iv) market data. *See* SEC Release No. 34-51808 (June 9, 2005). The Order Protection Rule (Rule 611) requires market centers to establish, maintain and enforce written policies and procedures that are reasonably designed to ensure the market centers do not execute trades at lower prices than the best automated quotations received.

458 In spite of these advantages, many trades do not occur on the NYSE, Nasdaq, or any other exchange. A substantial percentage of trading in securities occurs off-exchange, in dark pools, alternative trading systems, and high-frequency trading platforms.

459 *See* § 3.04, Note 498 for a discussion of the global share programs for the listing of ordinary shares.

460 A company is also required to list the shares underlying listed ADRs, although the share listing is not for trading purposes.

461 *See* NYSE LISTED COMPANY MANUAL § 103.00. A company's ADRs must be sponsored in order to qualify for listing. NYSE LISTED COMPANY MANUAL § 103.04. Where a foreign issuer does not have a broad liquid market for its shares in its home country, it may nevertheless list ADRs on the NYSE if it satisfies the NYSE's domestic listing standards, which call for a minimum distribution of ADRs in the United States. *See infra* Note 468.

462 In calculating publicly held shares, shares held by directors, officers or their immediate families and concentrated holdings of 10% or more are excluded. NYSE LISTED COMPANY MANUAL § 103.01.

463 For initial public offerings, if necessary, the NYSE may accept a written commitment from an underwriter with respect to the estimated value of the company's offering to determine compliance with the listing standards. If an issuer has a significant concentration of shares or an issuer's public market value has been adversely affected by market forces and would otherwise qualify for a listing, the NYSE will consider stockholders' equity of at least $100 million as an alternate measure of size, if the issuer's public market value is at least $90 million. *See* NYSE LISTED COMPANY MANUAL § 103.01.

464 For initial public offerings, an underwriter must provide a written representation that demonstrates the issuer's ability to meet any applicable market capitalization requirement. NYSE LISTED COMPANY MANUAL § 103.01.

465 A foreign issuer that qualifies as an EGC and avails itself of the provisions permitting EGCs to report only two years of audited financial statements may qualify with pre-tax earnings from continuing operations after minority interest, amortization and equity in the earnings or losses of investees, and as adjusted for certain specified items, of at least $100 million in the aggregate for the last two fiscal years with a minimum of $25 million in each year. NYSE LISTED COMPANY MANUAL § 103.01.

466 Reconciliation to U.S. GAAP for the third year would only be required if the NYSE determines it is necessary to demonstrate that the $100 million threshold is satisfied. NYSE LISTED COMPANY MANUAL § 103.01.

467 Reconciliation to U.S. GAAP for the third year would only be required if the NYSE determines it is necessary to demonstrate that the $100 million threshold is satisfied. NYSE LISTED COMPANY MANUAL § 103.01.

468 NYSE LISTED COMPANY MANUAL § 103.01. A foreign issuer can also elect to qualify under the NYSE's domestic listing standards, which impose substantially less stringent financial tests but require a minimum of (i) 400 U.S. holders of a unit of trading, generally 100 shares ("round lot holders"), or (ii) 2,200 total U.S. stockholders and average monthly U.S. trading volume of 100,000 shares during the most recent six months, or (iii) 500 total U.S. stockholders and average monthly U.S. trading volume of one million shares during the most recent 12 months and a minimum of 1.1 million shares publicly held in the United States, with a market value of at least $40 million in the case of companies that list at the time of their initial public offerings or as a result of spin-offs or under the affiliated company standard, or $100 million for other companies, excluding shares held by directors, officers, their immediate families or 10% or greater shareholders. A per share closing price of at least $4 at the time of an initial public offering is also required. *See* NYSE LISTED COMPANY MANUAL § 102.01. (If an issuer has a significant concentration of shares or an issuer's public market value has been adversely affected by market forces and would otherwise qualify for a listing, the NYSE will consider stockholders' equity of at least $40 million or $100 million, as applicable, as an alternate measure of size, if the issuer's public market value is no more than 10% below the minimum of $40 million or $100 million, as applicable.) For initial public offerings, if necessary, the NYSE may accept a written commitment from an underwriter with respect to the estimated value of the company's offering to determine compliance with the listing standards. *See* NYSE LISTED COMPANY MANUAL § 103.01.

Under the domestic listing standards, the NYSE also requires companies to meet one of three alternative financial standards (determined under U.S. GAAP) based on earnings, operating cash flow or global market capitalization, as follows: (i) to have aggregate pre-tax earnings from continuing operations, after minority interest, amortization and equity in the earnings or losses of investees, and as adjusted for certain specified items, of $10 million in the aggregate for the last three fiscal years, together with a minimum $2 million in each of the preceding two fiscal years and positive amounts in all three years, or (ii) to have aggregate pre-tax earnings from continuing operations, after minority interest, amortization and equity in the earnings or losses of investees and as adjusted for certain specified items, of $12 million in the aggregate for the last three fiscal years, with a minimum of $5 million in the most recent fiscal year and $2 million in the next most recent fiscal year (with an underwriter providing a written representation that demonstrates the company's ability to meet the market capitalization requirement upon completion of the offering), or (iii) a global market capitalization of at least $200 million. A company that qualifies as an EGC and avails itself of the provisions permitting EGCs to report only two years of audited financial statements can qualify under a separate test with pre-tax earnings from continuing operations after minority interest, amortization and equity in the earnings or losses of investees, and as adjusted for certain specified items, of at least $10 million in the aggregate for the last two fiscal years with a minimum of $2 million in each year. *See* NYSE LISTED COMPANY MANUAL § 102.01.

469 *See* NYSE LISTED COMPANY MANUAL § 103.01.

470 *See* NYSE MARKET COMPANY GUIDE § 101 for the domestic standards.

471 In calculating publicly held shares, shares held by directors, officers or their immediate families and concentrated holdings of 10% or more are excluded. NYSE LISTED COMPANY MANUAL § 102.

472 *See* NYSE COMPANY GUIDE § 110.

473 *See* NYSE LISTED COMPANY MANUAL § 104.00.

474 The total fees that may be billed to an issuer in a calendar year are capped at $500,000. NYSE LISTED COMPANY MANUAL § 902.02. In the case of a listing of ADRs, the NYSE fees are determined on the basis of the number of ADRs outstanding rather than the number of shares.

475 *See* NYSE LISTED COMPANY MANUAL § 703.00.

476 For a discussion of the NYSE policies applicable to listed foreign issuers, *see* §§ 5.02[1] and 5.05.

477 *See generally* Chapter 5 for a detailed discussion of the corporate governance requirements applicable to NYSE-listed foreign issuers.

478 In February 2008, Nasdaq acquired the OMX Group to become The Nasdaq OMX Group, Inc.

479 Nasdaq/GSM has higher initial listing standards than Nasdaq Global Market, while the continued listing standards are the same for both. The principal difference between Nasdaq Global Market and Nasdaq Capital Market is that the former presents the last sale prices of a security on an immediate basis, while the latter reports only current bid and offered quotations. Nasdaq and the AMEX merged in 1998. In January 2005, the members of the AMEX repurchased the exchange from Nasdaq, as a result of which Nasdaq and the American Stock Exchange re-separated. *See* Press Release, The American Stock Exchange, Transaction Closes Transferring Control of AMEX to Members (Jan. 3, 2005). On October 1, 2008, the NYSE Euronext completed its purchase of the AMEX, which is now known as NYSE MKT.

480 *See generally* NASDAQ Marketplace Rules, Rules 5300, 5300 and 5400, NASDAQ Manual .

481 For this purpose, any shares held by officers and directors of the issuer or by holders of more than 10% of such shares are deemed not to be publicly held.

482 Under NASDAQ Marketplace Rule 5000(a)(21), "listed securities" is defined as "securities listed on Nasdaq or another national securities exchange."

483 NASDAQ Marketplace Rules, Rules 5500, 5215(a), NASDAQ MANUAL. Rule 5500 is applicable to U.S. domestic and Canadian issuers, and Rule 5215(a) is applicable to non-Canadian foreign issuers. Both rules provide for essentially the same requirements. In the case of ADRs, however, the underlying shares will be considered when determining the ADR's qualification for listing on Nasdaq.

484 NASDAQ Marketplace Rules, Rule 5000 and 5700, NASDAQ MANUAL.

485 NASDAQ Marketplace Rules, Rule 5315, NASDAQ MANUAL.

486 NASDAQ Marketplace Rules, Rules 5225, 5300, 5400, 5500, NASDAQ MANUAL. The maintenance listing standards for the Nasdaq/GSM and the Nasdaq Global Market are the same. Under Rule 5215(a), non-Canadian foreign issuers listed on the Nasdaq Capital Market are subject to the same minimum $1 bid price and $1 million market value of publicly held shares requirements for continued listing as are applicable to U.S. domestic and Canadian issuers. *See* SEC Release No. 34-51221 (Feb. 17, 2005).

487 For a discussion of the Nasdaq policies applicable to listed foreign issuers, *see* §§ 5.02[1] and 5.05.

488 *See generally* Chapter 5 for a detailed discussion of the corporate governance requirements applicable to Nasdaq-listed foreign issuers.

U.S. Regulation of the International Securities and Derivatives Markets, § 3.04, AMERICAN DEPOSITARY RECEIPT PROGRAMS

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 § 3.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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ADR programs permit U.S. investors to invest in foreign securities in a form that trades in dollars with standard settlement timing [489] in the United

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States. [490] They also make available services such as conversion of dividend payments into dollars and distributions of proxy materials. [491] The SEC permits foreign companies, with the assistance of U.S. depositary banks, to create OTC ADR programs for shares already outstanding if the foreign company, among other things, makes available certain information in English on its website that it makes publicly available in its home country. As long as the issuer makes such information available, does not offer or sell its securities publicly in the United States or list its securities on a U.S. exchange and maintains a listing of the relevant class of its equity securities on one or more non-U.S. exchanges that are, in the aggregate, the primary trading market for that class of securities, it is exempt from the requirement that it register its equity securities under the Exchange Act by reason of the number of U.S. holders. [492] If an issuer offers or sells its ADRs publicly in the United States, or lists its ADRs on a U.S. exchange, the ADRs and the underlying securities must, as in the case of other public offerings or exchange listings, be registered under the Securities Act and the

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Exchange Act, respectively, as a result of which the issuer of the underlying securities becomes subject to SEC reporting and disclosure requirements, including the requirements of the Sarbanes-Oxley Act and the Dodd-Frank Act. [493]

Many applications for ADRs exist. ADRs have been used in connection with mergers and acquisitions, [494] restructurings, [495] privatizations [496] and employee benefit and compensation plans. [497] In addition, many offerings of ADRs have been made under Rule 144A under the Securities Act.

As an alternative to establishing an ADR program, a foreign issuer that is making arrangements for a U.S. listing may list its ordinary shares directly, including through a "global registered share" (or "global share") program (under which ownership of shares is recorded in a single global register regardless of whether the particular shares are acquired on a U.S. exchange or a foreign exchange) [498] or in a form adapted to the needs of U.S. investors (for instance "shares of New York Registry," such as those issued by Koninklijke Philips N.V. and ArcelorMittal). For a variety of reasons, issuers have generally preferred establishing ADR programs rather than listing their shares directly, and ADR listings are far more common than direct listing of foreign issuers' shares on U.S. exchanges.

[1] Principal Features of ADRs

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ADRs are instruments issued in registered form that evidence interests in securities of a foreign issuer. ADRs are usually issued by a U.S. commercial bank (the "Depositary") with whose foreign correspondent (the "Custodian") the underlying shares have been deposited. An ADR holder generally can exchange ADRs for the underlying shares at any time, and similarly, additional shares generally can be deposited against issuance of additional ADRs. [499]

Each ADR can represent, at the option of those creating the ADR program, one foreign share or a greater or lesser number of foreign shares, including fractions. The principal consideration in fixing the ratio of ADRs to shares is to arrive at a price per ADR that is believed to be attractive to U.S. investors.

The ADR mechanism was developed to overcome certain practical difficulties confronting residents of the United States who invest in shares of foreign companies. Some of these difficulties arise when these shares are available only in bearer form. Bearer shares are generally ineligible for a direct U.S. listing. [500] Additionally, dividends and other payments in respect of bearer shares are usually announced in foreign financial newspapers, and U.S. shareholders thus may not know when dividends are payable or how to obtain payment. ADR Depositaries collect the dividends paid on the shares on deposit with the Custodian, convert them into dollars if they are paid in a foreign currency and make payments to the holders of the ADRs. [501] ADRs also appeal to certain institutional investors whose investment restrictions limit them to securities that trade and settle in dollars.

The Depositary customarily informs ADR holders of important developments announced by the issuer of the underlying shares, such as recapitalization plans, exchange offers and subscription rights. In most cases, the Depositary

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informs ADR holders of matters submitted for the vote of shareholders. Depositaries will vote the shares they hold in accordance with instructions from ADR holders, and are often willing, subject to certain conditions, to vote shares for which no instruction is given in accordance with management's direction or in the same proportion that all other outstanding shares are voted. [502]

ADRs also facilitate the transfer of ownership. Whereas a holder of registered shares of a foreign company may be required to follow burdensome transfer procedures (including sending the certificates abroad for transfer and paying transfer taxes), ADRs may be transferred on the books of the Depositary in the United States in the same manner as shares of U.S. issuers. [503]

The Depositary ordinarily assists ADR holders with filings necessary for any reduction in foreign withholding tax on dividend payments that may be available under a tax treaty. The United States has entered into tax treaties with most of its major trading partners under which the rate of withholding tax imposed on dividends is generally limited to 15% for portfolio investors (*i.e.*, shareholders that do not hold substantial positions in the stock of the company paying the dividend). [504] The marketability of ADRs in the United States can be enhanced to the extent that the issuer makes arrangements with the Depositary for expedited procedures for claiming a reduced withholding rate and any other benefits to which a U.S. holder is entitled under a tax treaty. [505]

[2] Sponsorship

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A foreign company that wishes to "sponsor" an ADR program enters into a deposit agreement with the Depositary. The deposit agreement sets out the rights and obligations of the company, the Depositary and the ADR holders with respect to the creation and maintenance of the deposit facility. It covers such matters as the issuance of ADRs upon deposit of underlying shares (and the withdrawal of underlying shares upon presentation of ADRs), the treatment of dividends and other distributions, the procedure for voting the underlying shares and how the deposit agreement can be amended or terminated. Generally, the company agrees to indemnify the Depositary for liabilities arising in connection with the program. The deposit agreement also specifies the fees the Depositary will charge ADR holders, which are typically limited to charges for issuing and canceling ADRs.

An ADR program may also be "unsponsored," meaning that it is set up by a Depositary without the company's participation or even its consent. A Depositary will typically establish an unsponsored ADR program only if it believes that there is sufficient interest in the company's shares to generate adequate fee income, or if a broker-dealer has requested such a program and agreed to assist with the expense. While unsponsored ADRs are issued without the foreign issuer's cooperation, the foreign issuer must be a reporting company under the Exchange Act or exempt under Rule 12g3-2(b) [506] from the reporting requirements of that Act. Typically, the Depositary will request a letter of nonobjection from the issuer before establishing the program. Furthermore, the SEC staff takes the position that an SEC-registered unsponsored program may not coexist with an SEC-registered sponsored program for the same securities because of the potential for resulting market disorder. [507]

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In the case of a sponsored ADR program, the deposit agreement will specify the Depositary's fees for its services. Although the Depositary may seek reimbursement from the issuer for all or part of its expenses in establishing the program and payment of an administrative fee covering many of its ongoing services, additional fees for certain other services and reimbursement of its ongoing out-of-pocket expenses (postage, for example, in connection with mailing reports to ADR holders), in many cases depositaries will waive these fees and expenses and provide additional services or cash payments to the issuer in order to secure the opportunity to administer an ADR program. The details of the agreement between the issuer and the Depositary regarding fees, expenses and services are usually documented in a separate fee letter. [508] Depositaries for unsponsored ADRs generally charge fees to holders for the issuance and cancellation of ADRs and for services of the Depositary principally for the distribution of dividends.

[3] Registration

The creation of an ADR program where ADRs, whether sponsored or unsponsored, are newly issued and sold to the public, requires the registration of the ADRs under the Securities Act, since the SEC views the ADRs as newly issued securities separate from the underlying shares. [509] The establishment of an ADR program for underlying shares that are already outstanding and freely tradeable does not, however, require registration of the underlying shares under the Securities Act. [510]

The registration statement form for ADRs (which is separate from the registration statement for the shares to be deposited, if required as discussed below),

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Form F-6, is simple. [511] It requires certain information concerning the depositary arrangements and consists of little more than the deposit agreement (if the program is sponsored) and a sample ADR certificate (which constitutes the prospectus for purposes of the Securities Act). [512]

Use of Form F-6 is subject to three conditions. First, holders of the ADRs must generally be entitled to withdraw the underlying securities at any time. This right of withdrawal may be subject to (i) temporary delays caused by closing the transfer books of the Depositary or the issuer of the underlying shares in connection with voting at a shareholders' meeting or the payment of dividends, (ii) the payment of fees, taxes and similar charges and (iii) compliance with any laws or governmental regulations relating to ADRs or to the withdrawal of deposited shares. While this condition is intended to assure fungibility between the ADRs and the underlying securities, the third exception permits the creation of ADRs where the local law of the country of the issuer of the underlying shares restricts foreign ownership of the shares themselves. Second, the shares to be deposited must either be registered under the Securities Act or be freely tradeable by the depositors. Finally, the issuer of the underlying shares must (i) be a reporting company under the Exchange Act or (ii) be exempt from such reporting pursuant to Rule 12g3-2(b) thereunder. [513]

An issuer should consider the advantages and disadvantages of a Rule 12g3-2(b) exemption where it is not otherwise required. On the one hand, for example, apart from permitting the establishment of an ADR facility, a Rule 12g3-2(b) exemption can also be useful in facilitating access to the U.S. capital

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markets through Rule 144A placements. [514] On the other hand, if an issuer has a Rule 12g3-2(b) exemption but does not have a sponsored ADR program, Depositaries will be able to establish their own unsponsored ADR facilities without the issuer's consent, even though typically Depositaries request a letter of nonobjection from the issuer prior to establishment of their ADR facilities. The existence of unsponsored ADR facilities may become an obstacle to an issuer's registering a sponsored ADR facility later on, since it is the SEC's position that a sponsored ADR facility may not be registered unless all registered unsponsored ADR facilities relating to the same underlying securities are terminated. In such case, negotiated fees for cancellation of the unsponsored ADRs must be paid to their Depositaries; these fees can be significant and are typically borne by the issuer or by the Depositary of the new sponsored facility. According to the SEC, "[s]ometimes these fees have been disputed and the processing of withdrawal requests and establishment of the sponsored facility are delayed until negotiations are concluded." [515]

[4] Pre-Release

When a broker or other purchaser buys shares of a foreign corporation, its receipt of the shares may be delayed as a result of settlement procedures in the foreign country. Depositaries often reserve the right to "pre-release" ADRs, *i.e.*, to issue ADRs in respect of shares that have not yet been deposited with the Custodian, to enable these purchasers to sell ADRs representing the shares in the United States prior to the settlement date for the shares. Depositaries may also reserve the right to pre-release shares underlying the ADRs to allow purchasers of ADRs to sell the underlying shares prior to the settlement date for the ADRs. In the ADR Concept Release, the SEC noted the following with respect to pre-releases:

> Certain depositaries have established guidelines as to the amount of pre-release lending they will undertake, *e.g.*, 15% to 20% of the total amount of ADRs outstanding in the facility, although such limitations are not absolute. At least some depositaries undertake pre-release lending only upon the deposit of collateral that is marked to
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> market daily and after certification from the borrower that it has purchased the securities and will deposit them upon settlement. While some depositaries provide the right to demand the return of an ADR issued in a pre-release lending situation (either after a pre-determined period or after notice), few appear to prevent the borrower from transferring the pre-released ADR or withdrawing the not yet deposited security before it has been deposited. Withdrawal requests in that case presumably are satisfied by delivery of a security deposited by another ADR holder. [516]

Since no regulatory limitations are imposed on the amount of ADRs that may be issued on a pre-released basis, pre-release can reach levels far in excess of the self-imposed guidelines described above.

Pre-release agreements should contain provisions that ensure pre-released ADRs will be treated the same as the underlying shares for U.S. and foreign tax purposes. If pre-released ADRs are not treated the same as the underlying shares for such purposes, because, for example, the Custodian is not the owner of the shares while the pre-release is outstanding, ADR holders may not be eligible for the U.S. and foreign tax benefits associated with the ADRs, and in particular may not be able to claim the reduced tax rate applicable to some dividends earned by U.S. individuals, tax treaty benefits (such as a reduced rate of withholding tax, and the additional payments available under some treaties) or U.S. tax credits for foreign taxes withheld from dividend distributions. [517] If, however, the person obtaining the pre-released ADRs in fact owns the underlying shares and agrees to transfer its ownership interest in the shares to the Depositary pursuant to the pre-release transaction, the Depositary should be treated as the owner of the underlying shares for U.S. tax purposes even if it is not the registered holder of the shares. As described above, ADR programs typically incorporate provisions that are intended to ensure this result. [518]

Footnotes

489 Rule 15c6-1 under the Exchange Act makes three business days (T+3) the standard settlement time for securities trades that involve broker-dealers, subject to specified exceptions. SEC Release No. 34-35705 (May 11, 1995) (the "T+3 Release"). The SEC has proposed an amendment to Rule 15c6-1(a) under the Exchange Act that would shorten this standard settlement cycle from three business days after the trade date to two business days (T+2). SEC Release No. 34-78962 (Sept. 28, 2016) (the "T+2 Proposing Release"). Among other exceptions to T+3 settlement, Rule 15c6-1 makes four business days (T+4) the standard settlement time in the case of sales for cash of securities that are sold by an issuer to an underwriter on a firm commitment basis in an offering registered under the Securities Act, or sold to an initial investor by a broker-dealer participating in such an offering, if the securities are priced after 4:30 P.M. Eastern time. The T+2 Proposing Release does not include any proposed change to the T+4 settlement cycle applicable to such transactions (but does solicit comment on whether any adjustment should be made). Rule 15c6-1 under the Exchange Act allows broker-dealers and their customers to agree to a different settlement cycle if the agreement is express and is reached at the time of the transaction. The rule states that such an express agreement will be deemed to have been made by all parties contracting for the sale of securities that are sold for cash pursuant to a firm commitment offering if the managing underwriter and the issuer have agreed upon an alternate settlement cycle for the securities sold pursuant to the offering and the parties do not agree otherwise between themselves.

The SEC recognized that using a standard U.S. settlement cycle could create difficulties for broker-dealers that purchase and sell securities in non-U.S. markets because the purchase or sale executed in the non-U.S. market will settle in accordance with the local settlement cycle. SEC Release No. 33-7170 (May 22, 1995) (the "Non-U.S. Securities Release"). Where the local settlement cycle is longer than the standard U.S. settlement cycle, the broker-dealer will be unable to meet its obligations to its U.S. customers. In the Non-U.S. Securities Release, the SEC accordingly provided limited exemptions from Rule 15c6-1 for (i) securities of foreign issuers for which there is no transfer agent in the United States and that are not eligible for deposit at a registered clearing agency, (ii) securities of foreign issuers for which transfer or delivery facilities exist both inside and outside the United States, if the annual trading in such securities in the United States constitutes less than 10% of the aggregate worldwide trading volume, and (iii) contracts for the purchase and sale of securities of foreign issuers that are executed by a U.S. broker-dealer outside the United States and that provide for delivery or payment outside the United States. For purposes of these exemptions, an ADR is considered a separate security from the underlying instrument. This may have a number of implications. For example, if there are transfer facilities in the United States for an issue of ADRs, but not for the underlying instrument, transactions in the underlying instrument will be exempt from the rule pursuant to the exemption described in (i) above, but transactions in the ADRs would not be. If none of the exemptions set forth in the Non-U.S. Securities Release is available, a broker-dealer engaged in a foreign securities transaction may still agree with its customer on a settlement period longer than three business days, pursuant to the provisions of Rule 15c6-1 itself described above. The T+2 Proposing Release notes the relief granted in the Non-U.S. Securities Release without proposing any changes to that relief.

490 The SEC's regulations make a distinction between ADRs and American Depositary Shares ("ADSs"). According to the SEC, "under this distinction, an ADR is the physical certificate that evidences ADSs (in much the same way a stock certificate evidences shares of stock), and an ADS is the security that represents an ownership interest in deposited securities (in much the same way a share of stock represents an ownership interest in a corporation). Although conceptually accurate, some confusion has resulted from this distinction, and it appears that ADR market participants largely do not differentiate between ADRs and ADSs." SEC Release No. 33-6894 (May 23, 1991) (the "ADR Concept Release"). This book follows the approach of the ADR Concept Release. The term "ADS" is not used, and the term "ADR" may, depending

on its context, refer to either the physical certificate or the security evidenced by such certificate.

Since ADRs are rarely issued to represent debt securities, the following discussion assumes that the securities underlying ADRs are equity securities. The mechanics of an ADR program for debt securities are, nevertheless, basically the same as those described in the text.

491 Foreign issuers are exempt from the proxy solicitation rules under § 14 of the Exchange Act. *See* § 4.02[3][c][v].

492 *See* Rule 12g3-2(b) under the Exchange Act and the discussion in § 4.02[3][a][iv].

493 *See* Chapters 4 and 5. To obtain a quotation on the OTC Bulletin Board for their equity securities, issuers must generally be subject to the periodic reporting requirements of the Exchange Act, which, among other things, also subjects them to the Sarbanes-Oxley Act and the Dodd-Frank Act. *See supra* Note 31 for discussion of the OTC Bulletin Board. An issuer would not become subject to the reporting requirements of the Exchange Act or to the Sarbanes-Oxley or Dodd-Frank Acts by sponsoring an ADR program that is not accompanied by an exchange listing or quotation on the OTC Bulletin Board.

494 Two significant examples of an acquisition involving the issuance of ADRs are the 1998 acquisition by The British Petroleum Company p.l.c. of Amoco Corporation and the 2000 acquisition of Seagram by Vivendi. Other examples of mergers and acquisitions involving the issuance of ADRs are set out in the ADR Concept Release.

495 Racal Electronics spun off its cellular telephone subsidiary, Racal Telecom, in a 4.5 million ADR issue valued at $150 million. *See* Beth McGoldrick, *For ADRs, It Pays to Get Into Debt*, EUROMONEY 103, 104 (Dec. 1988) (cited in the ADR Concept Release).

496 For example, in 1996 the Italian government, in connection with the privatization of its state-owned insurance company INA, issued notes that were exchangeable for INA shares or for ADRs representing such shares.

497 For example, an ADR-funded benefit plan was said to help British Airways maintain favorable relations with U.S. employees by ensuring equal treatment with U.K. employees. Barbara Loos, *Deflecting the Raging Bull*, EUROMONEY SPECIAL SUPPLEMENT 21, 5, 25 (Feb. 1988) (cited in the ADR Concept Release).

498 DaimlerChrysler AG (now Daimler AG) was the first to issue global shares, in November 1998, though its shares no longer trade in that form. Only a small number of global share programs have ever been established, and half of those no longer exist (although shares of UBS Group AG, initially listed as UBS AG, and Deutsche Bank Aktiengesellschaft continue to trade in the form of global shares).

499 In certain foreign jurisdictions, however, laws or local practice relating to foreign ownership of domestic companies may limit ADR program sizes by prohibiting the deposit of additional shares and the resulting creation of additional ADRs. Form F-6 requires ADR holders to be permitted to withdraw deposited securities at any time, subject to limitations imposed for procedural reasons or to comply with local law. Form F-6, General Instruction I.A.1.

500 Shares in bearer form are generally ineligible for listing on the principal U.S. securities exchanges because of the difficulty of demonstrating that there are a sufficient number of U.S. shareholders to satisfy the exchange's listing requirements. The ADR mechanism allows the issuer of shares available only in bearer form to overcome the difficulty of demonstrating that it has sufficient U.S. shareholders to qualify for a listing in the United States. In addition, the requirements of the NYSE and Nasdaq with respect to registrars and transfer agents are such that only registered shares can be listed. *See* NYSE LISTED COMPANY MANUAL § 601.01.

501 The NYSE and Nasdaq permit charging ADR depositary dividend and servicing fees to investors. *See* SEC Release No. 34-53978 (June 13, 2006). Nonetheless, the ability of the Depositary to charge these fees to ADR holders is governed by the terms of the relevant deposit agreement.

502 On July 1, 2009, the SEC approved NYSE amendment number four to NYSE Rule 452, which took effect on January 1, 2010 and eliminated a practice known as broker discretionary voting with respect to director elections. *See* SEC Release No. 34-60215 (July 1, 2009). Rule 452 applies to all NYSE member

organizations, including with regard to the securities of foreign issuers. As such, NYSE member brokers voting shares in an election of a director at any public company (except for companies registered under the Investment Company Act of 1940) may not vote the shares held in their clients' accounts without having first received voting instructions from the beneficial holders of such shares. *See* SEC Release No. 34-60215 (July 1, 2009). The Dodd-Frank Act also imposed a prohibition on broker discretionary voting for matters relating to executive compensation and for other significant matters. *See* § 957 of the Dodd-Frank Act (prohibiting member organizations from voting shares on executive compensation matters without specific client instructions). However, neither NYSE Rule 452 nor § 957 of the Dodd-Frank Act affects the ability of the Depositary to vote or grant proxies pursuant to the ADR deposit agreement, since neither NYSE Rule 452 nor § 957 of the Dodd-Frank Act extends beyond NYSE members and the Depositary generally is not a NYSE member.

503 In order to be eligible for listing on the principal U.S. securities exchanges, the shares of a foreign company must be able to trade "regular-way" (*i.e.*, with settlement in three days under current rules or two days if the amendment proposed in the T+2 Proposing Release is adopted). If the home market of a foreign company does not have three-day settlement, the company can meet this requirement by establishing a share register in New York City or, alternatively, by creating an ADR program. *See supra* Note 489 for a discussion of the securities trade settlement schedule.

504 The 15% rate applies, for example, under the U.S. income tax treaties with France, Germany and Japan.

505 For example, certain tax treaties allow U.S. shareholders to claim a payment in respect of certain taxes paid by the company in its home jurisdiction (generally corresponding to tax credits that are available to local shareholders). The process of claiming such payments, as well as the process of obtaining a reduction of withholding taxes to the designated treaty rate, may in some cases be somewhat complex. In such cases, the Depositary may be able to facilitate ADR holders' ability to obtain such relief, for example by submitting the requisite documentation directly to the local tax authorities on behalf of all eligible U.S. holders.

506 Prior to August 2008, foreign companies were required to affirmatively seek an exemption under Rule 12g3-2(b) by making certain filings with the SEC. Since then, a foreign company is automatically exempt from registering a class of securities under § 12(g) of the Exchange Act if it (i) has no active reporting obligations under § 13(a) or § 15(d) of the Exchange Act (this means essentially that the foreign company has not listed or publicly offered securities in the United States), (ii) maintains a listing of such shares on one or more non-U.S. exchanges that are, in the aggregate, its primary trading market and (iii) publishes on its website, in English, the material information that it makes public in its home country, files with the principal exchange(s) in its primary trading market or distributes to its securityholders. *See* SEC Release No. 34-58465 (Sept. 5, 2008).

507 ADR Concept Release. Programs that are not SEC-registered, whether or not sponsored, may coexist. Unregistered programs generally consist of Rule 144A or Regulation S facilities. *See* §§ 7.02[3] for a discussion of Rule 144A, 8.02 for a discussion of Regulation S and 8.02[1][e] for a discussion of the interaction between Regulation S and Rule 144A.

508 Issuers must disclose in registration statements and annual reports on Form 20-F information concerning any payments made from the Depositary to the issuer. *See* Form 20-F, Item 12D.4.

509 When U.S. commercial banks first issued ADRs, they took the position that the ADRs were securities issued by U.S. banks and thus exempt from registration under § 3(a)(2) of the Securities Act (which exempts from registration securities issued or guaranteed by banks, as discussed in § 3.05[2]). However, the SEC rejected this position (because the security did not represent any interest in the bank but rather an interest in a third party or its obligation) and began to seek registration of ADRs. The commercial banks objected to the attempt to make them subject to the civil disclosure liability provisions of the Securities Act and the Exchange Act with respect to the ADRs and the underlying shares. As a compromise, the SEC decided to permit Depositaries to register ADRs on behalf of the ADR program itself, which is considered the issuer of the ADRs. As a result, the banks have no such liability with respect to the registration

statement; the liability is that of the program itself. *See* the ADR Concept Release.

510 *See* the discussion of registration under the Securities Act in § 3.04[3]. Unregistered ADR facilities can be created for the issuance of restricted ADRs in private placements under the Securities Act (*e.g.*, in accordance with Rule 144A). The establishment of such unregistered, restricted facilities in connection with private placements that are conducted in conjunction with Euro-offerings, followed by the filing of registration statements on Form F-6 for public U.S. ADR programs, has given rise to concerns on the part of the SEC regarding "leakage" of securities from the restricted to the public program.

511 A filing fee is collected by the SEC in connection with registration under the Securities Act. For registration statements on Form F-6, the fee is calculated on the maximum aggregate charges to be imposed in connection with the issuance of the ADRs. Rule 457(k) under the Securities Act. For a discussion of Securities Act filing fees, *see supra* Note 63.

512 If the deposit agreement to be used contains terms identical to those in effect for a program the Depositary has already registered, the Depositary may generally designate a date and time for the registration statement on Form F-6 to become effective. Rule 466 under the Securities Act. However, because the SEC applies this rule quite strictly, Depositaries derive little benefit from it. Notably, although § 15(d) of the Exchange Act generally imposes periodic reporting obligations on an issuer that has filed a registration statement that has become effective under the Securities Act, periodic reports are not required with respect to ADRs registered on Form F-6. Rule 15d-3 under the Exchange Act. The Depositary must, however, furnish semi-annually to the SEC information about the number of ADRs issued and canceled during the period, and make available at its principal office for inspection all reports and communications received by the Depositary as record owner of the underlying shares (if the underlying shares are issued in registered form).

513 Form F-6, General Instruction I.A.3. *See* § 4.02[3][a] for a discussion of the Exchange Act registration requirements, including the related Rule 12g3-2(b) exemption.

514 *See* Rule 144A(d)(4)(i) under the Securities Act.

515 ADR Concept Release, American Depositary Receipts, 56 Fed. Reg. 24,420, 24,425 (May 30, 1991). The SEC has considered the functioning and characteristics of the ADR marketplace and its regulation under the federal securities laws, including the issue of whether sponsored and unsponsored ADR facilities relating to the same underlying securities should be allowed to coexist. The ADR Concept Release contains a full discussion of the differences between sponsored and unsponsored programs. The SEC did not propose or adopt any rules as a result of the ADR Concept Release. *See* SEC Release No. 33-8287 (Sept. 11, 2003).

516 ADR Concept Release, American Depositary Receipts, 56 Fed. Reg. 24,420, 24,426 (May 30, 1991).

517 *See supra* Note 505 and accompanying text.

518 A typical provision in a deposit agreement limiting pre-release provides as follows:

> Neither the Depositary nor the Custodian will lend Deposited Securities. The Depositary may issue Receipts against rights to receive Shares from the Company, or any registrar, transfer agent, clearing agency or other agent of the Company recording Share ownership or transactions. The Depositary will not issue Receipts against other rights to receive Shares unless (i) such Receipts are fully collateralized (marked to market daily) with cash or U.S. government securities until such Shares are deposited, (ii) the applicant for such Receipts represents in writing that it was the beneficial owner of such Shares before the issuance of such Receipts, and has assigned all beneficial right, title and interest in such Shares to the Depositary for the benefit of the Holders and will hold them for the account of the Depositary until delivery upon the Depositary's request and (iii) all such Receipts represent not more than 20% of the Shares actually deposited. Such collateral, but not the earnings thereon, will be

> held for the benefit of the Holders. The Depositary may retain for its own account any compensation for the issuance of Receipts against such other rights to receive Shares, including without limitation earnings on the collateral securing such rights.

While this provision limits pre-release to 20% of the shares outstanding, many agreements do not have a firm percentage limitation. In addition, there are often further limitations on pre-release contained in a pre-release side letter (which, in SEC-registered ADR programs, generally is filed as an exhibit to the Form F-6 registration statement pursuant to Item 3(b)).

U.S. Regulation of the International Securities and Derivatives Markets, § 3.05, DEBT OFFERINGS IN THE UNITED STATES

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 § 3.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The requirements discussed in § 3.02 regarding registration of equity securities are also generally applicable to registration of public offerings of debt securities in the United States. However, there are certain special considerations relating to registration of debt offerings.

[1] Foreign Sovereign Issuers, Supranational Issuers, Issuers of Foreign Government-Backed Securities

Foreign sovereign issuers, certain supranational issuers and certain issuers of foreign government-guaranteed securities are permitted to provide less (and different) information than foreign private issuers. The applicable requirements are set out in Schedule B to the Securities Act. [519]

The Securities Act provides that Schedule B applies to "a security issued by a foreign government or political subdivision thereof," [520] which has been read to include national governments and governments of states, provinces and

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municipalities. The SEC staff has also interpreted this provision to permit certain supranational organizations [521] and certain issuers of foreign government-guaranteed securities to use Schedule B for the registration of their securities. [522]

The SEC staff has also historically viewed certain issuers as political subdivisions of, or as agencies or instrumentalities of, their nation's governments and thus eligible to employ Schedule B because investments in such issuers are secure from default to a degree equivalent to that of a sovereign credit. [523] In taking this position, the staff has generally given primary consideration to the interplay of three criteria: (i) guarantees or support of the issuer's securities by the sovereign credit, (ii) government ownership of the issuer, and (iii) government control of the issuer. With respect to the government guarantee, the SEC staff has accepted express guarantees, statutory guarantees and statutory provisions or legal requirements to provide the issuer with sufficient funds to enable the issuer to meet its obligations, which in the last case do not necessarily confer on the securityholders a direct right against the government. Whatever the mechanism for the government backing, the SEC has generally taken the position that the support of the foreign government for the issuing entity must carry with it the "full faith and credit" of the foreign government, and the SEC has looked to the legal opinion of local counsel as authority for the foreign government's guarantee or other necessary support. However, under certain circumstances (and always on a case-by-case basis), the SEC has granted Schedule B status where

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the foreign government's (or governments') support took the form of a "keepwell" arrangement, which unlike a guarantee cannot be enforced by the beneficiary. [524] Such "keepwell" arrangements are generally evidenced by statutes, general principles of administrative law and international agreements, such as an undertaking by member countries party to an international agreement establishing the issuer to make payment on callable capital. [525]

While Schedule B issuers have generally been wholly or substantially wholly owned by the related government, the SEC staff has permitted a few widely held, publicly listed issuers to use Schedule B. The staff has generally accepted as sufficient various combinations of general supervision, budgetary control and appointment of directors, officers or examiners by the related government. In determining whether an issuer should be treated as a part of a foreign government, the SEC staff has applied these criteria of government support, ownership and control as a whole on the basis of all the relevant facts and circumstances. Out of concerns for comity, the staff has historically avoided deciding an issuer's eligibility for Schedule B on the basis of the nature of its operations.

Where an instrumentality of a foreign government has been permitted to register under Schedule B, both the instrumentality as issuer and the government as guarantor or provider of other support have been required to register under Schedule B and sign the registration statement. [526] The issuer's authorized representative in the United States must also sign the registration statement. In these cases, as discussed below, the issuer is not required to meet all of the requirements of the detailed SEC rules applicable to disclosure by foreign private issuers.

There is no specific SEC form for disclosure for offerings falling within Schedule B. However, over the years the disclosure format for a sovereign issuer

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has become highly standardized, and includes substantial information not specifically called for by Schedule B about the country concerned, its form of government and general political situation, the principal features of its economy, its natural resources, population, trade, balance of payments, public sector finances and indebtedness, other factors affecting the availability of the currency in which the proposed U.S. public offering is to be made, the terms of the securities, risk factors, where appropriate, and any other information that would be considered material by investors in deciding whether to invest in the securities being offered or that is needed to ensure that the statements made in the prospectus are not misleading. Although Schedule B expressly requires as exhibits to the registration statement only the underwriting agreement and opinions as to the legality of the securities, customary practice includes filing fiscal agency agreements, indentures and certain other documents.

In the case of securities that are guaranteed by a foreign government, essentially the same disclosure requirements apply to the government. [527] Disclosure is also required about the issuer of the securities, [528] the sovereign and the issuer's relationship to its government, [529] but the specific requirements of Form 20-F (applicable to foreign private issuers) do not apply to an issuer that the SEC staff views as eligible to use Schedule B, although such requirements may provide useful guidelines as to information that would be considered material to investors. In particular, Regulations S-K and S-X do not generally apply to Schedule B filers, although some provisions are generally followed by analogy, and debt securities issued or guaranteed by a Schedule B filer are exempted from the provisions of the Trust Indenture Act. Schedule B filers are also exempt from Sarbanes-Oxley Act certification and auditor attestation requirements. The financial statements of such a foreign issuer are not required to be reconciled to U.S. GAAP, but instead such an issuer may provide its most recent available financial statements in the form in which they are ordinarily prepared and presented (translated into English), with no independent audit requirement. The SEC has accepted filings with financial statements prepared in accordance with IFRS as

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adopted by the EU, which it does not accept for private issuers that use IFRS (they are required to use the version of IFRS published by the IASB). Moreover, a considerable amount of other disclosure mandated by Form 20-F is in practice not included, or is provided only in reduced form, on the theory that the most important disclosure in connection with the offering pertains to the related government.

[2] Securities Issued or Guaranteed by Banks

Section 3(a)(2) of the Securities Act exempts from registration all securities issued or guaranteed by a bank organized under the laws of the United States or any state. [530] This exemption is not available to securities issued or guaranteed by a bank holding company that is not itself a bank; those securities must be registered with the SEC if issued to the public.

The SEC, implementing its policy of national treatment, has determined that U.S. federal or state branches or agencies of foreign banks should have the same right to issue or guarantee securities as their U.S. counterparts. [531] Thus, many U.S. branches and agencies of foreign banks have publicly offered and sold notes in the United States, in some cases with all or a portion of the proceeds remitted to the home office, without being required to register such offer and sale under the Securities Act. [532] The foreign bank itself, issuing from its home office, would not be entitled to the exemption under § 3(a)(2) of the Securities Act, although it is generally possible for a home office issuance of debt obligations to be eligible for the § 3(a)(2) exemption by having a U.S. branch or agency of the bank issue a letter of credit or some other form of guarantee of the home office's obligations. [533]

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In addition, many U.S. branches of foreign banks have issued letters of credit with respect to the obligations of U.S. commercial and municipal borrowers. Since a letter of credit is treated as a bank guarantee for the purposes of § 3(a)(2), neither the letter of credit nor the underlying "guaranteed" obligation need be registered. To date, obligations issued by U.S. branches of foreign banks have been debt. It is probably not possible for equity securities, including preferred stock, to be issued or guaranteed by a U.S. branch relying on the § 3(a)(2) exemption, since conceptually such instruments are not obligations of the U.S. branch, but rather represent ownership interests in the issuing entity as a whole. [534]

Although securities issued or guaranteed by a bank are exempt from registration, a disclosure document is generally prepared, in part for marketing reasons. It is, however, typically much less comprehensive than the prospectus for a registered offering. Because detailed SEC rules for registration statements do not apply, the amount of disclosure depends upon the circumstances of the individual offering, the concerns of the issuer and the underwriters and the requirements of the bank regulators. While liability pursuant to Rule 10b-5 under the Exchange Act attaches with respect to misstatements or omissions in any such disclosure document, the liability is not absolute or predicated on negligence, but based on actual fraud or reckless disregard for the truth. [535]

The SEC has submitted legislation to the U.S. Congress on various occasions to eliminate the § 3(a)(2) exemption, but to date it remains. If the exemption were eliminated, then all securities issued or guaranteed by a bank or its holding company would have to be registered (unless sold in transactions exempt from registration). [536]

The Office of the Comptroller of the Currency (the "Comptroller"), which regulates disclosure in connection with offers and sales of securities by national banks and federally licensed U.S. branches and agencies of foreign banks, [537] adopted regulations in 1994 that in many cases effectively require such issuers to comply with the registration requirements of the Securities Act. [538] Under these

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regulations, national banks and federal branches and agencies of foreign banks (but not state-licensed branches or agencies) conducting public offerings of securities are required to register the securities with the Comptroller, using the same form and providing the same information that they would use to register securities under the Securities Act if they were not exempt from such registration. Because the Comptroller's regulations in effect incorporate the SEC rules by reference rather than restate them, as in the past, they automatically remain current as the SEC adopts amendments to its rules. [539]

The regulations also contain a definition of "security," which cross-references the definition of that term in the Securities Act. Although the definition does not specifically exclude traditional bank products such as insured and uninsured deposits, letters of credit, banker's acceptances or repurchase agreements, the Comptroller explained in the related adopting release that it does not intend that the definition cover such products. The

Comptroller added that judicial precedents have generally found these products not to be securities. [540] Thus, letters of credit, and third-party securities backed by letters of credit, do not fall within the Comptroller's requirements so long as they qualify for the exemption from Securities Act registration provided by § 3(a)(2) (discussed above).

The regulations provide an exemption from the registration requirements if the securities would be exempt from registration under the Securities Act other than by reason of §§ 3(a)(2) or 3(a)(11) [541] thereof, or the securities are offered in transactions that satisfy certain exemptions under the Securities Act, such as Regulation D, Rule 144, Rule 144A or Regulation S. Although securities that are exempt from registration under § 3(a)(2) of the Securities Act are not generally exempt from the Comptroller's regulations, those regulations do contain an exemption for offers and sales of nonconvertible debt securities if a number of conditions are met, [542] including that:

- the issuer or its parent bank holding company has a class of securities registered under § 15(d) of the Exchange Act, [543] or, in the case of issuances by a federal branch or agency of a foreign bank, such federal branch or agency files with the Comptroller the information specified in Rule 12g3-2(b) under

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  the Exchange Act [544] and provides investors with the information specified in Rule 144A(d)(4)(i) under the Securities Act; [545]
- all offers and sales are to "accredited investors," as defined in Rule 501 under the Securities Act;
- the securities are investment grade; [546]
- the securities are sold in a minimum denomination of $250,000 and are legended to provide that they cannot be exchanged for securities in smaller denominations;
- prior to or simultaneously with the sale of the securities, the purchaser receives an offering document that contains a description of the terms of the securities, the use of proceeds and the method of distribution, and incorporates certain financial reports or reports filed under the Exchange Act; and
- the offering document and any amendments are filed with the Comptroller no later than the fifth business day after they are first used. [547]

The regulations also incorporate the periodic reporting requirements of the Exchange Act. Thus, a bank that is required to register its securities with the Comptroller will be subject to the same requirements as a company with a class of securities registered under § 15(d) of the Exchange Act. As a result, a federal branch or agency of a foreign bank required to register its securities with the Comptroller will be obliged to file with the Comptroller a Form 20-F and present financial statements prepared in accordance with, or reconciled to, U.S. GAAP, to the extent and as required for other foreign private issuers, on an ongoing basis. [548] However, these periodic reporting requirements do not apply if the bank is a subsidiary of a one-bank holding company, the financial statements of the bank and the parent bank holding company are substantially the same and

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the parent bank holding company complies with reporting requirements under the Exchange Act.

Another important feature of the regulations is the extension of shelf registration procedures to national banks and federal branches and agencies of foreign banks.

The regulations effectively eliminate the § 3(a)(2) exemption for public offerings by federally regulated banks, including federal branches and agencies of foreign banks, with respect to all but the most traditional banking products such as deposit instruments and letters of credit. Since the Comptroller's regulations have been in place, though, there has been no noticeable trend by the various state banking authorities to implement comparable measures that would affect banks regulated under state laws (including state-licensed branches and agencies). For example, New York State does not impose any specific securities offering disclosure rules for issuances by New York State-chartered banks or New York State-licensed branches and agencies of foreign banks.

[3] Commercial Paper

Commercial paper is a term that, although not defined in the securities laws, generally describes promissory notes with a maturity of nine months or less, and typically of 30 days or less. It is generally unsecured, issued in large denominations and sold in bearer (or book entry) form at a discount from face value. Commercial paper is normally issued pursuant to a commercial paper "program" established by the issuer, one or more commercial paper dealers and an issuing and paying agent. Under such a program, commercial paper is issued from time to time depending on a variety of factors, including the issuer's funding needs and customer demand. The documentation has become quite standard, and the costs of establishing a program are not substantial, except in cases where commercial paper is used in connection with a complex financing such as a structured receivables program. The process was further simplified by the introduction in the early 1990s of a book-entry system for the issuance and payment of commercial paper administered by The Depository Trust Company, under which practically all commercial paper is now issued. Commercial paper programs are not registered with the SEC under the Securities Act because of the availability of three exemptions: § 3(a)(3) of the Securities Act, § 4(a)(2) of the Securities Act and Regulation S under the Securities Act.

Commercial paper that satisfies certain criteria is exempt from the registration requirements pursuant to § 3(a)(3) of the Securities Act. Section 3(a)(3) itself is brief and does not provide much guidance as to its scope. It exempts any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine

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months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

The SEC's basic discussion of the scope of the § 3(a)(3) exemption was initially set forth in a 1961 interpretive release. [549] That release, together with subsequent no-action letters issued by the Office of the Chief Counsel of the SEC's Division of Corporation Finance (the "Division"), have established the criteria for exemption under § 3(a)(3). To qualify, commercial paper must:

- be of prime quality and negotiable;
- be of a type not ordinarily purchased by the general public;
- have a maturity not exceeding nine months; and
- be issued to facilitate current transactions.

Although the term "prime quality" has not been formally defined, issuers have customarily satisfied the prime quality requirement on the basis of ratings of their commercial paper by the nationally recognized rating services; such ratings depend on the creditworthiness of the issuer or the guarantor, if any. There are a few examples of no-action letters issued by the Office of the Chief Counsel of the Division for unrated commercial paper (including commercial paper of issuers with long-term ratings less than investment grade) on the basis of back-up bank facilities, but there is doubt whether the Division would currently issue such a letter. An alternative in a situation in which the commercial paper is not rated is for one of the sponsoring dealers to indicate, in a letter to counsel for the issuer (or the dealers), that in such dealer's view the paper would, if rated, be given a rating recognized as "prime" and for counsel to use such letter as a basis for opining that the paper is entitled to the § 3(a)(3) exemption. [550]

The important factors relevant to the requirement that the commercial paper be of a "type not ordinarily purchased by the general public" are denomination, purchasers and manner of sale. A minimum denomination of $100,000 is typical in transactions described in no-action letters, although the denominations of commercial paper are ordinarily substantially higher. To qualify for the § 3(a)(3) exemption, the purchasers of commercial paper should be institutions

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or sophisticated individuals who could qualify as purchasers in a private placement. No-action letters often refer to sales to "institutions or individuals who normally purchase commercial paper." The marketing of exempt commercial paper should be clearly aimed at such purchasers and, for example, should avoid advertising in publications of general circulation. [551]

Commercial paper programs are easily structured to satisfy the requirement of a "maturity not exceeding nine months" by limiting the permitted maturity to 270 days in the documentation establishing the program. [552]

The "current transactions" test has been the focus of most of the requests by issuers for no-action letters pertaining to § 3(a)(3). For corporate issuers, it is often relatively clear that the proceeds of commercial paper will be used for "current transactions" (*e.g.*, inventory or accounts receivable finance or recurring operating expenses). In many cases, however, issuers have explained that it is not possible to trace particular proceeds to particular uses. Utility companies, and subsequently other companies, have addressed this concern by representing that they would limit the amount of commercial paper issued according to formulas based on various categories of current transactions, and this approach has been accepted by the Division in a long line of no-action letters. The more expansive of the formulas favorably received by the Division include limiting the amount of commercial paper outstanding at any one time to not more than the aggregate amount utilized by the issuer for specified current transactions. [553] The principal

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use of proceeds that clearly does not qualify for "current transaction" status is to finance the purchase of securities, whether in connection with a takeover, for investment purposes or as issuer repurchases. [554]

Commercial paper is also sold in the United States without registration under the Securities Act in reliance on the exemption provided by § 4(a)(2) and, to some extent, the resale exemption provided by Rule 144A thereunder. Commercial paper sold pursuant to such exemptions is not required to satisfy the "current transactions" or nine-month maturity requirements of § 3(a)(3), although the term of such paper almost never exceeds one year. Some issuers have simultaneously maintained § 3(a)(3) commercial paper programs and § 4(a)(2) commercial paper programs in the United States and have issued commercial paper under the § 4(a)(2) commercial paper program, for example, when raising money for the purchase of a fixed asset (*e.g.*, for takeover financing). [555]

Finally, issuers that are unable to issue commercial paper on the basis of their own credit sometimes obtain bank letters of credit to assure payment of their commercial paper. In these circumstances, both the letter of credit (if it is deemed a security) and the commercial paper will (as discussed in § 3.05[2]) be exempt from registration under the Securities Act on the basis of § 3(a)(2) without regard to the use of proceeds.

[4] The Trust Indenture Act of 1939

Debt securities that must be registered under the Securities Act (except for foreign government securities registered on Schedule B to the Securities Act) must also be issued under a trust indenture that has been qualified in accordance with the Trust Indenture Act. In order to protect the rights of holders of debt, the Trust Indenture Act imposes standards of independence and responsibility upon the trustee and incorporates certain minimum protections into the related indentures. Trustees must meet certain financial and other qualifications and may not have certain interests that might conflict with the exercise of their duties. [556] The Trust Indenture Act also guarantees certain rights of securityholders, including

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rights to receive certain reports, to have access to trustees' lists of holders for correspondence and to sue individually for nonpayment of principal or interest.

Foreign issuers offering their debt securities to the public in the United States should be able to comply without difficulty with the Trust Indenture Act provided they govern the debt securities and the indenture under a body of U.S. law, such as New York law. If they wish to make a global offering of fungible securities that includes their home jurisdiction, however, they will have to choose generally between a U.S. body of governing law and their local law. [557] Although the Trust Indenture Act permits debt securities issued under a qualifying indenture, and the indenture itself (subject to the mandatory incorporation of certain provisions of the Act required by § 318), to be governed by foreign law, there are jurisdictions in which local law is not compatible with one or more of the mandatory provisions of the Act. [558]

Even where foreign law is not incompatible with the Trust Indenture Act, issuers and underwriters may conclude that a U.S.-style indenture is not consistent with market practice in the home jurisdiction. Two major European issuers, Daimler Benz (in 1997) and Ericsson (in 1993), have used a structure involving the creation of a U.S. depositary facility to permit an entire issue of debt securities to be governed by local law without a qualifying indenture while at the same time subjecting the depositary securities sold in the United States (representing these debt securities) to an indenture governed by New York law

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complying with the Trust Indenture Act. In each case, an exemptive order from the SEC pursuant to § 304(d) of the Trust Indenture Act was obtained. [559]

Following its amendment by the Trust Indenture Reform Act of 1990, [560] it was thought that the Trust Indenture Act might better accommodate issues by foreign companies. First, as amended the Trust Indenture Act allows the SEC, pursuant to such rules or regulations as it may prescribe or by order on application, to permit a foreign financial institution to act as sole trustee under an indenture qualified pursuant to the Trust Indenture Act if such entity (i) is authorized under the laws of the jurisdiction where it is organized to exercise corporate trust powers and (ii) pursuant to such laws, is subject to supervision or examination that is substantially equivalent to the supervision or examination applicable to U.S. institutional trustees. [561] One of the factors to be considered by the SEC when promulgating any such rules or regulations or making any such order is whether the relevant foreign jurisdiction would allow a U.S. entity to act as sole trustee under an indenture relating to securities sold in that jurisdiction. [562]

Second, an indenture trustee (for issues by either a domestic or a foreign issuer) is now considerably less likely to have a disqualifying conflicting interest. A trustee is deemed to have a conflicting interest with respect to an issuer's indenture if the trustee has one of ten prohibited relationships with the issuer or an underwriter of the issuer. [563] Those prohibited relationships generally arise when the relevant indenture securities are in default and (i) the trustee is a trustee for two or more classes of the issuer's securities that rank differently in seniority, (ii) the trustee has a specified direct or indirect affiliation (*e.g.*, through a control relationship, interlocking management or personnel, or securities holdings) with the issuer or an underwriter [564] of the issuer or (iii) the trustee is otherwise a creditor of the issuer. If a trustee has or acquires a conflicting interest, it must generally, within 90 days after ascertaining that it has such conflicting interest,

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either eliminate such conflicting interest or resign. If, however, the default giving rise to the conflict of interest is not a payment default, the trustee will not be required to resign if it can satisfy the SEC that (i) the default may be cured or waived within a reasonable period and (ii) a stay of the trustee's duty to resign will not be inconsistent with the interests of holders of the indenture securities. [565] Additionally, the Trust Indenture Act prohibits an obligor on the indenture securities or a person directly or indirectly controlling, controlled by or under common control with such an obligor from acting as trustee under a qualified indenture regardless of whether the indenture securities are in default. [566]

To provide flexibility in administration and allow the SEC to adapt to future developments, the Trust Indenture Act also gives the SEC broad authority to provide, upon its own motion or by order on application by an interested person, conditional and unconditional exemptions from any or all of the provisions of the Trust

Indenture Act. [567]

[5] Credit Ratings

Ratings assigned by credit rating agencies such as Moody's Investors Service, Standard & Poor's and Fitch Ratings play a key role in the pricing of debt securities, particularly investment grade debt securities. While such ratings have historically also figured prominently in the regulatory treatment of debt securities, their use is being phased out in response to public policy considerations.

In 2003, in response to the mandate contained within § 702 of the Sarbanes-Oxley Act, the SEC submitted to Congress a detailed report on credit rating agencies. The report addressed the topics identified for study in § 702, including the role of rating agencies and their importance to the securities markets, impediments faced by rating agencies in performing that role, measures to improve information flow to the market from rating agencies, barriers to entry into the ratings business and conflicts of interest faced by rating agencies. The report also addressed certain issues regarding rating agencies, such as allegations of anticompetitive or unfair practices, the level of diligence of rating agencies and the extent and manner of SEC oversight, that went beyond those specifically required by the Sarbanes-Oxley Act. The SEC followed up on issues raised by the report by issuing a concept release on the topic. [568]

In 2006, Congress responded by enacting the Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327 (2006) (the "Rating Agency Act"), and in 2007 the SEC adopted new rules to implement it. The Rating Agency Act and the SEC rules established a program for NRSRO registration and oversight by the SEC. Under these provisions, a credit rating agency seeking to be treated as an NRSRO must apply for, and be granted, registration with the SEC, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. [569]

As a result of the subprime mortgage crisis and ensuing credit crunch that began in mid-2007, the SEC in 2008 proposed a number of reforms relating to the regulation of NRSROs. The rules were adopted in 2014. Among other things, the rules are designed to address conflicts in the ratings process; mandate public disclosure of ratings-related information; require differentiation of structured product ratings from corporate debt ratings; and avoid encouraging "undue reliance" on ratings. [570]

Pursuant to § 939A of the Dodd-Frank Act, the SEC was charged with removing from SEC regulations all references to or requirements of reliance on credit ratings. In rules proposed in February 2011 and adopted in July 2011, the SEC replaced each of the qualifications in Forms S-3, F-3, S-4 and F-4 and Rules 138, 139 and 168 under the Securities Act that required an investment grade rating with a qualification that is met if the registrant has issued at least $1 billion of nonconvertible, SEC-registered securities (other than common equity) for cash during the prior three years when the registrant seeks to rely on the safe harbor of any such rules.

The Dodd-Frank Act also eliminated former Rule 436(g) under the Securities Act. Under that rule, an issuer that referred to credit ratings in a Securities Act registration statement or a prospectus for a registered offering did not need to file the consent of the rating agency. This allowed the rating agencies to avoid expert liability under § 11 of the Securities Act. The effect of the elimination of Rule 436(g) is, with certain exceptions outlined below, to require NRSROs to file consents to be named as experts each time their ratings are used in a prospectus or registration statement. Prior to the passage of the Dodd-Frank Act, the rating agencies consistently took the position that the ratings they provided were not expertized information as described in §§ 7 and 11 of the Securities Act. They argued that ratings are inherently forward-looking in nature and are based on assumptions and predictions that by their very nature cannot be verified. [571] In response to the passage of the Dodd-Frank Act and the concurrent repeal of Rule 436(g), the major rating agencies reiterated this stance and stated that they would

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not consent to the inclusion of their ratings in prospectuses and registration statements. [572]

One important exception to the requirement that NRSROs file consents is that a company that is not subject to Regulation AB disclosure requirements is not required to seek NRSRO consent for ratings-related information included in a registration statement or prospectus if such information is included to satisfy certain general disclosure requirements (such information being referred to as "issuer disclosure-related information"). [573] Issuer disclosure-related information is comprised of changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant or the terms of agreements that refer to credit ratings. Registrants should therefore not have to alter their practices regarding ratings disclosure in, for example, a risk factor that outlines the adverse effect that a hypothetical downgrade would have, in the liquidity portion of the MD&A and in descriptions of debt covenants tied to credit ratings.

Footnotes

519 For this reason, such issuers are often referred to as "Schedule B issuers." Schedule B requires disclosure of the following:

- the estimated net amount and proposed use of the proceeds of the offering;
- the amount and the principal terms of the sovereign's "funded" (long-term) and "floating" (short-term) debt (both foreign and domestic);
- any defaults on external securities during the preceding 20 years;
- the registrant's revenues and expenditures (including deficits) during the three most recent fiscal years;
- the name(s) of any authorized agent(s) in the United States;
- the name(s) of counsel who pass upon the legality of the issue;
- the terms of the distribution, including the underwriting arrangements, if any, and the names of the underwriters;
- the price at which the securities are to be offered (or the method by which the price is to be determined);
- the commissions or other compensation to be paid to underwriters; and
- other expenses of the offering.

520 § 7 of the Securities Act.

521 The rationale for permitting supranational organizations to use Schedule B has generally been that these organizations have sovereign nations as their members, serve a governmental function and have the right to make capital calls on their member countries in the event that the organizations cannot meet their obligations under their debt securities. *See*, *e.g.*, *Nordiska Investeringsbanken* (avail. Feb. 1, 1982); and *European Economic Community* (avail. June 21, 1976), allowing the European Economic Community ("EEC") to register using Schedule B, "without deciding whether the EEC [was] a 'foreign government or political subdivision thereof' within the meaning of Section 7 of the Securities Act"). Securities offerings of certain supranational organizations, including the African Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the Council of Europe Development Bank ("CEB") and the International Bank for Reconstruction and Development (known as the World Bank), are governed by specific statutes enacted by Congress and regulations that exempt their securities from SEC registration and are thus even more favorable than Schedule B. *See*, *e.g.*, General Rules and Regulations Pursuant to § 9(A) of the European Bank for Reconstruction and Development Act, 17 C.F.R. §§ 290.1 *et seq*.

522 As discussed above, *see supra* Note 519 and accompanying text, the SEC staff has permitted the registration under Schedule B of securities that are supported by statutory "keepwell" arrangements, as well as those backed by an express or statutory guarantee.

523 Certain foreign banks that are eligible to use Schedule B may also be able to take advantage of the exemption in § 3(a)(2) of the Securities Act, if they issue their securities through a U.S. federal or state branch. *See* § 3.05[2].

524 A number of central banks have been permitted to register debt securities on Schedule B even though such obligations did not carry the full faith and credit of the sovereign or benefit from a formal sovereign guarantee or "keepwell" arrangement. In *Bank of Greece* (avail. June 2, 1993), the only no-action letter in which this issue has been addressed, the staff stated that it would raise no objection to that central bank's use of Schedule B, but noted particularly (i) the bank's status as the central bank of Greece and (ii) that the Republic of Greece would sign the registration statement. The SEC permitted a Schedule B filing under similar circumstances by Bangko Sentral ng Pilipinas, the central bank of the Philippines, in 1997.

525 In the case of the CEB, an international organization established by member states of the Council of Europe, the Schedule B filing specifically states that neither the Council of Europe nor the CEB's member states guarantee the securities being issued. Furthermore, the CEB may make calls upon subscribed and unpaid capital in order to enable the CEB to meet its obligations, but member states are not required to subscribe to capital increases.

526 Where the issuer is not an instrumentality of a specific foreign government but rather has been established under international agreements among various sovereigns, the issuer alone (along with its authorized U.S. representative) may sign the registration statement.

527 As a technical matter, whether the government's support for the securities represents a guarantee of the securities that is itself a separate security that must be registered under the Securities Act may depend on the nature of the support. In any case, the registration statement will include the above disclosure and the government will be required to co-sign the registration statement and to provide legal opinions with respect to its support for the securities or the issuer.

528 Although foreign governments are subject to essentially the same requirements as foreign private issuers, foreign governments are not eligible for a number of the safe harbors relating to publicity and research reports that are available to foreign private issuers. Accordingly, special considerations apply in these areas in the context of an offering by a foreign sovereign.

529 A shelf issuer may incorporate by reference annual reports filed voluntarily on Form 18-K and amendments filed on Form 18-K/A instead of including country disclosure in the prospectus (included in the registration statement) or in a prospectus supplement, if the SEC issues a no-action letter allowing it to do so. *See*, *e.g.*, *Republic of Chile* (avail. April 27, 2015).

530 However, a class of § 3(a)(2) exempt securities that is listed on a national securities exchange must nevertheless be registered under the Exchange Act. *See* § 3.03[1][a].

531 SEC Release No. 33-6661 (Sept. 23, 1986). The release stipulates that in order for the § 3(a)(2) exemption to be available, the nature and extent of federal or state regulation and supervision of the issuing branch or agency must be "substantially equivalent" to that applicable to federal or state chartered domestic banks in the same jurisdiction. *See also* § Part IV.A.2.c of Robert L. Tortoriello, Derek M. Bush and Hugh C. Conroy, Jr., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. Thomson 2016).

532 A public offering of securities by a U.S. or foreign issuer that is exempt from federal securities registration requirements under § 3(a)(2) may nevertheless remain subject to review under FINRA Rule 5110. If the securities are not nonconvertible debt securities or nonconvertible preferred securities with an investment-grade rating or if an affiliate of the issuer is a FINRA member participating in the distribution of the securities, a filing must generally be made with and approval received from FINRA prior to proceeding with the offering. However, if an offering of securities issued by a U.S. or foreign bank (whether or not exempt from registration under § 3(a)(2)) is structured as a private placement under the Securities Act, such offering would not be subject to FINRA review.

533 *See*, *e.g.*, *Sumitomo Bank* (avail. Oct. 29, 1984).

534 However, equity-, index- and credit-linked "hybrid" securities, *see* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, §§ 2.03[5], 2.04[3], and

2.05[4], may generally be issued or guaranteed by a U.S. branch or agency of a foreign bank in reliance on the § 3(a)(2) exemption because they are generally classified as direct or contingent debt obligations of the branch or agency issuer or guarantor.

535 Securities issued or guaranteed by a bank are exempt from the liability provisions of § 12(a)(2) of the Securities Act.

536 Certain bank obligations (including, for example, certain certificates of deposit) are not "securities" within the meaning of the Securities Act and thus would not need to be registered even if the § 3(a)(2) exemption were eliminated. *See* § 12.01[2][c].

537 *See* Robert L. Tortoriello, Derek M. Bush and Hugh C. Conroy, Jr., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. Thomson 2016) for a fuller discussion of the regulation of securities activities of banks.

538 12 C.F.R. Part 16.

539 *But see* 12 C.F.R. Parts 11 and 16, as amended, to reflect those provisions of the Sarbanes-Oxley Act that the Comptroller is required to administer and enforce with respect to registered national banks.

540 Securities Offering Disclosure Rules, 59 Fed. Reg. 54,789, 54,791 (Nov. 2, 1994).

541 Section 3(a)(11) of the Securities Act exempts from registration offerings conducted entirely within a single state.

542 12 C.F.R. § 16.6.

543 *See* § 4.02[2].

544 *See* § 4.02[3][a][iv].

545 *See* § 7.02[3][d].

546 Pursuant to § 939A of the Dodd-Frank Act, the Comptroller has removed all references to or requirements of reliance on credit ratings. *See* Alternatives to the Use of External Credit Ratings in the Regulations of the Comptroller, 77 Fed. Reg. 35,253 (June 13, 2012) (to be codified at 12 C.F.R. Parts 1, 5, 16, 28, and 160). "Investment grade" for this purpose means the issuer of the security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the issuer is low and the full and timely repayment of principal and interest is expected. 12 C.F.R. § 16.2(g). *See* § 3.05[5].

547 Although the Comptroller has clarified that amendments that contain only pricing information relating to a particular transaction, updated financial information concerning the issuer or nonmaterial information relating to the issuance program need not be filed with the Comptroller. Comptroller Interpretive Letter No. 662 (May 31, 1995) Fed. Banking L. Rept. (CCH) ¶ 83,610.

548 *See* §§ 3.03[1][b], 4.02[3][c][i] and 4.05.

549 SEC Release No. 33-4412 (Sept. 20, 1961).

550 Pursuant to § 939A of the Dodd-Frank Act, the SEC was charged with removing from SEC regulations all references to or requirements of reliance on credit ratings. *See* § 3.05[5]. No action has yet been taken by the SEC regarding the "prime" requirement of the § 3(a)(3) exemption. The SEC has, however, amended Rule 2a-7 under the Investment Company Act to eliminate the requirement that money market funds, which have traditionally been major purchasers of commercial paper, invest only in securities in the two highest rating credit categories. Instead, a money market fund must rely on its own determination that the security has "minimal credit risks" after analyzing certain prescribed factors when investing. *See* SEC Release No. IC-31828 (Sept. 16, 2015) (effective Oct. 26, 2015).

551 The SEC staff has not objected to tombstone advertisements that announce the establishment of § 3(a)(3) programs.

The SEC staff also issued a no-action letter in July 1994 that provided it would not recommend any enforcement action by the SEC if GE Capital and certain of its affiliates publish limited advertisements about their commercial paper in publications with a general circulation so long as certain steps are followed.

General Electric Capital Corporation; General Electric Company; General Electric Capital Services, Inc. (avail. July 13, 1994). The letter outlined a number of steps that would be taken to ensure that individuals and unsophisticated institutions do not actually purchase the paper.

552 Debt instruments with maturities of one year or less are not required by TEFRA to be in registered form and thus technically are not subject to the TEFRA rules governing the offer and sale of bearer debt discussed in § 8.04[2]. However, in the case of a debt instrument with a term of more than 183 days, the "portfolio interest exception" from US withholding tax is available only for debt issued in registered form. Furthermore, even though debt instruments with terms of 183 days or less generally are not subject to US withholding tax, they are nonetheless subject to information reporting and backup withholding requirements. *See generally* § 8.04[2] for a discussion of rules imposed on offers of bearer debt.

553 For various reasons, non-U.S. companies often issue commercial paper in the United States through a finance subsidiary. Such commercial paper is generally guaranteed by, or benefits from, "keepwell" arrangements from the parent because the subsidiary on its own would not be sufficiently creditworthy to make its commercial paper marketable or to satisfy the "prime quality" test of the § 3(a)(3) exemption. In such a structure, the Division has issued a no-action response where the proceeds of the commercial paper were loaned or advanced to the guarantor (or its subsidiaries) and the guarantor represented that the aggregate amount of outstanding commercial paper would be less than various listed "current transactions" of the guarantor and its subsidiaries even though such proceeds would not be segregated or traceable to specific current transactions. *Meridian Bancorp, Inc., Meridian Funding Corp.* (avail. Sept. 21, 1984).

554 Other nonqualifying uses include: discharging existing indebtedness unless such indebtedness is itself exempt under § 3(a)(3); purchasing or constructing a plant; purchasing durable machinery or equipment; funding commercial real estate development or financing; purchasing real estate mortgages; financing mobile homes or home improvements; or purchasing or establishing a business enterprise. SEC Release No. 33-4412 (Sept. 20, 1961).

555 The SEC staff has issued letters to the effect that enforcement action on the basis of the integration doctrine would not be taken so long as the purpose and use of proceeds of the two programs are distinct. *See*, *e.g.*, *Security Pacific Corp.* (avail. Oct. 14, 1976). *See* § 7.02[6] for a discussion of the integration doctrine.

556 § 310 of the Trust Indenture Act.

557 This choice will not be available to all foreign issuers because there are jurisdictions, such as France, that restrict the issuance of debt securities within the jurisdiction governed otherwise than by local law.

558 Conflicts arising from "collective action clauses," pursuant to which debt security payment terms may be amended with the consent of the holders of a majority or supermajority of the outstanding principal amount (to be contrasted with the unanimous bondholder approval requirements of the Trust Indenture Act), are particularly prevalent in Europe and elsewhere overseas. French law, for example, confers upon the majority of the bondholders, acting through their representative, the right to consent to amendments to the terms of the securities governing payment of principal and interest. French law also requires that if a legal entity is to act as the bondholders' representative, such legal entity be incorporated in France. The Trust Indenture Act, as discussed below, permits foreign entities to act as sole trustee under a qualified indenture in limited circumstances (although to date no foreign entity has actually been granted an order allowing it to so act). In the event of a Trust Indenture Act conflict, the SEC may issue rulings allowing securities issuances to proceed. § 304(d) of the Trust Indenture Act; *see* SEC Release No. 2430 (Oct. 13, 2004) (order granting application for exemption from § 316(b) of the Trust Indenture Act to Petroleos Mexicanos and the Pemex Project Funding Master Trust to permit the inclusion of "collective action clauses" in certain indentures to be qualified under the Trust Indenture Act). Many foreign governmental issuers, which as Schedule B registrants are not required to have qualified indentures and generally issue their debt securities under fiscal agency agreements, have collective action clauses. Since 2013, sovereign issuers within the Eurozone have been required to include collective action clauses in bonds they issue with maturities exceeding one year. *See* Conclusions of the Heads of State or Government of the Euro Area of

Mar. 11, 2011.

559 *See* Daimler-Benz Aktiengesellschaft, SEC Release No. 39-2353 (Apr. 25, 1997) (Order) and LM Ericsson Telephone Company, SEC Release No. 39-2312 (June 1, 1993) (Order), which include a description of the deposit arrangements.

560 Trust Indenture Reform Act of 1990, Pub. L. No. 101-550, 104 Stat. 2713 (1990).

561 No foreign financial institution has, however, yet been permitted to act as sole trustee. In at least one instance, the staff of the SEC has not been satisfied that the proposed foreign trustee was subject to supervision or examination that is substantially equivalent to the supervision or examination applicable to U.S. institutional trustees. This was attributable to the fact that U.S. trustees are typically commercial banks, while the proposed foreign trustee, like many other foreign trustees, was not a commercial bank.

562 § 310(a)(1) of the Trust Indenture Act.

563 § 310(b) of the Trust Indenture Act.

564 The term "underwriter," when used with reference to an obligor on indenture securities, is defined to mean every person who, within one year of the date of determination, was an underwriter of any security of such obligor outstanding at such date. § 310(b) of the Trust Indenture Act.

565 § 310(b) of the Trust Indenture Act.

566 § 310(a)(5) of the Trust Indenture Act.

567 § 304(d) of the Trust Indenture Act.

568 *See* SEC, Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (Jan. 2003); SEC Release No. 33-8236 (June 4, 2003).

569 *See* SEC Release No. 34-55857 (June 5, 2007).

570 *See* SEC Release No. 34-72936 (Aug. 27, 2014).

571 *See* Press Release, Fitch Ratings, Fitch Comments on U.S. Financial Reform Act's Implication for Credit Rating Agencies (July 19, 2010).

572 Rating agencies are not required to consent to the inclusion of their ratings in a free writing prospectus, and should not be treated as experts under the Securities Act as a result of doing so. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 233.06 (July 27, 2010). Accordingly, ratings are generally included in a free writing prospectus that provides the final terms of a registered offering of debt securities.

573 *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 233.04 (July 27, 2010).

U.S. Regulation of the International Securities and Derivatives Markets, § 3.06, FINRA

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 § 3.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Several rules of the Financial Industry Regulatory Authority, Inc., or FINRA, [574] a U.S. securities industry self-regulatory organization that is charged with overseeing the activities of essentially all SEC-registered broker-dealers, have an impact on the conduct of public offerings in the United States and outside the United States to the extent a member of FINRA participates in the offering. Some of the more important FINRA provisions that may affect a public offering are summarized below.

[1] Conflicts of Interest

Special FINRA rules must be observed for U.S. public offerings in which a FINRA member affiliated with the issuer participates or in which a FINRA

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member otherwise is deemed to have a conflict of interest. [575] A FINRA member participating in a public offering has a conflict of interest under FINRA Rule 5121 if, among other things, (i) the securities are to be issued by the FINRA member or its affiliate, (ii) at least 5% of the offering proceeds, not including underwriting compensation, is intended to be directed to the FINRA member or certain of its related persons, or (iii) the issuer is controlled by or under common control with a FINRA member participating in the offering or certain related persons. [576]

When a conflict exists as a result of a FINRA member's interest in the securities being offered publicly, the nature of the conflict must be prominently disclosed in specific sections of the prospectus or other offering document and either (i) a qualified independent underwriter ("QIU") must participate in the due diligence process and preparation of the prospectus or other offering document or (ii) an exemption from the QIU requirement must apply. No QIU is required to participate in a public offering if (i) the FINRA member principally responsible for managing the offering does not have a conflict of interest and can meet certain other requirements, (ii) the securities being offered have a "bona fide public market" (as defined in FINRA Rule 5121), or (iii) the securities being offered are investment-grade rated or are in the same series as, or rank *pari passu* with, investment-grade rated securities that have equal rights and obligations. [577] Disclosure documents for all offerings requiring the participation of a QIU must be filed with FINRA for review, even if the offering would otherwise be exempt from filing under FINRA Rule 5110(b)(7). [578]

[2] Initial Public Offerings of Equity Securities

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[a] IPO Purchase and Sale Restrictions

FINRA Rule 5130 prohibits FINRA members from selling "new issues" of equity securities to certain "restricted persons." [579] Like its predecessors—NASD Conduct Rule 2790 and the NASD's interpretation on "free-riding and withholding" of "hot issues" (*i.e.*, where secondary trading commences at a premium relative to the offering price) (the "Interpretation")—FINRA Rule 5130 is designed to ensure that FINRA members: (i) make *bona fide* public offerings of new issues of equity securities at the offering price, (ii) do not withhold securities in a public offering for their own benefit or use the securities being offered to reward those who are in a position to direct future business to them, and (iii) do not exploit their insider position to purchase new issues at the expense of public customers. [580]

However, in contrast to the Interpretation, which applied to all "hot issues" (and, therefore, was potentially applicable to all securities offerings, since it was often impossible to know in advance with absolute certainty whether a particular securities offering would begin to trade at a premium in the secondary market), FINRA Rule 5130 applies only to IPOs of equity securities. [581] More specifically, FINRA Rule 5130 prohibits, subject to certain exceptions, a FINRA member (or

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an associated person thereof) [582] from: (i) selling a new issue to an account in which a restricted person has a beneficial interest, [583] (ii) purchasing a new issue for any account in which such member or associated person has a beneficial interest, and (iii) continuing to hold new issues acquired as an underwriter, selling group member or otherwise, in each case, except as expressly permitted by the rule. [584] For purposes of the rule, "restricted persons" include, among others, FINRA members and other broker-dealers, certain owners and associated persons of broker-dealers, finders, portfolio managers and certain immediate family members of the foregoing. [585]

In addition to these prohibitions, the rule imposes an affirmative obligation on FINRA members to comply with specified preconditions before selling a new issue. Specifically, within the 12 months prior to any such sale, a FINRA member must have obtained in good faith: (i) a representation from the holder of any account to which an offer will be made (or a person authorized to represent the beneficial owner of such an account) stating that the account holder is eligible to purchase new issues in compliance with FINRA Rule 5130, [586] and (ii) a representation from any U.S. or non-U.S bank, broker-dealer or investment adviser or other conduit that all purchases of new issues will be in compliance with FINRA Rule 5130. [587]

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Offerings excluded from the definition of "new issue," and thus excluded from the restrictions of FINRA Rule 5130, include:

- securities offered in private placements, including pursuant to Rule 144A under the Securities Act; [588]
- securities offered in rights offerings, exchange offers or offerings made pursuant to a merger or acquisition;
- offerings of debt securities;
- offerings of convertible securities;
- offerings of preferred securities;
- offerings of securities (in the form of ordinary shares or ADRs registered on Form F-6 under the Securities Act) that have a preexisting market outside the United States;
- offerings of investment-grade asset-backed securities;
- offerings of securities of an investment company registered under the Investment Company Act;
- offerings of exempted securities under § 3(a)(12) of the Exchange Act and the rules promulgated thereunder; and

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- offerings of securities of a commodity pool operated by a commodity pool operator as defined under § 1a(5) of the Commodity Exchange Act. [589]

In addition to the foregoing exclusions, FINRA Rule 5130 contains certain exemptions applicable to particular accounts or entities with large numbers of beneficial owners based on the premise that these types of accounts are likely to have only a small percentage of restricted persons as beneficial owners and thus are not the sort of accounts sales to which the rule should prohibit. [590] These exemptions include sales to, and purchases by, the following accounts or persons, whether directly or indirectly through accounts in which they have a beneficial interest:

- publicly traded entities (other than certain broker-dealers and broker-dealer affiliates) that are listed on a national securities exchange in the United States or that are foreign issuers whose securities meet the quantitative designation criteria for listing on such an exchange;
- an account in which the beneficial interests of restricted persons do not exceed 10% in the aggregate;
- investment companies registered under the Investment Company Act;
- subject to certain conditions, non-U.S. investment companies; [591]
- charitable organizations with tax-exempt status under § 501(c)(3) of the Internal Revenue Code;
- certain ERISA plans qualified under § 401(a) of the Internal Revenue Code;
- subject to certain conditions, common trust funds or similar funds, as defined in § 3(a)(12)(A)(iii) of the Exchange Act; and

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- subject to certain conditions, insurance company accounts. [592]

Certain restricted persons may also be able to acquire equity securities otherwise subject to FINRA Rule 5130, among other circumstances, (i) pursuant to detailed exemptions from the rule applicable to issuer-directed share programs (sometimes referred to as "friends and family" programs), (ii) where securities are directed by the issuer in offerings where, among other things, there is no underwriting, solicitation or sale by any broker-dealer, (iii) in certain purchases designed to prevent the dilution of equity stakes held for more than one year prior to an offering, (iv) pursuant to stand-by underwriting arrangements, or (v) by underwriters for their investment account in under-subscribed offerings. [593]

[b] Restrictions on New Issue Allocations

For more than a decade, the NASD, NYSE, FINRA and SEC often have expressed concern regarding IPO allocation abuses and their effects on public confidence in the capital markets. [594] In November 2010, FINRA Rule 5131—

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specifically prohibiting certain abuses in the allocation, pricing, distribution and trading of IPO securities—was approved. [595]

FINRA Rule 5131 prohibits FINRA members and associated persons from engaging in the following activities in connection with new issues [596] of equity securities:

- granting or threatening to withhold allocations of IPO shares as consideration or inducement for the receipt of excessive compensation for services; [597]
- allocating IPO shares to any account in which an executive officer or director of a public company or a covered nonpublic company (as defined in FINRA Rule 5131), or a member of the household of such officer or director, has a beneficial interest (i) if the company is a current investment banking client of the FINRA member or if the FINRA member has received compensation for investment banking services from the company within the 12 months preceding the allocation, (ii) if the person allocating the IPO shares knows or has reason to know that the FINRA member expects to receive investment banking business from, or intends to provide investment banking business to, the company in the next three

months, or (iii) on the express or implied condition that such executive officer or director, on behalf of the company, direct future investment banking business to the FINRA member (known as "spinning"). [598] The spinning prohibitions do not apply to (i) certain accounts that

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are also exempt from FINRA Rule 5130 pursuant to FINRA Rule 5130(c), [599] (ii) any account in which the beneficial interests of the officers and directors of a company do not, in the aggregate, exceed 25% of such account, [600] or (iii) issuer-directed shares, provided the FINRA member has no direct or indirect influence or other involvement in such allocation by the issuer; [601]

- imposing penalties to recoup sales commissions or credits from representatives who have sold shares to a customer who resold the shares within 30 days of the offering's effective date (known as "flipping"), unless the managing underwriter has imposed the penalties on the entire syndicate; [602] or
- accepting market orders (but not limit orders) for IPO shares prior to the commencement of secondary market trading following the IPO. [603]

In addition to prohibiting the activities described above, FINRA Rule 5131 places the following affirmative obligations on FINRA members in connection with IPO pricing and trading practices:

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- reports by the book-running lead manager to the issuer's pricing committee (or board of directors, if no pricing committee has been appointed) providing indications of interest and final allocations of IPO shares sold in the offering; [604]
- inclusion in any lock-up agreement relating to the offering of (i) a requirement that the lock-up apply to any issuer-directed shares to be received by the officer or director subject to the lock-up and (ii) an agreement by the book-running lead manager to notify the issuer and the public at least two business days in advance of any waiver of a lock-up, except when the waiver is only to permit transfer of the shares as a *bona fide* gift and the recipient agrees to be bound by the same lock-up terms; [605] and
- inclusion in the agreement among underwriters of certain procedures for handling shares that are returned to a syndicate member after secondary market trading commences when such shares are trading at a premium in the secondary market (such procedures are aimed at ensuring that reneged IPO shares are not used to benefit favored clients of the underwriters). [606]

Both FINRA Rule 5130 and Rule 5131 are applicable to FINRA members, which, in general, would not include a non-U.S. broker-dealer not registered with the SEC. Accordingly, these rules should have little effect on a non-U.S. underwriter acting as a lead manager or on other non-U.S. underwriters, unless any such non-U.S. broker-dealer is acting as a "conduit" for a FINRA member or determines to adhere voluntarily to the principles set forth in the rules. However, both FINRA rules do apply to a FINRA member (or a non-FINRA member acting as a "conduit" for a FINRA member) participating in an IPO of equity securities conducted outside the United States pursuant to Regulation S. [607]

[3] Maintaining a Fixed-Price Offering

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FINRA Rule 5141 is intended to ensure that securities in a U.S. public offering (including those comprising part of a global offering) are sold at the specified (or "fixed") public offering price, without granting direct or indirect discounts, selling concessions or other allowances except to members of the selling syndicate or selling group (including foreign broker-dealer members of the syndicate or group). [608] The rule replaced a number of NASD rules and related interpretations commonly referred to as the "Papilsky Rules." [609] Notably, while the Papilsky Rules required that any FINRA member granting a selling concession, discount or other allowance in a U.S.

public offering to a foreign broker-dealer obtain a written agreement that such foreign broker-dealer would comply with the same pricing requirements and related matters as applied to FINRA members when they distributed securities, FINRA Rule 5141 contains no such requirement. [610] However, the standard form of Master Agreement Among Underwriters requires a foreign broker-dealer to comply with FINRA Rule 5141 as though it were a member of FINRA to the extent it acts as a "conduit" for, or receives any selling commissions, discounts, allowances or other compensation from, or is otherwise being directed with respect to allocations or disposition by, a FINRA member. Additionally, unlike NASD Rule 2750, which prevented NASD members from allocating securities in a fixed-price offering to related persons of the member, FINRA Rule 5141 explicitly permits sales of securities in a fixed-price offering to affiliates of a member of the selling syndicate or selling group provided that such sale is made at the fixed public offering price and not a "reduced price" (as defined in the rule) and otherwise complies with FINRA Rule 5130 where applicable. [611]

It is important to note that FINRA Rule 5141 does not require that securities offerings be conducted on a fixed-price basis, nor does it prohibit multiple-price offerings. Such multiple-price offerings, however, generally should not be structured in a manner that discriminates among classes of investors; they may,

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for example, provide for volume-related discounts applicable to all participating investors. The rule also allows a reduction in the public offering price of securities in an under-subscribed offering and allows placement of the remaining securities in such "sticky deal" in a FINRA member's investment account or the account of an affiliate. [612] By its express terms, FINRA Rule 5141 only applies until the offering is terminated or can no longer be sold at the stated public offering price. [613]

[4] “Fair and Reasonable” Compensation

Pursuant to FINRA Rule 5110 (the "Corporate Financing Rule"), FINRA members may not participate in a public offering if the underwriting compensation received or to be received in connection therewith is considered excessive. In addition, the underwriting arrangements and compensation for certain public offerings must be reviewed and approved by FINRA's Corporate Finance Department before sales can be made. [614] Although there are certain exemptions from the review requirement, [615] there is no exemption from the substantive terms

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of the Corporate Financing Rule in the context of a U.S. public offering. [616] In general, the Corporate Financing Rule is intended to ensure that the underwriting terms and arrangements in connection with a public offering in which a FINRA member participates are "fair and reasonable." [617] Some of the more significant issues presented by the Corporate Financing Rule are set forth below.

[a] Overallotment Options

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The Corporate Financing Rule has a direct impact on the size of overallotment options that may be granted to the underwriters in connection with U.S. public offerings conducted on a firm commitment basis. FINRA Rule 5110(f)(2)(J) prohibits the receipt of an overallotment option of more than 15% of the securities being offered (the "firm securities"), without taking into account the securities offered pursuant to the overallotment option. [618] Thus, while the underwriting syndicate can overallot more than 15% of the firm securities being offered, it can only receive an option from the issuer or selling securityholders to purchase up to an aggregate of 15% of the firm securities. If the syndicate overallotted more than 15%, it would be "naked" short the balance and would need to satisfy this excess short position through other means such as open-market purchases. [619]

In the past, there had been some question whether the 15% limitation applied on an aggregate or syndicate-by-syndicate basis in a global offering. In response, FINRA staff provided guidance that permits FINRA members participating in a global offering to be allocated overallotment option securities of up to an aggregate of 15% of the securities registered with the SEC in the global offering, so long as FINRA members are subject to a firm commitment underwriting agreement and regardless of the number of securities eventually sold by such members (including securities offered by such members outside the United States).

[b] Limits on Compensation

The Corporate Financing Rule places certain limitations on the total amount of underwriting compensation that underwriters and certain "related persons" may receive in connection with a public offering. [620] The rule also prohibits participation in the offering if the underwriting compensation received or to

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be received in connection with the offering is considered "unfair or unreasonable." [621]

Underwriting compensation consists not only of cash compensation in the form of the underwriting discount, but also any other "item of value" received by the underwriting group from any source within the period beginning 180 days prior to the filing date of the registration statement with FINRA and ending on the day the offering commences (the "compensation review period"), unless such item falls within a specific exemption. [622] In addition, items of value received within 90 days after the commencement of the offering are subject to FINRA review to determine whether they should be deemed "underwriting compensation" in connection with the offering. [623]

Items of value include, among other things, underwriting commissions and discounts, expense reimbursements (including reimbursement of fees and expenses of underwriters' counsel), [624] finder's fees and financial and consulting and advisory fees. Securities of the issuer, even if not acquired from the issuer or if received in connection with another offering or for providing other services,

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are also items of value. Cash compensation received for acting as a private placement agent, providing a loan or credit facility or for providing services in connection with a merger or acquisition are not considered items of value. [625]

In addition to the exclusion of specified items from the category of items of value, the Corporate Financing Rule contains five exceptions that are intended to distinguish items of value received as consideration for underwriting services from those received as consideration for other financial services, such as venture capital services. [626] The transactions covered by the five categories include acquisitions of securities:

- in private placements or as compensation for a loan or credit facility by certain entities that routinely make investments in, or provide loans or credit facilities to, other companies, and meet a "capital under management" test or that are banking or insurance companies;
- in issuers that have significant institutional investor involvement in their corporate governance before the required filing date of the public offering;
- in private placements that have significant institutional investor participation;
- made to prevent dilution of an investor's position, including as a result of preemptive right exercises, stock splits or *pro rata* rights offerings or the conversion of securities not deemed to be underwriting compensation; and
- made to prevent dilution before the effective date of a public offering where the purchaser has a prior investment history. [627]

Regardless of whether securities received by a member of an underwriting group are deemed underwriting compensation, if such securities are unregistered and received within the 180-day period prior to the filing date of the registration statement with FINRA, the Corporate Financing Rule imposes a lock-up on their

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sale (actual or through derivatives transactions) for 180 days following the commencement of the offering. Unregistered equity securities received after the filing are also subject to the lock-up, but only if they are deemed underwriting compensation in connection with the offering. [628] The imposition of a lock-up reflects FINRA's concern that "underwriters holding significant amounts of unregistered equity could dilute or manipulate the market for an issuer's equity securities immediately following the public offering, especially in the case of thinly traded issuers." [629]

Footnotes

574 FINRA was created in July 2007 through combination of the National Association of Securities Dealers ("NASD") and the member regulation operations of the NYSE. The current FINRA rulebook includes (i) FINRA rules and legacy NASD rules applicable to all member firms, unless more limited application is specified in such rule, and (ii) legacy NYSE rules applicable only to FINRA members that are also members of the NYSE. Helpful rule conversion charts can be found on FINRA's website: www.finra.org.

575 *See* FINRA Rules, Rules 5121, 5110(b)(1) and 5110(b)(7), FINRA MANUAL.

576 Control is presumed at 10% or more beneficial ownership of common or preferred equity, 10% or more interest in a partnership's profits or losses or the power to direct the management or policies of the relevant entity. Under this definition of control, ownership of nonvoting securities could fall within the definition if the ownership is substantial enough to influence management. Additionally, the criteria for control under FINRA Rule 5121 is not limited to securities beneficially owned by a participating FINRA member but also includes any such securities the FINRA member has the right to acquire within 60 days of its participation in the public offering. *See* FINRA Rules, Rule 5121(f)(6), FINRA MANUAL.

577 *See* FINRA Rules, Rule 5121(a), FINRA MANUAL.

578 FINRA Rule 5122 applies similar investor protections to certain private offerings made by a FINRA member or an entity that controls, is controlled by or is under common control with a FINRA member (as "control" is defined in the rule). Investors must receive written disclosure of the intended use of proceeds, the amount of offering expenses and the amount of compensation to be paid to the FINRA member in connection with the private offering, and such disclosure must be filed with FINRA on or before the date it is distributed to investors. FINRA Rule 5122 also places a 15% cap on the amount of offering proceeds the participating FINRA member can receive for costs, discounts, commissions or other sales incentives. Many types of private offerings are exempt from the requirements and limitations of FINRA Rule 5122, including offerings made under Rule 144A or Regulation S, offerings of investment-grade rated debt or preferred securities, as well as sales to employees and affiliates of the issuer, qualified purchasers under the Investment Company Act and qualified institutional buyers as defined in Rule 144A. Notably, however, FINRA Rule 5122 does apply to private offerings by FINRA members made in reliance on § 4(a)(2) of the Securities Act or Regulation D thereunder.

FINRA Rule 5123 generally requires FINRA members and associated persons to file with FINRA any private placement memorandum or term sheet used in connection with certain private offerings no later than 15 days after the document is provided to investors. Such disclosure must include a description of the anticipated use of offering proceeds and the amount and type of offering expenses and offering compensation. Because of its numerous exemptions—which include most offerings to institutional investors (including offerings made pursuant to Rule 144A) and offerings pursuant to Regulation S, as well as offerings of nonconvertible debt or preferred securities by issuers that meet the eligibility criteria for use of Form S-3 and F-3 for primary offerings—from a practical perspective the rule mainly applies to private placements by smaller issuers of securities to individual investors. *See* FINRA Rules, Rule 5123, FINRA MANUAL.

579 *See* FINRA Rule 5130, FINRA MANUAL.

580 *See* FINRA Rules, Notice to Members No. 03-79 (Dec. 2003); SEC Release No. 34-48701 (Oct. 24, 2003);

NASD Conduct Rules, IM-2110-1, FINRA MANUAL.

581 The term "equity security" is defined in FINRA Rule 5130 by reference to § 3(a)(11) of the Exchange Act.

Although FINRA Rule 5130 applies to IPOs of equity securities, as noted below, it exempts from its scope offerings of securities (whether in the form of ordinary shares or ADRs registered on Form F-6 under the Securities Act) that have a preexisting market outside the United States.

582 For this purpose, the term "associated person of a member" includes natural persons registered under FINRA rules, sole proprietors, partners, officers, directors and branch managers of a FINRA member or other natural persons occupying a similar status or performing similar functions, and natural persons engaged in the investment banking or securities business who are directly or indirectly controlling or controlled by a FINRA member. *See* FINRA By-Laws of the Corporation, Article I, Paragraph (rr), FINRA MANUAL.

583 "Beneficial interest" is broadly defined in FINRA Rule 5130(i)(1) to mean "any economic interest, such as the right to share in gains or losses," but does not include fees received by an entity for acting in a fiduciary capacity or managing or operating a collective investment account.

584 *See* FINRA Rules, Rule 5130(a), FINRA MANUAL.

585 *See* FINRA Rules, Rule 5130(i)(10), FINRA MANUAL.

586 The Securities Industry and Financial Markets Association has developed a standard form of representation letter that may be sent to prospective investors for this purpose and for purposes of obtaining representations under FINRA Rule 5131. In addition, certain third-party providers, such as Dealogic, offer a service whereby they will collect and maintain representation letters from prospective investors on behalf of FINRA member clients. *See* FINRA Interpretive Letter to Tom Fleming of Dealogic (Feb. 17, 2004).

587 FINRA Rules, Rule 5130(b), FINRA MANUAL. In single syndicate transactions that include both U.S. and non-U.S. underwriters, and in dual syndicate transactions in which there may be transfers of allocated securities between the U.S. and non-U.S. syndicates, there may be some question as to whether the non-U.S. underwriters are acting as "conduits" for the U.S. underwriters and thus would need to comply with the restrictions of FINRA Rule 5130 in connection with sales made to non-U.S. persons. In general, however, we are of the view that where a non-U.S. broker-dealer is selling securities to non-U.S. investors for which it bears the underwriting risk (where those non-U.S. investors have not been selected by a FINRA member), the non-U.S. broker-dealer should not need to comply with FINRA Rule 5130. On the other hand, if a FINRA member engages a non-U.S. broker-dealer to sell securities in the offering to non-U.S. investors for which the FINRA member bears the underwriting risk or with respect to which the FINRA member grants a selling concession, discount or other allowance to the non-U.S. broker-dealer, the non-U.S. broker-dealer may be viewed as a "conduit" for the FINRA member and should take steps to reasonably ensure that the non-U.S. offerees are not "restricted persons" under the rule. One such step required by standard U.S. master agreements among underwriters ("MAAUs") is for the FINRA member to ensure that any non-U.S. broker-dealer complies with FINRA Rule 5130 as if such non-U.S. broker-dealer were a member of FINRA.

Additionally, under the prior Interpretation, certain firms established barriers designed to prevent transfers of securities between the U.S. and non-U.S. syndicates (or between U.S. and non-U.S. underwriters in a single syndicate structure) in order to establish that non-U.S. underwriters would not receive selling compensation from the U.S. underwriters and thus that such non-U.S. underwriters were not subject to the Interpretation's prohibitions. Although FINRA Rule 5130 does not mandate such procedure, it might nonetheless continue to be useful as a means of establishing that the non-U.S. underwriters were not acting as "conduits" for the U.S. underwriters, particularly in U.S.-led offerings.

588 Although private placements are exempted from the rule, FINRA Rule 5130 does apply to IPOs of equity securities conducted outside the United States pursuant to Regulation S if the sales are made by a FINRA member or an entity (including, *e.g.*, a foreign broker-dealer or bank) acting as a "conduit" for a FINRA member. *See supra* Note 581.

589 FINRA Rules, Rule 5130(i)(9), FINRA MANUAL.

590 *See* FINRA Notice to Members No. 03-79 (Dec. 2003).

591 *See* FINRA Rules, Rule 5130(c)(6), FINRA MANUAL. Non-U.S. investment companies are eligible for this exemption only if (i) they are listed on a foreign exchange for sale to the public or authorized for sale to the public by a non-U.S. regulatory authority and (ii) no person owning more than 5% of its shares is a restricted person. A number of non-U.S. investment company trade associations submitted comment letters in connection with original NASD Rule 2790 objecting to the way in which this exemption was crafted. These letters contend that the exemption effectively precludes non-U.S. investment companies from participating in IPOs subject to the rule because non-U.S. funds frequently do not know who their ultimate beneficial owners are. (The same problem also precludes non-U.S. funds from relying on the exemption described above allowing sales to accounts in which the beneficial interests of restricted persons do not exceed 10% in the aggregate.) This remains an issue for non-U.S. investment companies as the exemptions did not substantively change when NASD Rule 2790 was redesignated as FINRA Rule 5130.

592 FINRA Rules, Rule 5130(c), FINRA MANUAL.

593 *See* FINRA Rules, Rule 5130(d)-(g), FINRA MANUAL.

594 In August 2002, the NASD first proposed rulemaking to prohibit certain allocation abuses. *See* NASD Notice to Members No. 02-55 (Aug. 2002). Then, in May 2003, the NASD and NYSE issued a joint task force report containing proposals for additional rulemaking regarding IPO allocation practices. *See* NYSE/NASD IPO Advisory Committee Report and Recommendations of a committee convened by the New York Stock Exchange, Inc. and the NASD at the request of the SEC (May 2003). The report articulated four general themes from which its recommendations were derived: (i) promoting transparency and avoiding aftermarket distortions, (ii) eliminating abusive allocation practices, (iii) improving access to information regarding IPOs, and (iv) encouraging underwriters to maintain high standards of conduct and promote education related to IPOs. Following the report, in November 2003, the NASD supplemented its existing rule proposal to reflect several of the report's recommendations, and in February 2004, the NYSE submitted its own rule proposal with respect to IPO allocations that largely mirrored the NASD proposed rule. *See* NASD Notice to Members No. 03-72 (Nov. 2003); SEC Release No. 34-50896 (Dec. 20, 2004).

The issue of abusive allocations of IPO shares was also addressed in connection with the April 2003 Global Research Settlement among the SEC, NYSE, NASD and various other securities regulators, on the one hand, and several of the largest investment banks, on the other. *See* § 14.07[5][b] for a discussion of the Global Research Settlement. In conjunction with the Global Research Settlement, the settling firms entered into a voluntary initiative pursuant to which they each agreed to implement policies and procedures reasonably designed to prevent the allocation of securities in "hot" IPOs (*i.e.*, those IPOs where the securities begin trading at a premium in the secondary market) to executive officers and directors of U.S. public companies and non-U.S. public companies with a principal equity trading market in the United States. *See* Press Release, SEC, Voluntary Initiative Regarding Allocations of Securities in "Hot" Initial Public Offerings to Corporate Executives and Directors (Apr. 28, 2003).

In addition, the SEC deemed it appropriate in April 2005 (especially following settlements regarding hot IPO allocations with certain investment banks earlier in the year) to issue an interpretive release reminding investment banks that attempts to induce aftermarket bids or purchases during a Regulation M restricted period violate the regulation (and indeed always have violated Regulation M). The release focuses, in particular, on the application of Regulation M to the book-building process, emphasizing the impermissibility of arrangements such as tie-ins (*i.e.*, agreements to purchase shares in the aftermarket in exchange for receiving an allocation), laddering (*i.e.*, allocating IPO shares based on a commitment to purchase shares at specified prices in the aftermarket) and certain other forms of soliciting aftermarket bids or purchases. SEC Release No. 33-8565 (Apr. 7, 2005). In addition to describing a number of examples of impermissible conduct during the restricted period, the release notes that certain conduct occurring after the restricted period, though not itself violative of Regulation M, could be evidence of an attempt at impermissible inducement. Citing several enforcement cases, the release specifically mentions: (i) carrying out follow-up solicitations for immediate aftermarket orders with customers who earlier indicated aftermarket interest; and (ii) tracking or monitoring customer purchases to determine if customers have purchased in accordance with their earlier indications of aftermarket interest (although the release recognizes that there may be legitimate reasons to monitor customer activity).

595 *See* FINRA Regulatory Notice 10-60 (Nov. 2010); SEC Release No. 34-63016 (Sept. 29, 2010).

596 FINRA Rules, Rule 5131 adopts the same definitions of "new issue" and "beneficial interest" found in FINRA Rule 5130. *See supra* Notes 579 and 583 and accompanying text.

597 *See* FINRA Rules, Rule 5131(a), FINRA MANUAL.

598 *See* FINRA Rules, Rule 5131(b)(1)(A)–(C), FINRA MANUAL.

599 *See* FINRA Rules, Rule 5131(b)(2), FINRA MANUAL; *supra* Notes 586–588 and accompanying text.

600 *See* FINRA Rules, Rule 5131(b)(2), FINRA MANUAL.

601 *See* FINRA Rules, Rule 5131, Supplemental Material.01, FINRA MANUAL. In making an IPO allocation in compliance with FINRA Rule 5131, FINRA members may rely on written representations provided by the beneficial owner of an account within the prior 12 months, provided such FINRA member does not believe, or have reason to believe, such representations are inaccurate. FINRA Rules, Rule 5131, Supplemental Material.02, FINRA MANUAL.

Additionally, effective February 3, 2014, FINRA adopted new supplemental guidance for FINRA Rule 5131, making it easier for certain "fund of funds" or similarly structured entities to receive IPO allocations. Under Supplemental Material.02(b), FINRA members are permitted to allocate IPO shares to an account that has provided a written representation that

- it does not look through to the beneficial owners of any "unaffiliated private fund" (as defined below) that has invested in the account (except for beneficial owners that are control persons of the investment adviser to such unaffiliated private fund); and
- any "unaffiliated private fund" that has invested in the account (a) is managed by an investment adviser; (b) has assets greater than $50 million; (c) owns less than 25% of the account receiving the IPO shares and no single investor in the "unaffiliated private fund" has an economic interest of 25% or greater; and (d) was not formed for the specific purpose of investing in the account to receive the IPO shares. *See* FINRA Rules, Rule 5131, Supplemental Material.02(b), FINRA MANUAL.

An "unaffiliated private fund" is defined as a private fund (as defined in the Investment Advisers Act) whose investment adviser does not have a "control person" in common with the investment adviser of the account to receive the IPO shares. A "control person" means a person with direct or indirect control over the investment adviser, as the term control is defined in Form ADV.

602 FINRA members are also obligated to promptly record and maintain information regarding any penalties assessed by such member on a representative in connection with a penalty bid. *See* FINRA Rules, Rule 5131(c)(2), FINRA MANUAL.

603 *See* FINRA Rule 5131(d)(4), FINRA MANUAL.

604 *See* FINRA Rule 5131(d)(1), FINRA MANUAL.

605 *See* FINRA Rules, Rule 5131(d)(2), FINRA MANUAL. As a practical matter, most IPO underwriting agreements now will include (i) an agreement by the book-running lead manager to notify the issuer of an impending lock-up waiver at least three business days prior to the effective date of the waiver and (ii) an agreement by the issuer to make public announcement of the waiver through a major news service at least two business days prior to the effective date of the waiver. Placing the obligation of public announcement on the issuer is permitted by Supplemental Material.03 to FINRA Rule 5131. To facilitate compliance with FINRA Rule 5131, forms of a lock-up waiver letter and an issuer press release announcing a waiver are often included as exhibits to IPO underwriting agreements.

606 *See* FINRA Rules, Rule 5131(d)(3), FINRA MANUAL.

607 *See supra* Notes 581 and 587.

608 FINRA Rules, Rule 5141, FINRA MANUAL. The rule does not apply to "at-the-market" offerings or to global

securities offerings where the U.S. portion is conducted on a private placement basis.

609 FINRA Rule 5141 replaced NASD Rules 2730, 2740 and 2750, as well as NASD IM-2730, IM-2740 and IM-2750. *See* FINRA Regulatory Notice No. 10-47, Note 5 (Oct. 2010).

610 Indeed, the SEC release proposing FINRA Rule 5141 specifically acknowledged that "[u]nderwriting terms in foreign jurisdictions vary considerably, as do applicable regulatory requirements" and that "[t]he relationships between foreign nonmembers and their customers are beyond the scope of the proposed rule change." Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc., Notice of Filing of Proposed Rule Change To Adopt FINRA Rule 5141 (Sale of Securities in a Fixed Price Offering) in the Consolidated FINRA Rulebook, SEC Release No. 34-62299 (June 16, 2010), 75 Fed. Reg. 35,105, 35,108 & n.31 (June 21, 2010).

611 FINRA Rules, Rule 5141(a) and Supplemental Material.01, FINRA MANUAL.

612 *See* SEC Release No. 34-62299 (June 16, 2010).

613 Securities that immediately trade in the secondary market at or above their public offering price are presumed to have been salable at the fixed public offering price, and, therefore, to have not been eligible for price reduction. *See* FINRA Rules, Rule 5141(a), FINRA MANUAL.

614 *See* FINRA Rules, Rule 5110(c)(1), FINRA MANUAL. Generally, in its reviews of public offerings subject to the provisions of FINRA Rule 5110 and/or the conflict of interest provisions of FINRA Rule 5121, FINRA examines copies of the relevant registration statement and offering document, the underwriting agreement and the engagement letter, if any, among other information, all of which must be filed with FINRA. FINRA staff has issued an interpretive letter pursuant to which it has concluded that free writing prospectuses prepared by any party are excluded from these filing requirements. FINRA Interpretive Letter to Eileen Ryan of the Securities Industry Association and Sarah Starkweather of The Bond Market Association (Aug. 1, 2006).

615 One notable exemption from the review requirements is for securities both (i) registered on Forms S-3 or F-3 pursuant to the standards for those forms in effect prior to October 21, 1992 and (ii) offered pursuant to Rule 415 under the Securities Act (the "Seasoned Issuer Exemption"). FINRA Rules, Rule 5110(b)(7)(C)(i), FINRA MANUAL. There have been significant changes in the eligibility standards for those forms since 1992, so an offering on one of those forms today may not, in fact, fit within this exemption. For example, prior to October 21, 1992, Form F-3 had a 36-month reporting history requirement and a public float requirement of $150 million (or $300 million for F-3 issuers). The reporting history requirement has since been reduced to 12 months for corporate issuers, and the public float test has been reduced to $75 million. *See* § 3.04[6]. Offerings of nonconvertible, investment-grade debt or preferred securities are also exempt from the FINRA review process. FINRA Rules, Rule 5110(b)(7)(B), FINRA MANUAL, unless participation of a QIU is required due to a FINRA "conflict of interest," *see supra* text accompanying Note 577 .

While there is no blanket FINRA filing exemption for WKSI shelf registration statements, in September 2013, FINRA implemented an immediate clearance process through which WKSI and certain other shelf filings can be automatically and immediately issued 24-hours a day, seven days a week. To be eligible for immediate clearance, (i) the submitter must represent that any additional information required to complete the FINRA filing will be submitted within three business days and (2) the FINRA filing fee must have been paid prior to the shelf having been filed with FINRA and wire transfer details must be provided. Prospectus supplements relating to offerings off a WKSI shelf generally will not need to be filed with FINRA for the three-year life of the WKSI shelf. No filing of a WKSI shelf is required if a general filing exemption under FINRA Rule 5110(c) is satisfied , unless participation of a QIU is required due to a FINRA "conflict of interest." *See supra* text accompanying Note 577. A same-day clearance process is also available for registered primary offerings conducted under Rule 415 under the Securities Act, subject to certain conditions. For shelf offerings that must be reviewed, there is generally "Life of Shelf" clearance, pursuant to which a FINRA member would be granted clearance for any offering based on the same shelf registration statement after the initial filing of the shelf documents with FINRA and receipt of a FINRA no-objections opinion covering that FINRA member (assuming certain other requirements are met).

Along with the shelf immediate clearance process, in September 2013, FINRA introduced two additional, streamlined clearance processes for nonshelf registration statements: limited review and expedited review. For the majority of IPOs, limited review generally is available and, because of its simplified filing process, is preferable for timely deal clearance. Because full review remains the default when submitting a transaction for review in FINRA's Public Offering System, counsel to the underwriters must select an alternative review process and make certain representations to FINRA regarding the terms of the underwriting compensation arrangements, including that all relevant documentation will be submitted to FINRA no later than five business days prior to the member's participation in the offering. FINRA staff then will consider counsel's request for an expedited or limited review in light of several factors, including the complexity of the underwriting arrangements and the timing of the transaction. For further information on the FINRA review options, please *see* FINRA's Public Offering Review Programs Guide, http://www.finra.org/sites/default/files/p353162.pdf (May 2016).

616 *See* FINRA Rules, Rules 5110(b)(7) and 5110(b)(8), FINRA MANUAL.

617 Certain underwriting arrangements have been determined by FINRA to be *per se* unreasonable and specifically forbidden by FINRA Rule 5110(f)(2). Such prohibited arrangements include the underwriter's receipt of a nonaccountable expense allowance in an amount greater than 3% of the offering proceeds and any right of first refusal ("ROFR") with a duration of more than three years or that provides more than one opportunity to waive the refusal right for a fee. As of May 2014, FINRA no longer considers certain agreements to pay an underwriter a termination fee or grant a ROFR in a terminated transaction *per se* unreasonable. Such agreements are permissible, provided that (i) the agreement specifies that the issuer has a right of "termination for cause" that eliminates its obligation to pay the termination fee or grant the ROFR; (ii) the fees to be paid under the agreement are not excessive, but reasonable and customary; and (iii) the agreement is void two years from the date of termination.

618 *See* FINRA Rules, Rule 5110(f)(2)(J), FINRA MANUAL.

619 *See* § 3.02[9][d] for a discussion of syndicate short sales.

620 Parties subject to the Corporate Financing Rule include all FINRA members participating in the public offering (whether in an underwriting or other capacity), affiliates (including non-U.S. affiliates) of the participating FINRA members, associated persons of the participating FINRA members (and their immediate family members), financial consultants and advisers, finders and underwriters' counsel. *See* FINRA Rules, Rules 5110(a)(4) and 5110(a)(6), FINRA MANUAL. These parties are collectively referred to herein as the "underwriting group."

Underwriters occasionally enter into agreements under which they agree to compensate out of their own pockets a finder or consultant in connection with an offering. In these circumstances, even though the aggregate amount of compensation paid by the issuer to the underwriting group is unaffected, the fee paid to the finder or consultant by the underwriters may be viewed as "underwriting compensation" by FINRA since it is technically an "item of value" received by an entity falling within the scope of the underwriting group. FINRA has indicated that it should be informed of such arrangements so that it can make a determination as to whether the payment should be viewed as "underwriting compensation" and disclosed in the prospectus as such. Note that both the Corporate Financing Rule and SEC Regulation S-K require disclosure in the prospectus of all items considered by FINRA to constitute underwriting compensation. *See* FINRA Rules, Rule 5110(c)(2)(C), FINRA MANUAL; Item 508(e) of Regulation S-K. *See also supra* Note 328 for a discussion of the treatment of overallotment options that are structured as "free options" as underwriters' compensation.

621 *See* FINRA Rules, Rule 5110(c)(1), FINRA MANUAL. FINRA Rule 5110(c)(2)(E) states that the amount of underwriting compensation considered "fair and reasonable" varies directly with the amount of risk assumed by the underwriting group and inversely with the aggregate amount of offering proceeds. In addition, although no stated maximum amount of underwriting compensation is set forth in the Corporate Financing Rule, historically, FINRA staff has informally indicated its view that such compensation should generally not exceed 8% or 9% of the offering proceeds. (Shelf offerings are no longer required to include a

representation in the disclosure document that the maximum underwriting compensation in connection with any offering under the shelf will not exceed 8%.) If the maximum compensation threshold is exceeded due to the receipt of items of value other than the underwriting discount itself (*see* discussion below regarding the broad definition of "items of value"), in certain circumstances, one or more FINRA members may need to be expelled from the underwriting group in order to bring the aggregate amount of underwriting compensation below the acceptable limit.

622 *See* FINRA Rules, Rule 5510(d)(1), FINRA MANUAL.

623 *See* FINRA Rules, Rule 5510(d)(2), FINRA MANUAL.

624 Because FINRA's Corporate Finance Department must be able to determine that the maximum amount of underwriting compensation to be paid by the issuer to the underwriting group in connection with a public offering is not "unfair and unreasonable," they often require expense reimbursement sections in underwriting or other deal-related agreements to include a cap on the overall amount to be reimbursed by the issuer. This capped amount, representing the maximum possible reimbursement to the underwriter group, is then factored into the overall underwriting compensation analysis.

625 FINRA Rules, Rule 5110(c)(3)(B)(ii), FINRA MANUAL. The rule also provides that nonconvertible and nonexchangeable debt securities and derivative instruments acquired or entered into during the compensation review period (*i.e.*, the period beginning 180 days prior to the filing of the registration statement with FINRA and ending 90 days after the commencement of the offering) are not considered items of value so long as they are at a "fair price" (as such term is defined in the rule) and acquired or entered into in the ordinary course of business in transactions unrelated to the public offering. *See* FINRA Rules, Rule 5110(c)(3)(B)(vi) and (vii), FINRA MANUAL. If such securities are acquired or derivatives entered into in connection with the public offering, they will be deemed items of value and will count as underwriting compensation, but if entered into at a fair price, will have zero compensation value for purposes of determining the overall compensation limit. *See* FINRA Rule 5110(e)(5), FINRA MANUAL.

626 *See* SEC Release No. 34-48989 (Dec. 23, 2003).

627 Qualification for each of the five excepted transaction categories requires satisfaction of further detailed requirements. *See* FINRA Rules, Rule 5110(d)(5), FINRA MANUAL.

628 In addition to exceptions to the lock-up covering certain transfers, such as transfers by operation of law or in connection with the reorganization of the issuer, the Corporate Financing Rule excepts from the lock-up requirements securities acquired subsequent to the issuer's IPO pursuant to a sale under Rule 144A under the Securities Act, as well as securities held by the underwriter or a related person that equal less than 1% of the total securities being offered in the IPO. *See* FINRA Rules, Rule 5110(g)(2), FINRA MANUAL. Acquisitions of securities to prevent dilution of an investor's position, including as a result of preemptive right exercises, stock splits or *pro rata* rights offerings or the conversion of securities not deemed to be underwriting compensation are also not subject to the lock-up requirement. *See* FINRA Rules, Rule 5110(g)(1), FINRA MANUAL.

629 *See* NASD Notice to Members No. 04-13 (Feb. 2004).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.01, 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 § 4.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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This chapter describes the circumstances requiring the registration of securities in the United States under the Securities Act and the Exchange Act, disclosure requirements applicable to foreign issuers that have registered their securities under the Securities Act or the Exchange Act and considerations for such public companies communicating with their investors and financial analysts in the United States. The Securities Act provides a statutory framework for the disclosures an issuer must make to conduct a public offering in the United States, while the Exchange Act provides a framework for the disclosures an issuer must make in connection with both (i) an initial registration of securities that are listed on a national (U.S.) securities exchange or of equity securities that are otherwise publicly held, [1] and (ii) periodic reports following initial registration. After discussing registration and the disclosure regime for a public company, the final section of this chapter summarizes the process for subsequently delisting and deregistering securities in the United States.

Both acts provide that the SEC specify the detailed disclosure requirements through its rules. In fact, the disclosure requirements set out in those rules under the Securities Act and the Exchange Act are currently largely identical. [2]

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Foreign issuers file Form 20-F, which contains detailed disclosure requirements for foreign companies, with the SEC both for an initial registration of a class of securities under the Exchange Act and for annual reports filed under the Exchange Act. Form 20-F is also the source of disclosure requirements for registration statements filed by foreign issuers under the Securities Act to register public offerings of securities. Following an issuer's initial registration, an issuer can generally conduct a public offering of securities with a Securities Act registration statement that "incorporates by reference" the required information from previously filed Exchange Act reports. [3] This feature of the integrated disclosure regime reduces the size of the prospectus in a registration statement under the Securities Act and the time necessary for its preparation.

Footnotes

1 Section 12(b) of the Exchange Act requires registration of securities listed on a national (U.S.) securities exchange. Under § 12(g) of the Exchange Act, foreign issuers must register a class of equity securities if the issuer has total assets exceeding $10,000,000 and that class of securities is held of record by (i) 2,000 or more worldwide holders (or, for an issuer that is not a bank, a bank holding company or a savings and loan holding company, 500 or more worldwide holders who are not "accredited investors") and (ii) 300 or more U.S. holders. *See* Rule 12g3-2(a) under the Exchange Act (exempting from registration foreign issuers with fewer than 300 U.S. holders, based on the exemptive authority granted to the SEC under § 12(g)(3) of the Exchange Act); *see also* Rule 12g5-1 under the Exchange Act (defining securities "held of record" for purposes of § 12(g) of the Exchange Act); Rule 501(a) under the Securities Act (defining "accredited investors" as used in Regulation D).

2 Originally, the disclosure required under the Securities Act was not the same as the disclosure required under the Exchange Act, and the two regimes were administered separately. Beginning in the early 1980s,

however, the SEC developed the view that the information necessary for investors purchasing in a distribution should be the same as the information necessary for investors to make informed secondary market trading decisions (which was the primary rationale for imposing periodic reporting in the Exchange Act). This recognition led to two important developments. First, the accounting and disclosure requirements for a public offering were made substantially identical to the accounting and disclosure requirements for registration of a class of securities under the Exchange Act or for periodic reporting thereunder. *See* SEC Release No. 33-6437 (Nov.19, 1982). In 2008, the SEC eliminated one lingering inconsistency in the accounting requirements for financial statements, as described in § 4.05[3]. Second, an integrated disclosure system was developed, an important consequence of which was shelf registration and later automatic shelf registration.

Although registration and periodic reporting under the Exchange Act now require disclosures similar to those required under the Securities Act, some differences remain. For example, the requirements in § 404 of the Sarbanes-Oxley Act— *i.e.*, to maintain internal control over financial reporting and for management to provide an annual assessment of the effectiveness of internal control over financial reporting—are only required in annual reports. *See* § 5.03[5]. Certain other disclosure requirements under the Sarbanes-Oxley Act—the auditor attestation requirement, disclosures on audit committee financial experts, codes of ethics, etc.—also are only required in annual reports. *See* § 5.03[5] for discussion of these requirements.

Another example is the conflict minerals and mine safety disclosures required under the Dodd-Frank Act, which are only required in periodic reports. *See* § 4.08.

3 §§ 13(a) and 15(d) of the Exchange Act. *See* § 3.02[1][b] for a discussion of the Securities Act registration statement forms.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.02, EVENTS REQUIRING REGISTRATION, AND THE RESULTING PUBLIC DISCLOSURE OBLIGATIONS

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 § 4.02 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Public Offering in the United States

Any foreign issuer conducting a public offering in the United States must register the securities being offered under the Securities Act, unless an exemption from registration is available. If the securities will also be listed on an exchange or, in the case of equity securities, if the issuer meets certain size and shareholder levels, the issuer must also register those securities under the Exchange Act pursuant to §§ 12(b) and 12(g) thereof. If the securities are registered under § 12 of the Exchange Act or offered pursuant to a registration statement that became effective under the Securities Act, the issuer generally becomes subject to periodic and supplementary reporting obligations under the Exchange Act.

[2] Securities Act Registration Statements and Resulting 15(d) Registration

Although securities sold in a public offering in the United States would need to be registered under the Securities Act, they would not necessarily need to be registered under the Exchange Act. For example, if an issuer (whether U.S.

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or foreign) publicly offers debt securities in the United States without a U.S. listing, or a foreign issuer publicly offers equity securities in the United States without a listing or quotation on the OTC Bulletin Board and after the offering there are fewer than 300 U.S. holders, no Exchange Act registration is necessary. [4] However, as a result of having a registration statement (for debt or equity securities) declared effective under the Securities Act, § 15(d) of the Exchange Act requires an issuer to file with the SEC the same periodic reports under the Exchange Act for the fiscal year in which the Securities Act registration statement became effective (assuming securities were sold thereunder) and for any subsequent year in which there are 300 or more U.S. holders of record [5] of the class of securities as it would have had to file if the class had been registered under the Exchange Act. [6] If the securities are held of record by less than 300 persons on a worldwide basis or less than 300 persons resident in the United States

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(for debt or equity securities), or if the trading volume in the United States is 5% or less of its worldwide trading volume during a recent 12-month period (for equity securities), then a foreign private issuer may terminate its Exchange Act periodic reporting obligations by filing a certification on Form 15F with the SEC and satisfying all the other conditions under Rule 12h-6, which include a one-year reporting history and the filing of at least one annual report. [7]

[3] Exchange Act Registration

[a] Requirements

[i] *Listed Securities*

Any issuer (either U.S. or foreign) that has a class of securities listed on a U.S. securities exchange must register that class under the Exchange Act. [8] This requirement applies whether or not there has been a public offering of the securities in the United States. Thus, a foreign issuer wishing to diversify its shareholder base by listing a class of its outstanding securities on the NYSE or Nasdaq must register that class of securities under the Exchange Act.

The registration requirement for securities listed on an exchange applies to both debt and equity. Thus, U.S.-listed bonds issued by a foreign government, as well as U.S.-listed shares or debt securities issued by a foreign company, are all required to be registered. Listing ADRs on an exchange requires registration of the underlying ordinary shares or other underlying securities. Since Exchange Act registration is necessary before the securities begin trading, registration is coordinated with the approval of listing by the pertinent exchange and, in the case of a U.S. public offering, with the registration process under the Securities Act.

A registration statement filed under the Exchange Act in connection with a listing becomes effective 30 days after the SEC receives the exchange's certification of its approval, but the SEC staff can and generally will accelerate the effective date if there are no unusual disclosure issues. [9] There is no material difference between the disclosure about the company and its affairs required in an

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Exchange Act registration statement for debt securities and that required for equity securities.

[ii] *A Class of Widely Held Equity Securities*

Registration under the Exchange Act may also be required, regardless of whether the issuer seeks an exchange listing, if the issuer meets certain size and shareholder levels. If a U.S. company other than a bank, a bank holding company or a savings and loan holding company has $10 million or more in assets on the last day of its most recent fiscal year, it must register any class of equity securities if it is held of record by either 2,000 or more persons or by 500 or more persons that are not accredited investors. [10] An issuer that is required to register a widely held class of unlisted equity securities must file an Exchange Act registration statement within 120 days after the end of the fiscal year in which it exceeded the thresholds for the number of shareholders and total assets. The registration statement becomes effective 60 days after filing unless the SEC accelerates the effective date. [11]

The rules for foreign private issuers are somewhat different. As a general rule, a foreign issuer meeting the minimum asset requirement must register any class of equity securities if it is held of record by 2,000 or more persons worldwide, including 300 or more persons resident in the United States. [12] However, the securities are exempt from registration if the issuer is eligible for an exemption pursuant to Rule 12g3-2(b) under the Exchange Act. [13]

[iii] *Succession*

Subject to certain exceptions, under Rule 12g-3 under the Exchange Act, if a class of securities of an issuer that is not already registered pursuant to § 12 of

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the Exchange Act is issued, in connection with a succession [14] by merger, consolidation, exchange of securities, acquisition of assets or otherwise, to the holders of any class of securities of another issuer that is so registered, then the class of securities of the successor issuer will be deemed to be registered under the Exchange Act. [15] Such securities will not be deemed to be registered, however, if, upon consummation of the succession (i) the class of securities issued by the successor issuer is exempt from Exchange Act registration requirements other than by Rule 12g3-2, (ii) all securities of such class are held of record by fewer than 300 persons worldwide or (iii) the successor issuer is a Canadian corporation meeting certain additional requirements.

Unless one of the exceptions applies, the successor issuer must file with the SEC an annual report on behalf of the acquired company, covering the acquired company's last full fiscal year before the succession occurred, containing information that would have been required if filed by the acquired company, unless that annual report has already been filed. The filing must take place, in the case of a foreign issuer, within four months of the end of the fiscal year for which it is required. [16] In addition, the successor issuer will be required to file with the SEC annual reports in respect of its own business "for each fiscal year beginning on or after the date as of which the succession occurred." [17] In the interim, before filing its first annual report on Form 20-F, the issuer's shares can

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be listed and traded on a national securities exchange or traded on the OTC Bulletin Board. A previously non-reporting acquiror may avail itself of the successor provisions to start a trading market for its securities in the United States even if there is a lapse of time before it must file its first annual report.

Rule 12h-6(d) under the Exchange Act, adopted in 2007, enabled a non-Exchange Act reporting foreign private issuer that acquires a reporting foreign private issuer in a transaction exempt under the Securities Act, for example, under Rule 802 [18] or § 3(a)(10) of the Securities Act, to qualify immediately for termination of its Exchange Act reporting obligations under Rule 12h-6, without having to file an Exchange Act annual report, as long as the successor issuer meets the Rule's foreign listing, dormancy and quantitative benchmark conditions, and the acquired company's reporting history fulfills Rule 12h-6's prior reporting condition. [19] However, if a previously non-Exchange Act reporting foreign private issuer acquires an Exchange Act reporting company by consummating an exchange offer, merger or other business combination registered under the Securities Act, most likely through use of a Form F-4 registration statement, the acquiror would have to fulfill Rule 12h-6's prior reporting condition without reference to the acquired company's reporting history. [20]

[iv] *Rule 12g3-2(b) Exemption*

As discussed in § 3.04, a foreign issuer that has sponsored an American Depositary Receipt ("ADR") program with respect to its outstanding shares but has not obtained a U.S. exchange listing can qualify for an exemption under Rule 12g3-2(b). [21] Since in such a case the issuer has taken steps to promote trading of its securities in the United States, it seems reasonable to require the issuer either to register the securities or to have an exemption. But what many foreign issuers fail to realize is that, as discussed in § 4.02[3][a][ii], the registration provisions of the Exchange Act apply by their terms whether or not a foreign issuer has taken any action to cause or increase the trading of its securities in the United States. Thus, if there are 300 or more holders of record in the United States of any class of equity securities that is issued by any foreign issuer and held of

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record worldwide by at least 2,000 persons, and the issuer otherwise meets the asset test described above, it technically must either register that class or be eligible for the exemption provided by Rule 12g3-2(b). [22] If required to register, it must file an Exchange Act registration statement within 120 days after the end of the fiscal year in which it exceeded the thresholds for assets and numbers of shareholders described above. [23]

Under Rule 12g3-2(b), as amended in 2008, a foreign company is automatically exempt from the registration requirement of § 12(g) if:

- it has no active Exchange Act reporting obligations under § 13(a) or § 15(d) (this means essentially that the foreign issuer has not listed or publicly offered securities in the United States);
- it maintains a listing of its shares [24] on one or more non-U.S. exchanges that are its "primary trading market"; [25] and
- it publishes on its website, [26] in English, the material information [27] that it makes public in its home

country, files with the principal exchange(s) in its

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primary trading market or distributes to its securityholders. [28] To be eligible for the exemption initially, the foreign company must have already electronically published on its website in English all of the relevant documents [29] that it has published, filed or distributed since the beginning of its most recent fiscal year. Thereafter, the English documents must be published promptly [30] after publication or distribution in the home market.

Information electronically published by a foreign issuer on its website pursuant to Rule 12g3-2(b) is not considered to be filed with the SEC for the purposes of § 18 of the Exchange Act and is not otherwise subject to the liabilities imposed by that section. [31] Furthermore, obtaining an exemption and publishing information on a website pursuant to Rule 12g3-2(b) does not cause a foreign company to become an issuer subject to the Sarbanes-Oxley Act.

The SEC's rules only allow a depositary bank to establish an unrestricted ADR facility for a foreign issuer if either the issuer of the underlying shares is a reporting company under the Exchange Act, or the shares are exempt from registration under Rule 12g3-2(b). [32] The 2008 amendments to Rule 12g3-2(b) eliminated requirements for issuers to apply for the exemption and to submit documents to the SEC. This extended the exemption to vast numbers of foreign companies, increasing the number of foreign companies whose shares would be eligible for ADR facilities. While this made it easier for foreign companies to establish "sponsored" ADR facilities pursuant to an agreement between a foreign company and a depositary bank, it also made it easier for banks to establish "unsponsored" ADR facilities without such an agreement, because foreign companies' consent or cooperation is no longer necessary to allow banks to establish

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unsponsored ADR facilities. Such depositary banks can simply establish an unsponsored ADR facility based on their reasonable, good faith belief, after exercising reasonable diligence, that a foreign company complies with Rule 12g3-2(b). [33] Many new unsponsored ADR facilities have been set up since the effectiveness of the amendments.

Foreign companies also may seek to ensure that they benefit from the Rule 12g3-2(b) exemption to avoid the information-furnishing requirements of Rule 144A under the Securities Act. [34]

The exemption under Rule 12g3-2(b) is available to a foreign company until it either (i) fails to make required publications, (ii) fails to maintain a listing of its shares on its primary trading market or (iii) registers a class of securities under § 12 or otherwise incurs reporting obligations under § 15(d) of the Exchange Act. [35] The SEC has not provided any cure period for foreign companies that fail to make required publications in order to maintain their eligibility for the exemption. Difficulties with the SEC arose in the past where a foreign issuer that exceeded the registration threshold allowed the exemption to lapse and then sought to requalify for the exemption. However, in the release accompanying the final rule amendments, the SEC indicated that a foreign company must either re-establish compliance "in a reasonably prompt manner" or else register under the Exchange Act. [36] A foreign issuer seeking to ensure that it can avail itself of the exemption should therefore develop internal procedures to ensure ongoing publication on its website of required documentation.

[b] Classes of Issuers

[i] *Foreign Private Issuers*

Registration under the Exchange Act of a class of securities of a foreign issuer is made on Form 20-F. [37] Selected financial data for the past five years

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must be provided, including audited financial statements for the three most recent financial years, [38] together with a complete business description, an MD&A, [39] risk factors and a description of the terms of the class of securities being registered. [40]

[ii] *Foreign Government Issuers*

Foreign government issuers and certain other issuers eligible to register public debt offerings on Schedule B to the Securities Act must register securities that are listed on a U.S. exchange and file annual reports on Forms 18 and 18-K, respectively, under the Exchange Act. The requirements of these forms are comparable to the requirements of Schedule B and call for disclosure appropriate for such issuers. [41] Some large government issuers voluntarily register and file periodic reports in order to provide updated information that is incorporated by

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reference in their Securities Act shelf registration statements in order to facilitate rapid access to the market. [42]

[c] Periodic Reporting

[i] *Annual Reports on Form 20-F*

All foreign private issuers with a class of securities registered under the Exchange Act or subject to Exchange Act reporting requirements under § 15(d) [43] are required to file annual reports on Form 20-F within four months after the end of a fiscal year. [44]

In accordance with § 408 of the Sarbanes-Oxley Act, the SEC conducts regular and systematic reviews of annual reports on Form 20-F of every foreign issuer at least once every three years, although it provides no indication of when a review is underway or when comments might be forthcoming. The scope of the review covers all of the disclosure in the filing, including financial statements, and is often followed by a comment letter requiring the issuer's responses and, as necessary, revisions to the disclosure in the Form 20-F. However, SEC reviews do not necessarily cover the entire document. The SEC typically requests that the company respond to the comments within 10 business days, although companies requiring more time to respond have often been able to obtain extensions. In most cases, the SEC requests that companies make changes to their disclosure in

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subsequent fiscal years, although if the SEC considers that an issue merits more immediate attention, it can request that the current year Form 20-F be amended.

Foreign issuers that have filed annual reports on Form 20-F are not necessarily required to accept the SEC's comments or recommendations, although the SEC has the discretion to seek enforcement action against the company or its management. In addition, if a foreign issuer with unresolved comments on its Form 20-F seeks to register a securities offering on a registration statement that is not automatically effective, the SEC could refuse to declare the registration statement effective until the company resolves the SEC's comments. Item 4A of Form 20-F requires a company that is an accelerated filer, a large accelerated filer or a well-known seasoned issuer to disclose in its annual report any material SEC comments that were received 180 days or more before the end of the fiscal year to which the annual report relates and remain unresolved. [45]

While all foreign private issuers filing annual reports can expect regular reviews, under § 408 of the Sarbanes-Oxley Act, the frequency of the SEC's review may be increased for: (i) issuers that have issued material restatements of financial statements, (ii) issuers that experience significant volatility in their stock price as compared with other issuers, (iii) issuers with the largest market capitalization, (iv) emerging companies with disparities in price to earnings ratios and (v) issuers whose operations significantly affect any material sector of the economy. [46] Recent experience and SEC guidance suggest that the Form 20-F annual reports of large foreign issuers will continue to be subject to review on a more frequent basis than the three-year minimum.

[ii] *Interim Reports*

SEC rules require U.S. issuers to file quarterly reports on Form 10-Q as well as annual reports on Form 10-K. [47] Foreign issuers are only required by the SEC to file annual reports on Form 20-F. However, if foreign issuers make interim reports available for legal reasons (*e.g.*, if required by another country having jurisdiction over a foreign issuer) or as a matter of practice, these reports would be filed on Form 6-K as discussed below. [48] Both the NYSE and Nasdaq

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require at least semi-annual financial reporting as a condition of listing, including by foreign issuers, and any such reports would then be filed with the SEC. [49]

[iii] *Current Reports on Form 6-K*

Form 6-K requires that a foreign private issuer promptly provide to the SEC and to each U.S. stock exchange on which its securities are listed material information about the issuer or its subsidiaries that the issuer (i) made public in its country of domicile or incorporation pursuant to the law of that country, (ii) filed with any foreign stock exchange on which its securities are listed and that was made public by such exchange or (iii) distributed to its securityholders. [50] This information would include periodic financial reports in the home jurisdiction or to foreign exchanges and could also concern changes in management or control, acquisitions or dispositions of a material amount of assets, changes in the company's certifying accountants, financial condition or results of operations, material legal proceedings, changes in the constituent documents governing the terms of any class of securities registered with the SEC, material increases or decreases in the outstanding amount of the company's securities or indebtedness, the results of the submission of matters to a vote of the company's securityholders or any other information that the company deems of material importance. [51]

With respect to acquisitions or dispositions of material amounts of assets, foreign companies are generally subject to less rigorous reporting requirements

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than U.S. companies subject to the Exchange Act's periodic reporting requirements. U.S. companies must file on Form 8-K detailed information about any material acquisition or disposition of assets, including historical and/or *pro forma* financial statements presented in accordance with U.S. GAAP. [52] In contrast, a foreign company is not required to file additional information with the SEC, but if the information is material and is otherwise made public, it must then be filed "promptly" on Form 6-K. Such information may be much more limited in scope. [53]

When information is made public by press release, distributed directly to securityholders or contains annual audited or interim consolidated financial information, a full English translation is required if the information is not already in English. [54] In most other cases, including generally with respect to reports required to be furnished and made public under the laws of a foreign issuer's home country or the rules of any foreign stock exchange, English summaries meeting the requirements of Rule 403(c)(3)(ii) under the Securities Act and Rule 12b-12(d)(3)(ii) under the Exchange Act may be used. [55]

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The obligation to file current reports is not procedurally burdensome because Form 6-K consists simply of cover and signature pages, signed by a duly authorized officer, to which the relevant information is attached. [56] Copies of the original documents are not required, and the documents included in a report on Form 6-K are not considered to be filed for the purposes of § 18 of the Exchange Act or otherwise subject to the liabilities imposed by that Section. [57] However, disclosures in the documents are subject to Rule 10b-5 under the Exchange Act and general antifraud provisions, and the SEC may also bring an administrative proceeding if the Form 6-K contains materially misleading information. [58]

[iv] *Notification Requirements*

Rule 10b-17 under the Exchange Act imposes, in certain circumstances, an affirmative notification requirement on issuers of securities that are publicly traded in the United States. For example, issuers with securities listed on the NYSE must provide notification, either to FINRA or in accordance with the relevant exchange procedures, of specified dividends, stock splits, reverse splits, rights or other subscription offerings no later than ten days prior to the record date involved or, in case of a rights subscription (or other offering if advance

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notice is not practical), on or before the record date. [59] FINRA also requires compliance with Rule 10b-17 as a condition to trading on over-the-counter markets. [60]

[v] *Proxy Materials and Reports to Shareholders*

The Exchange Act and rules thereunder also set forth requirements with respect to the solicitation of proxies (written authorizations permitting other individuals to vote securities on behalf of securityholders) from holders of securities registered under the Exchange Act. [61] These provisions specify the information required to be disclosed to securityholders prior to or at the time of a proxy solicitation, the presentation of such information, the form of proxies and the treatment of proposals made by securityholders. They also prohibit certain proxy solicitations and false or misleading statements in proxy materials and require an annual report (containing financial statements and an MD&A largely equivalent to that required in a Securities Act registration statement) to be furnished to securityholders prior to or at the time of a proxy solicitation. [62]

Foreign companies are generally exempt from these provisions. [63] However, foreign companies that have securities listed on a national securities exchange are required by the relevant exchange to make annual reports that are required to be filed with the SEC available to U.S. holders of their listed securities. [64] The NYSE also has established rules requiring an "actively operating"

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company to solicit proxies from its shareholders for all shareholder meetings, [65] although the NYSE may grant, in very limited circumstances, an exemption from this rule when applicable law precludes or makes virtually impossible the solicitation of proxies in the United States. [66] Foreign companies whose securities are not so listed are not subject to any requirement to provide reports or notices to securityholders in the United States. They nevertheless may choose to do so in accordance with their home-country laws and practices. Often, this will mean that notices will be given through publication in newspapers in an issuer's home country. If a foreign company has a sponsored ADR program, however, it will usually agree to make the notices or reports available to the depositary, which will agree in turn to forward them to the ADR holders. [67]

[vi] *Annual Special Disclosures on Conflict Minerals*

In order to comply with the Dodd-Frank Act, in 2012, the SEC adopted rules on specialized disclosure relating to the use of conflict minerals from

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covered countries. [68] [69] These rules set forth additional requirements for periodic reporting. Section 4.08 discusses the framework and current status of these required disclosures.

Footnotes

4 *See* §§ 12(b) and 12(g) of the Exchange Act and Rules 12g-1 and 12g3-2(a) thereunder. *See also supra* Note 1 (describing conditions under which an Exchange Act registration statement is not required).

5 In general, a security is deemed to be held of record by each person identified as such in records of

securityholders maintained by or on behalf of the issuer. Rules 12g3-2(a) and 12g5-1 under the Exchange Act. There is no general duty of inquiry placed on issuers, and issuers may rely on such records, except when securities are held of record by a broker-dealer, securities depository (such as DTC), bank (including an ADR depositary) or a nominee for any of them. Rules 12g3-2(a) and 12g5-1 under the Exchange Act; SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rules, Question 152.01 (Sept. 30, 2008). In such a case, the issuer must inquire of such financial intermediaries as to the ownership of such securities, and the securities are counted as held in the United States by the number of separate U.S. resident customer accounts for which the securities are held. Rule 12g3-2(a) under the Exchange Act. In addition, if the issuer is aware of the existence of an ADR facility for its bearer equity securities (whether sponsored or unsponsored), the issuer must contact the depositary for the ADR facility, request the number of U.S. holders on the depositary's records, and include this figure in its total number of U.S. securityholders. Rule 12g5-1(b)(1) under the Exchange Act. An issuer may rely in good faith on information about the residence of (i) the beneficial owner of securities held in "street name" that is furnished by the broker, dealer, bank or nominee that is the record holder of securities and (ii) the record holder of ADRs evidencing bearer securities that is furnished by the depositary for the ADR program. Rules 12g3-2(a) and 12g5-1(b)(1) under the Exchange Act.

6 *See* § 15(d) of the Exchange Act; *see also* SEC, Division of Corporation Finance, Staff Legal Bulletin No. 18 (Mar. 15, 2010), Fed. Sec. L. Rep. (CCH) ¶60,018 (confirming that reporting requirements are not triggered by an abandoned offering). Section 15(d) does not in fact provide that an exemption from registration is available for a foreign issuer if such foreign issuer has fewer than 300 U.S. holders, but instead provides for such exemption if the subject securities "are held of record by less than 300 persons or, in the case of a bank, a savings and loan holding company (as defined in § 10 of the Home Owners' Loan Act), or a bank holding company, as such term is defined in § 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841), 1,200 persons" without distinguishing the type of issuer or where the holders are located. While the SEC staff interprets § 15(d) technically to refer to the number of holders worldwide, it has provided no-action relief to foreign issuers whose worldwide holders exceeded 300 in number but whose U.S. holders did not. *See*, *e.g.*, *Suncor Inc*. (avail. Mar. 11, 1982); *Super-Sol Ltd*. (avail. Jan. 4, 1982). The requirement to file periodic reports for the first fiscal year or for any subsequent year when there are 300 or more U.S. holders, even if not registered under the Exchange Act, does not apply to foreign government issuers.

7 Rule 12h-6 under the Exchange Act. *See* § 4.03[a][iii] for a discussion of the conditions required under Rule 12h-6.

8 §§ 12(a) and 12(b) of the Exchange Act. Prior to Nasdaq's transition to a national securities exchange on August 1, 2006, securities quoted on Nasdaq had to be registered under § 12(g) of the Exchange Act. *See* § 2.01, Note 2 for discussion of Nasdaq's transition to a national securities exchange.

9 § 12(d) of the Exchange Act.

10 § 12(g) of the Exchange Act and Rule 12g-1 thereunder; *see* s *upra* Note 6. The Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (the "JOBS Act"), which was signed into law on April 5, 2012, amended § 12(g) of the Exchange Act to increase the holder of record threshold from 500 persons to 2,000 persons. The JOBS Act also created a separate holder of record threshold for banks, bank holding companies and savings and loan holding companies, which is 2,000 persons with no limit on the number of investors that are not accredited investors. For all companies, the holder of record threshold was amended to exclude securities held by persons who received the securities pursuant to employee compensation plans in transactions exempt from Securities Act registration, but in adopting these changes into the Exchange Act rules, the SEC also amended Exchange Act Rule 3b-4 to clarify that employees must continue to be counted for purposes of determining a company's foreign private issuer status. *See* SEC Release No. 33-10075 (May 10, 2016); *see also* § 3.01, Note 1 for a definition of "foreign private issuer."

11 § 12(g) of the Exchange Act.

12 § 12(g) of the Exchange Act and Rules 12g-1 and 12g3-2(a) thereunder.

13 *See* § 4.02[3][a][iv] for a discussion of Rule 12g3-2(b) under the Exchange Act.

14 Although "succession" is defined for certain Exchange Act purposes to exclude the acquisition of control of a business not followed by the direct acquisition of its assets, *see* Rule 12b-2 under the Exchange Act, the SEC has found Rule 12g-3 to apply in cases where the successor entity ultimately holds all shares of the predecessor entity. *See*, *e.g.*, *Transocean Inc*. (avail. Sept. 26, 2007); *China Light & Power Company Limited* (avail. Jan. 2, 1998); *Grand Metropolitan Public Limited Company* (avail. Dec. 16, 1997).

15 Rule 12g-3 under the Exchange Act. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rules, Question 150.01 (Sept. 30, 2008).

16 *See* § 4.02[3][c][i] for a discussion of the shortening in the required filing period from six months to four months.

17 Rule 12g-3(g) under the Exchange Act. In connection with a U.K. business combination, the SEC found Rule 12g-3 to apply to the entity, Diageo plc, formed by the merger of Grand Metropolitan Public Limited Company and Guinness PLC by way of a scheme of arrangement. The scheme of arrangement involved an exchange of shares of Diageo for shares of Grand Metropolitan. Before the succession, shares of Diageo were not registered pursuant to the Exchange Act, but shares of Grand Metropolitan were so registered. The SEC found the merger to be a succession for purposes of Rule 12g-3, and shares of Diageo were deemed registered pursuant to the Exchange Act following the merger. Registration under the Securities Act was not necessary because shares issued in a scheme of arrangement are exempt from the registration requirements under § 3(a)(10) of the Securities Act, provided certain conditions are met (*see* § 9.05[4][a], Note 164 for a discussion of the § 3(a)(10) exemption as applied to schemes of arrangement in the United Kingdom and similar mechanisms in other countries). As a successor registrant, Diageo was required to file an annual report with the SEC on Form 20-F following the effectiveness of the scheme. *See Grand Metropolitan Public Limited Company* (avail. Dec. 16, 1997).

18 Foreign bidders that do not have a class of equity securities registered under the Exchange Act sometimes exclude U.S. holders because of the necessity to register shares to be issued in the United States under the Securities Act. Rule 802 under the Securities Act, however, provides an exemption from Securities Act registration for the issuance of securities in connection with the acquisition of non-U.S. companies with limited U.S. share ownership. *See* § 9.03[9][c].

19 *See* Rule 12h-6(d) under the Exchange Act; SEC Release No. 34-55540 (Mar. 27, 2007); *see also* § 4.11[2] for a discussion of various conditions required under Rule 12h-6.

20 *See* SEC Release No. 34-55540 (Mar. 27, 2007); SEC Release No. 34-55005 (Dec. 22, 2006).

21 An issuer that has obtained an OTC Bulletin Board quotation would not be able to rely on the Rule 12g3-2(b) exemption.

22 *See supra* Note 5.

23 § 12(g) of the Exchange Act; *see* text accompanying *supra* Note 10; *see also* text accompanying *infra* Note 647.

24 Section 12(g) applies to any class of equity securities, so that a company with both ordinary shares and preference shares would need to have a separate exemption for each class to avoid registration. In an instruction to amended Rule 12g3-2(b), the SEC has said that compensatory stock options are automatically exempt if the underlying shares are exempt, even if the options would otherwise constitute a separate class.

25 Rule 12h-6(a)(3) under the Exchange Act defines the "primary trading market" for a class of securities to mean one or two foreign jurisdiction(s) in which at least 55% of the trading in such securities took place in, on or through the facilities of a securities market or markets during a recent 12-month period. If trading in two foreign jurisdictions is aggregated for the purpose of satisfying the 55% test, the trading market for the issuer's securities in at least one of the two foreign jurisdictions must be larger than the U.S. trading market for the same class of securities.

26 The amended rule also allows an issuer to publish the information through a freely accessible electronic delivery system established by a securities regulator in the issuer's primary trading market. The SEC's release cited the Canadian SEDAR system as an example of such a system.

27 The amended rule continues to provide that only "material" information must be published. Under the U.S. securities laws, information is generally considered "material" if it changes the overall mix of information available to the market, and if a reasonable investor would consider it important in making an investment decision. The amended rule provides a non-exhaustive list of information that would ordinarily be material, including information concerning: (i) results of operations or financial condition, (ii) changes in business, (iii) acquisitions or dispositions of assets, (iv) issuance, redemption or acquisition of securities, (v) changes in management or control, (vi) granting of options or payment of other remuneration to directors or officers and (vii) transactions with directors, officers or principal securityholders. *See* Rule 12g3-2(b)(3)(i) under the Exchange Act. *See also infra* Note 51.

28 The SEC staff views press releases, articles and advertisements (although not standard product advertisements) published in newspapers and magazines as information a company "distributes to its shareholders," even if they are not sent directly to the shareholders. Likewise, information that a company posts on an Internet website is considered to be information that the issuer has made public for purposes of Rule 12g3-2(b). *See* SEC, Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Supplement, Exchange Act Rule 12g3-2(b), Question 9S (Mar. 1999).

29 At a minimum, an issuer is required to publish English translations of (i) its annual report, including or accompanied by annual financial statements, (ii) interim reports that include financial statements, (iii) press releases and (iv) all other communications and documents distributed directly to securityholders. *See* Rule 12g3-2(b)(3)(ii) under the Exchange Act.

30 The SEC did not define the term "promptly," but stated in the release accompanying the final rule that this will depend on the type of document and the amount of time required to prepare an English translation. It said that a foreign issuer must publish a material press release "on or around" the same business day on which the original language document is published. *See* SEC Release No. 34-58465 (Sept. 5, 2008).

31 *See infra* Note 57 and accompanying text. Such information is, however, subject to the antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

32 *See* the discussion of registration of ADRs on Form F-6 in § 3.04[7][c].

33 SEC Release No. 34-58465 (Sept. 5, 2008). A foreign company with an unsponsored ADR program does not set the terms or conditions of the ADRs, nor does it have the ability to terminate the program directly. Moreover, if a company were to seek the establishment of a sponsored ADR program, it would require the termination of any existing unsponsored ADR program and, therefore, the cooperation of that unsponsored program's depositary bank.

34 *See* § 7.02[4][b].

35 *See* Rule 12g3-2(c) under the Exchange Act.

36 SEC Release No. 34-58465 (Sept. 5, 2008).

37 *See* § 4.04 for a discussion of Form 20-F. If registration under the Exchange Act is undertaken in connection with a public offering, a short-form registration statement on Form 8-A is used, which incorporates information from the prospectus contained in the corresponding Securities Act registration statement, the disclosure in which is derived primarily from the requirements of Form 20-F.

Under Regulation S-T, all documents filed with or furnished to the SEC by U.S. and, with certain exceptions, foreign issuers must be submitted electronically, using EDGAR. EDGAR filings are accessible by the public through the SEC's website, www.sec.gov. For a description of the documents that foreign issuers may continue to submit by paper, *see* Rule 101(b) of Regulation S-T and *infra* Note 55.

38 Unless such financial statements are prepared in accordance with U.S. GAAP or in accordance with IFRS as issued by the IASB, they must include a "U.S. GAAP reconciliation" (*i.e.*, a factual discussion and numerical indication of the material differences between U.S. GAAP and the accounting principles upon which the statements are based). *See* §§ 4.05[1] and [2] for a discussion of U.S. GAAP reconciliation and the SEC rule change to eliminate the U.S. GAAP reconciliation requirement for foreign issuers that prepare their financial statements in accordance with IFRS as issued by the IASB. Additionally, financial statement

requirements for foreign issuers that are considered emerging growth companies ("EGCs") under the JOBS Act are less burdensome. *See generally* Chapter 3 for a discussion of EGC requirements.

39 The section is titled "Operating and Financial Review and Prospects" in Form 20-F but, consistent with market practice, is referred to in this chapter as MD&A.

40 *See* § 4.04[2]. The SEC adopted a rule in 2008 that eliminated a distinction in financial statement requirements between Exchange Act and certain Securities Act filings, and instead requires all mandated U.S. GAAP reconciliations to be prepared under Item 18 of Form 20-F for the registrant's financial statements for fiscal years ending on or after December 15, 2011. This requires inclusion of full industry and geographical segment disclosure pursuant to SFAS 131, as well as other information required to be included by the relevant SFAS in an appropriate footnote (*e.g.*, with respect to the values of securities, funding of pension plans, accounting for derivatives and fair market values at risk). *See* SEC Release No. 33-8959 (Sept. 23, 2008). Despite this amendment, Item 17 is still available for separate financial statements of a non-reporting company other than the issuer (*e.g.*, an acquired company or an equity-method investee, for which financial statements may be required under Rule 3-05 or Rule 3-09 of Regulation S-X) and for pro forma information pursuant to Regulation S-X Article 11. *See* Item 18(b) of Form 20-F; SEC Release No. 33-8959; SEC, Division of Corporation Finance, FINANCIAL REPORTING MANUAL, Topic 6410.1.

41 *See* § 3.05[1] for a discussion of the disclosure requirements for securities issued or guaranteed by foreign government issuers.

42 §§ 12(b) and 15(d) of the Exchange Act. As noted above, the requirement to file periodic reports under § 15(d) of the Exchange Act as a result of registering securities for a public offering under the Securities Act does not apply to foreign government issuers.

43 *See* § 4.02[2].

44 *See* § 4.04 for a discussion of the disclosure requirements of Form 20-F. Foreign private issuers unable to file Form 20-F within the prescribed period are required to file a Form 12b-25 explaining the reasons for the delay in filing Form 20-F. Rule 12b-25 under the Exchange Act. The SEC has taken enforcement action in the past against issuers who have failed to file a Form 12b-25 explaining a late filing under the Exchange Act. *See*, *e.g.*, *SEC v. Learning Annex, Inc.*, SEC Litigation Release No. 12481 (May 21, 1990). In addition, the SEC has taken enforcement action against an issuer as a result of allegedly false and misleading statements contained in the issuer's Form 12b-25 filings. *See*, *e.g.*, *In re FFP Marketing Co., Inc.*, SEC Admin. Proc. File No. 3-11826 (Feb. 14, 2005).

The four-month deadline may be particularly challenging for a foreign company that must reconcile its financial statements to U.S. GAAP. However, an issuer that prepares financial statements under IFRS as issued by the IASB is not subject to this reconciliation requirement. *See* SEC Release No. 33-8879 (Dec. 21, 2007). The filing deadline thus provides an additional reason for a foreign issuer to switch from home-country GAAP to IFRS, especially if IFRS financial statements are acceptable for home-country reporting. The SEC in fact cited a desire to allow time for foreign issuers and foreign regulators to adopt IFRS as a reason for delaying the effectiveness of its amendment of Form 20-F in September 2008 to shorten the filing deadline from six months after the end of a fiscal year to four months.

As discussed in § 4.02[3][b][ii], to the extent required, foreign government issuers and guarantors use Form 18-K to file their annual reports under the Exchange Act's periodic reporting requirements.

45 *See* Rule 12b-2 under the Exchange Act for the definitions of an "accelerated filer" (generally, a company with a public float of at least $75 million but less than $700 million that has been publicly reporting for at least one year) and a "large accelerated filer" (generally, a company with a public float of at least $700 million that has been publicly reporting for at least one year); *see* Rule 405 under the Securities Act for the definition of a "well-known seasoned issuer." *See* § 3.02[3][a][ii] for a discussion of well-known seasoned issuer status.

46 *See* § 408 of the Sarbanes-Oxley Act.

47 Rule 13a-13 under the Exchange Act.

48 Rule 13a-16 under the Exchange Act.

49 *See* NYSE Listed Company Manual § 203.03; NASDAQ Marketplace Rules, Rule 5250(c)(2), NASDAQ Manual.

50 *See* Note 27 (discussing the interpretation of "material" information under the U.S. securities laws and the guidance with respect thereto contained in Rule 12g3-2(b)(3)(i) under the Exchange Act). In 2004, the SEC significantly expanded the list of items that U.S. issuers must disclose on Form 8-K. The expanded list requires disclosure of, among other things, the entry into or termination of material agreements not made in the ordinary course of business, the creation of, and events triggering, material direct or contingent financial obligations, material costs associated with exit or disposal activities, material impairments and determinations that an issuer's financial statements should not be relied upon because they must be restated as a result of an error. In addition, the SEC generally shortened the length of time during which U.S. issuers are required to file reports on Form 8-K to four business days after the occurrence of the events requiring disclosure. *See* SEC Release No. 33-8400 (Mar. 16, 2004). When the SEC amended Form 8-K in 2004, it did not amend Form 6-K to require new disclosures by foreign private issuers or to change the illustrative list of disclosure items in the instructions to Form 6-K. However, at a minimum, foreign private issuers should consider the expanded list of items in Form 8-K in deciding whether particular press releases or home-country filings are material (and thus covered by Form 6-K) and which Form 6-K reports should be incorporated into their Securities Act registration statements.

51 Form 6-K, General Instruction B. The information required by Form 6-K is comparable to that required under Rule 12g3-2(b) under the Exchange Act. For a discussion of the SEC's interpretation of information "distributed" to securityholders in the context of Rule 12g3-2(b), *see supra* Note 28.

52 Form 8-K, Items 2.01, 9.01. This information must generally be filed within four business days after the consummation of the acquisition or disposition, although the required financial statements may, under certain circumstances, be filed up to 71 days later.

53 Form 6-K, General Instruction B. However, if a foreign private issuer files a registration statement in connection with a public offering, it will be required to include financial statements with respect to any acquired business with a defined level of materiality (or with respect to a very substantial business whose acquisition is probable), as well as related *pro forma* financial information. *See* § 4.05[5][a] for a discussion of when the inclusion of such financial statements is required and how they must be prepared. Significant dispositions by foreign companies may trigger the requirement to include certain *pro forma* financial information. The SEC rarely waives these requirements. *See* § 9.05[4] for a discussion of certain limited exceptions to these disclosure requirements. As a general matter, foreign issuers that may wish to register a public offering in the United States should ascertain whether the financial statements of any significant company they propose to acquire are suitable for inclusion in a U.S. registration statement.

54 Form 6-K, General Instruction D(1). The SEC staff has informally indicated, however, that where the translation requirement would result solely from inclusion of consolidated financial information, full translation is not required if the consolidated financial information has been previously filed with or submitted to the SEC electronically *via* EDGAR. If, however, such consolidated financial information has not been so previously filed or submitted, the SEC staff has noted that an English summary of the document would be permissible so long as the summary contained a full translation of the portion of the document including the consolidated financial information.

55 Form 6-K, General Instruction D(2). Reports required to be furnished and made public under the laws of a foreign issuer's home country or the rules of any foreign stock exchange (other than press releases or documents that have been distributed directly to a foreign issuer's securityholders) may also be submitted in paper format, rather than electronically by EDGAR, to the extent any "material event" discussed in such report has already been the subject of a Form 6-K or other submission on EDGAR. Rule 101(b)(6) of Regulation S-T.

See Rule 12b-12(d)(2) under the Exchange Act for a list of those documents for which full translation is nevertheless required (including articles of incorporation, by-laws, instruments defining the rights of securityholders, voting agreements and certain contracts and financial information).

56 Filings on Form 6-K must be covered, however, by an issuer's disclosure controls and procedures under the Sarbanes-Oxley Act. *See* § 5.03[7][a].

57 If the information on Form 6-K is subsequently incorporated by reference into a registration statement on Form F-3, the information so incorporated would be subject to the liability provisions of the Securities Act. *See* the discussion of Form F-3 in § 3.02[1][b]. The required disclosure in current reports on Form 8-K by U.S. issuers should be considered by foreign issuers in deciding which filings on Form 6-K to incorporate into Securities Act filings.

58 In 1998, the SEC brought proceedings against Sony Corporation in which the SEC found that Sony and an officer of Sony responsible for disclosure matters had violated SEC reporting requirements by failing to describe, in Sony's annual report on Form 20-F and in its periodic earnings reports on Form 6-K, losses suffered by one of its subsidiaries, Sony Pictures. *In re Sony Corporation*, SEC Release No. 34-40305 (Aug. 5, 1998). The SEC found that Sony failed to identify greater than anticipated losses at Sony Pictures and to discuss a "known trend" involving cumulative losses of more than $1 billion. The SEC applied Exchange Act Rule 12b-20 to Sony's Form 6-K filing, which requires that Exchange Act periodic reports include any additional information "as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading." Rule 12b-20 under the Exchange Act. The SEC did not bring the proceedings under the antifraud provisions of Rule 10b-5 under the Exchange Act and has made it clear that, without alleging fraud or recklessness tantamount to fraud, it can bring an administrative proceeding, which could result in the imposition of substantial fines, if either a Form 20-F or a Form 6-K contains materially misleading information. Sony consented, among other things, to the payment of a fine of $1 million and to procedural changes in responsibility within the company for the preparation of its SEC periodic reports. The SEC also pursued claims against the individual Sony officer responsible for the disclosure. *SEC v. Sony Corp.*, SEC Litigation Release No. 15832 (Aug. 5, 1998).

59 *See*, *e.g.*, NYSE LISTED COMPANY MANUAL § 204.12.

60 *See* FINRA Regulatory Notice 10-38 (Aug. 2010). In the Level 1 ADR context, in which there is over-the-counter trading in the United Sates but no listing on a U.S. exchange, a foreign issuer does not have to comply with this requirement because the foreign issuer is not the issuer of the ADRs. The ADR program's depositary bank, on the other hand, needs to comply with this requirement because it sets the record dates for dividends and determines other related events as they apply to the traded ADRs. In the case of sponsored Level 1 ADRs, the foreign issuer may agree to comply with this requirement to facilitate the depositary bank's compliance with it. *See* § 3.04[1] for a general discussion of ADR programs. If a foreign issuer's ordinary shares or other securities underlying the ADRs were to trade on over-the-counter markets, compliance with this requirement would be a condition to such trading.

61 § 14(a) of the Exchange Act and Regulation 14A thereunder.

62 § 14(a) of the Exchange Act and Regulation 14A thereunder. *See* § 4.06 for a discussion of the requirements relating to MD&A.

63 Rule 3a12-3 under the Exchange Act; *see Schiller v. Tower Semiconductor Ltd*., 449 F.3d 286 (2d Cir. 2006) (reaffirming the SEC's authority to create exemptions to proxy statement requirements under § 14(a) of the Exchange Act and upholding the exemptions for foreign private issuers under Rule 3a12-3).

64 A foreign private issuer is required to issue a press release announcing the filing of its annual report with the SEC, to make such annual report available on or through its website and to provide hard copies of its audited financial statements, in the case of NYSE-listed companies, and the full annual report, in the case of Nasdaq-listed companies, upon request to all shareholders. Foreign issuers do not need to satisfy these requirements if, with respect to NYSE-listed companies, they are subject to the U.S. proxy rules or provide the required information to shareholders in a way that is consistent with the physical or electronic delivery requirements set forth in Rules 14a-3 and 14a-16 of the U.S. proxy rules, or with respect to Nasdaq-listed companies, they mail the required information to shareholders or provide such information in a way that is consistent with the electronic delivery requirements set forth in Rule 14a-16 of the U.S. proxy rules. *See*

NYSE LISTED COMPANY MANUAL § 203.01; NASDAQ Marketplace Rules, Rule 5250(d)(1), NASDAQ MANUAL.

65 *See* NYSE LISTED COMPANY MANUAL § 402.04. The NYSE rules require proxy materials to be formatted and distributed as permitted or required by applicable law and regulations. *See* NYSE LISTED COMPANY MANUAL § 402.04(b). Given that the SEC's rules governing proxy solicitations are not applicable to foreign private issuers, foreign private issuers required to solicit proxies pursuant to the NYSE rules may follow their home country practices with respect to procedures.

66 The NYSE listing agreement for foreign private issuers requires the issuer to "solicit proxies for all meetings of stockholders," and the NYSE listing rules provide that "actively operating" companies are required to solicit proxies except where "applicable law precludes or makes virtually impossible the solicitation of proxies in the United States." NYSE LISTING AGREEMENT FOR FOREIGN PRIVATE ISSUER EQUITY SECURITIES; NYSE LISTED COMPANY MANUAL §402.04(A). Certain ADR depositaries take the view that the proxy solicitation requirement is satisfied by mailing voting instruction cards to registered holders (rather than beneficial owners) of the underlying securities; these registered holders typically pass along the voting instruction cards to beneficial owners. Other depositaries believe the NYSE requirement is only met if an issuer solicits proxies directly from beneficial owners, which is generally accomplished by sending owners a voting instruction card through a proxy solicitation firm, who then coordinates the delivery of the voting instruction card with The Depository Trust Company. *See also* NASDAQ Marketplace Rules, Rules 5615(a)(3) and 5620(b), NASDAQ MANUAL (requiring each company that is not a limited partnership to solicit proxies and provide proxy statements for all meetings of shareholders, but allowing foreign private issuers to follow home country practice in lieu of the Nasdaq's corporate governance rules).

67 While not subject to U.S. proxy requirements under the Exchange Act, foreign issuers are still subject to the antifraud provisions of § 10(b) of the Exchange Act. *See also* § 3.04[1][a], Note 502 for discussion as to the elimination of broker discretionary voting in uncontested director elections.

68 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,286 (Sept. 12, 2012).

69 [Reserved].

U.S. Regulation of the International Securities and Derivatives Markets, § 4.03, CONTENT OF SCHEDULE B

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 § 4.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The requirements for disclosure in U.S. public offerings by foreign sovereign issuers, certain supranational issuers and certain issuers of foreign government-guaranteed securities are set out in Schedule B to the Securities Act.

Section 3.05[1] discusses Schedule B and the types of disclosures provided by foreign government filers.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.04, CONTENT OF FORM 20-F

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 § 4.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Overview

Foreign private issuers file Form 20-F with the SEC for an initial registration of a class of securities under the Exchange Act and for annual reports under the Exchange Act. Form 20-F also is the basis for the disclosures required when a foreign private issuer registers a U.S. public offering under the Securities Act. Form 20-F consists of three parts. All three parts are required in annual reports, whereas only two parts are required when Form 20-F is used as a registration statement under the Exchange Act in connection with the listing of securities. [70] While Form 20-F elicits disclosures "as equal as practicable" to those provided by U.S. domestic issuers in Form 10-K reports or in their registration statements under the Securities Act and Exchange Act, certain accommodations have been made in Form 20-F to improve the accessibility of the U.S. capital markets to foreign issuers in light of the different national laws and accounting regulations to which such issuers are subject. [71] This section provides an overview of each part of Form 20-F. [72]

[2] Part I

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Part I calls for, among other items, a detailed description of the issuer's financial condition, risk factors, business operations and principal activities, organizational structure, properties, information regarding the company's management, information regarding major shareholders and related-party transactions, and the market risk exposure of the company. [73] Shareholders owning 5% or more of any class of voting securities must be identified if known, selected

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financial data for five years must be furnished, [74] and all taxes, including withholding provisions to which U.S. securityholders are subject under the laws of the country where the company is organized, must be described.

Perhaps the most important requirement of Part I is the requirement in Item 5 that the filing contain an MD&A section, for the period covered by the financial statements included in the filing pursuant to Part III. The MD&A requires a discussion of liquidity, capital resources, results of operations and other information necessary for an understanding of the company's financial condition, changes in financial condition and results of operations. It is taken very seriously by the staff of the SEC, and if not prepared adequately, extensive comments may be received and revision required. Extensive guidance provided by the SEC and the adoption of disclosure rules under the Sarbanes-Oxley Act are evidence of the importance of this section. More information about the disclosure required in this section is described in § 4.06.

When Form 20-F is used as a registration statement, Part I also calls for a detailed description of the securities being registered, including ADRs. While not required by the form, in the case of registering equity securities, a practice has developed of describing the principal features of the foreign corporate law applicable to the issuer. Particular attention is given to the process by which directors are elected and the matters that must be submitted to a vote of the shareholders, as well as the rules applicable to the conduct of shareholder meetings.

[3] Part II

The requirements of Part II apply to annual reports filed on Form 20-F but do not apply in the case of a Form 20-F filed to register securities. [75] Part II requires an issuer to identify any of its indebtedness or indebtedness of a significant subsidiary with respect to which there has been, during the year, default in the payment of a principal, interest or sinking fund obligation or in the performance of any other material term not cured within 30 days if the amount of the indebtedness exceeds 5% of the total assets of the registrant and its consolidated subsidiaries. In addition, if the constituent instruments defining the rights of holders of any class of registered securities have been materially modified during the year, the modification and its effect must be described. Part II also requires disclosure, in the annual report on Form 20-F immediately following the first Securities Act registration statement filed by the issuer, regarding the use of

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proceeds of the offering pursuant to that registration statement. Finally, Part II contains disclosure requirements adopted for reporting companies under the Sarbanes-Oxley Act, such as disclosure regarding audit committee financial experts and an issuer's code of ethics, as well as more recent disclosure requirements regarding the amount of fees paid to independent auditors for specified services and corporate governance matters.

A foreign issuer with securities listed on a national securities exchange must also include in Part II of its annual report on Form 20-F (but not on a Form 20-F used to register securities) a concise summary of any significant ways in which the issuer's corporate governance practices differ from those followed by U.S. domestic issuers under the listing standards of that exchange. [76] This requirement is similar to that imposed on listed foreign issuers by the New York Stock Exchange and Nasdaq. [77]

[4] Part III

Part III sets out the financial statement requirements. The basic provisions require audited income statements, cash flow statements and statements of changes in equity for the three most recent fiscal years, and audited balance sheets as of the three most recent fiscal year-ends generally must be included, in each case on a consolidated basis and otherwise in accordance with U.S. GAAP or IFRS as issued by the International Accounting Standards Board (the "IASB"), or reconciled to U.S. GAAP. [78] For first-time registrants, reconciliation to U.S. GAAP need only be for the two most recently completed fiscal years and any required interim periods. [79] These requirements, and limited exceptions thereto, are discussed below. [80]

Part III has two items that govern financial statement disclosure requirements—Item 17 and Item 18. Historically, Item 17 of Form 20-F was a less demanding alternative that omitted business segment data and permitted

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limited reconciliation to U.S. GAAP. Modifications to Form 20-F in 2009 largely eliminated the relaxations that had been afforded by Item 17. [81]

Certain documents must be filed as exhibits to Form 20-F, including material contracts and instruments defining the rights of securityholders of the class being registered. [82] These exhibits are available to the public. Therefore, if any material contract contains sensitive information, confidential treatment that would allow the redaction of that information should be requested. [83]

Footnotes

70 *See* Form 20-F, General Instruction E. As a general matter, Parts I, II and III must be included in an annual report, but the specific instructions to sections included in those Parts may limit the information required in the case of annual reports. Only Parts I and III are required for registration statements filed under the Exchange Act. Registration statement forms under the Securities Act direct issuers to the disclosure requirements in Items of Form 20-F.

71 *See* § 3.03[1][b] for a discussion of the integrated disclosure system and Form 20-F. *See also* SEC Release No. 33-8959 (Sept. 23, 2008), 73 Fed. Reg. 58,300, 58,301 (Oct. 6, 2008) (the "2008 Form 20-F Reporting Enhancement Release").

72 On December 20, 2013, the SEC issued a staff report to Congress titled the "Report on Review of Disclosure Requirements in Regulation S-K " (the "Disclosure Report"), which was mandated by the JOBS Act. The purpose of the Disclosure Report was to analyze Regulation S-K, which provides the disclosure requirements for domestic companies for non-financial statement portions of registration statements and periodic reports, to find additional ways to modernize and simplify the SEC's disclosure requirements. After a detailed overview of the history and the structure of the SEC disclosure regime, the staff concluded in the Disclosure Report that it needs to develop a plan for systematic review of the SEC's disclosure requirements, including those under Regulation S-K and Regulation S-K, which provides the form and content requirements for financial statements included in registration statements and periodic reports, and that, after gathering sufficient information after such review, it would recommend any proposals for revisions of the disclosure rules to the SEC. In addition to the JOBS Act, the Fixing America's Surface Transportation Act (the "FAST Act"), which was signed into law on December 4, 2015, also directed the SEC to conduct a study on modernization and simplification of Regulation S-K and submit a report to Congress within 365 days. H.R. Rep. No. 114-279 (2015). As part of the initiative, on September 25, 2015, the SEC issued a request for comments on the effectiveness of financial disclosure requirements in Regulation S-K. SEC Release No. 33-9929 (Sept. 25, 2015). In 2016, the SEC issued a series of releases under the initiative, starting with a concept release on business and financial disclosure items in Regulation S-K in April 2016 (the "Concept Release"), followed by a June 2016 proposal to replace the disclosure requirements for SEC-registered mining companies, a July 2016 proposal to amend certain disclosure requirements that became "redundant, duplicative, overlapping, outdated, or superseded," an August 2016 request for comments on Subpart 400 of Regulation S-K (the "Subpart 400 Release") and an August 2016 proposed rule requiring hyperlinks to each exhibit filed under Item 601 of Regulation S-K. SEC Release Nos. 33-10064 (Apr. 13, 2016), 33-10098 (June 16, 2016), 33-10110 (July 13, 2016), 33-10198 (Aug. 26, 2016) and 33-10201 (Aug. 31, 2016). On November 28, 2016, the SEC issued the report required by the FAST Act, titled "Report on Modernization and Simplification of Regulation S-K " (the "Fast Act Report"). The Fast Act Report presented the SEC staff's recommendations on a number of items of Regulation S-K and reflected the staff's work on the Concept Release and the Subpart 400 Release. The Disclosure Report and the Fast Act Report do not provide a timeline for effecting any changes to the existing disclosure requirements. Generally, the review and comment process for such proposals, concept releases and requests for comments take considerable time and it is unclear what specific changes, if any, will result under the initiative or whether any such changes will affect foreign private issuers.

73 Item 11 of Form 20-F requires the issuer to provide, in its reporting currency, quantitative information about market risk-sensitive instruments (*e.g.*, derivatives, outstanding floating rate debt, fixed rate investments or investments or debt denominated in a currency other than its reporting currency) as of the end of the latest fiscal year. The issuer must also provide qualitative information concerning the issuer's primary market risk exposures (*e.g.*, interest rate and foreign currency exposure) and how those exposures are managed. *See* § 4.07[11] for a more complete discussion of derivatives disclosure requirements.

74 Selected financial data for one or more of the earliest three years of the relevant five-year period may be omitted in certain circumstances. *See* § 4.05[2].

75 Even if not strictly required by Form 20-F, issuers filing Form 20-F to register securities need to consider in any event whether this or any other information not strictly called for by the applicable form might need to be included to satisfy the general antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

76 Form 20-F, Item 16G.

77 *See* NYSE LISTED COMPANY MANUAL § 303A.11; NASDAQ Stock Market Rules, IM-5615-3. Both the instructions to Item 16G and to the NYSE LISTED COMPANY MANUAL emphasize that the discussion should be brief and general, not a detailed, item-by-item analysis. Nasdaq requires disclosure of each corporate

governance requirement from which a company is exempted by Nasdaq and a description of the home country practice, if any, followed by the issuer in lieu of the requirements that would otherwise be applicable.

78 A balance sheet as of the end of the earliest of the three years is not required, however, if that balance sheet is not required by the registrant's home jurisdiction (or any other jurisdiction whose rules are applicable to the registrant outside the United States).

79 *See* SEC Release No. 33-7053 (Apr. 19, 1994). In each subsequent reporting year, an additional year of required financial statement data would need to be provided in accordance with U.S. GAAP or IFRS or reconciled to U.S. GAAP.

80 *See* § 4.05[1].

81 *See* § 4.05[1], [2] and [3].

82 A full English translation is required for exhibits in a foreign language, as set out in Rule 403(c)(2) under the Securities Act and Rule 12b-12(d)(2) under the Exchange Act. These exhibits include articles of incorporation, by-laws, instruments defining the rights of securities holders, voting agreements and certain contracts and financial information.

83 Public filings, if required, are made in redacted form while the confidential treatment process plays out. *See* Rule 406 under the Securities Act and Rule 24b-2 under the Exchange Act; SEC, Division of Corporation Finance, Staff Legal Bulletin No. 1A (Feb. 28, 1997), Fed. Sec. L. Rep. (CCH) ¶60,001 (Addendum included: July 11, 2001) (setting out the procedures for the SEC staff's handling of confidential treatment requests). In recent years, the SEC staff has questioned issuers on the amount of text redacted, requiring issuers to narrow their confidential treatment requests to very specific information.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.05, FINANCIAL STATEMENTS IN SEC REGISTRATION STATEMENTS AND OTHER FILINGS

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 § 4.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

[1] Basis of Presentation (U.S. GAAP, IFRS and U.S. GAAP Reconciliation)

Financial statements of foreign companies may be prepared in accordance with U.S. GAAP, [84] IFRS as issued by the IASB, [85] or another comprehensive

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body of accounting principles, but in the last case a reconciliation of the financial statements to U.S. GAAP generally must be provided.

In 2007, the SEC decided to accept financial statements of foreign companies prepared in accordance with IFRS as issued by the IASB without requiring a reconciliation to U.S. GAAP. [86] The rules took effect with respect to fiscal years ending after November 15, 2007. This significant relaxation is only available to foreign companies that prepare financial statements in accordance with IFRS as issued by the IASB. For example, the reconciliation requirement still applies in the case of financial statements prepared in accordance with IFRS as adopted by the EU (but not in compliance with IFRS as issued by the IASB), which provide for certain departures from IASB-approved IFRS, including in the area of accounting for derivatives. [87]

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The FASB and IASB continue to work together on convergence projects to harmonize the accounting standards under U.S. GAAP and IFRS as issued by the IASB. In addition, the SEC had taken various steps to consider the adoption of IFRS as an option for presentation of financial statements for U.S. issuers. [88] Despite the efforts, in a May 2015 speech, then-SEC Chief Accountant James Schnurr acknowledged that feedback from various U.S. constituents revealed "virtually no support" for an SEC-mandated IFRS for all U.S. registrants and "little support" for an option to prepare financial statements under IFRS for U.S. registrants. [89] However, he continued to encourage IASB and FASB to work towards converging the financial accounting standards, viewing "continued collaboration [as] the only realistic path to further the objective of a single set of high-quality, global accounting standards." [90] In terms of adopting IFRS as an option for presentation of financial statements for U.S. issuers, SEC Chief Accountant Wesley R. Bricker noted in a December 2016 speech that "for at least the foreseeable future," financial reporting by U.S. issuers will continue to be based on U.S. GAAP, although he expressed an interest in continuing to consider whether to allow U.S. issuers to provide financial information based on IFRS as issued by the IASB as a supplement to their financial statements provided under U.S. GAAP. [91]

If a reconciliation of the financial statements to U.S. GAAP is required, the reconciliation must include an explanation of the principal differences between the accounting principles used and U.S. GAAP, a numerical reconciliation (except in limited circumstances in which a foreign issuer is permitted to elect Item 17 of Form 20-F [92]) of the differences in financial results and principal balance sheet items as reported under its accounting practices and under U.S. GAAP, and an explanation of the reasons for the differences. [93]

First-time foreign registrants are required to reconcile only the last two complete fiscal years of financial statements and the financial statements for any required interim periods. [94] For each subsequent reporting year, an additional year of reconciliation is required. Foreign companies are allowed to use a cash flow statement prepared in accordance with International Accounting Standard No. 7, Cash Flow Statements, as amended ("IAS 7"), without reconciliation to U.S. GAAP. [95]

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Foreign companies also are required to reconcile to U.S. GAAP selected financial data in their Securities Act and Exchange Act registration statements and Exchange Act annual reports, but only for those periods for which they are required to reconcile the primary annual financial statements and any interim financial statements included in those registration statements or reports. [96]

[2] Required Financial Statements Under Item 8 of Form 20-F and Stale Financial Statements

Under the Item 8 requirements of Form 20-F, financial statements contained or incorporated in a filing generally must include audited balance sheets as of the end of each of the three most recent fiscal years and audited statements of income and cash flows for each of the three most recent fiscal years. [97] Form 20-F generally requires that a registration statement of a foreign issuer (whether under the Exchange Act, for an initial listing, or under the Securities Act, for an offering of securities) include audited financial statements no more than 15 months old (and in the case of an initial public offering ("IPO"), 12 months old). [98] Issuers generally must also include in a filing five years of selected financial data. [99]

Accommodations from the audited financial statement and selected financial data requirements described above are available in certain limited circumstances. Foreign emerging growth companies ("EGCs") are permitted to

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provide only two years of audited financial statements, and only those two years (rather than five) of selected financial data in IPO registration statements. [100]

The SEC also permits first-time foreign issuer registrants that prepare their primary financial statements in accordance with U.S. GAAP to include financial statements for the two most recent fiscal years, rather than three years. Selected financial data for five fiscal years is still required, although SEC staff guidance permits one or more of the oldest three years to be presented in home country GAAP if U.S. GAAP financial data is not available for those years. [101]

Lastly, foreign issuers that adopt IFRS as issued by the IASB, in their first year after adoption, are permitted to file two years rather than three years of audited financial statements, with appropriate related disclosure. [102] In their second year of reporting under IFRS as issued by the IASB and thereafter, three years of audited financial statements must be provided. [103] This accommodation does not apply to issuers that transition to IFRS as issued by the IASB from a different IFRS accounting body. [104] Foreign private issuers relying on the

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first-time IFRS adopter exception need include only the two years of selected financial data and may omit the prior three years of selected financial data. [105]

As for interim financial statements, Item 8 of Form 20-F requires that if a registration statement becomes effective more than nine months after the end of the last audited fiscal year, it must contain interim financial statements covering at least the first six months of the following year. The interim financial statements may be unaudited, but they must include a U.S. GAAP reconciliation if they are presented in accordance with home-country GAAP other than IFRS as issued by the IASB. [106] Accordingly, the last effective date for a calendar-year issuer to avoid including interim financial statements is September 30.

As a result of these requirements, a foreign issuer can find itself "blacked out," *i.e.*, unable to have a registration statement become effective, beginning on April 1, for example, for an issuer reporting on a calendar fiscal year, if it is not yet prepared to provide audited financial statements for all or part of the previous year and to be blacked out beginning on October 1 if it is not yet prepared to provide financial statements, which may be unaudited, for an interim period. This is similar to the requirements applicable in most cases to a U.S. domestic issuer. [107] Furthermore, as noted above, if a foreign issuer is making its IPO (meaning that before the offering the foreign issuer is public in neither the United States nor its home country), the last audited financial statements must be no older than 12 months prior to the filing of the registration statement, although the instructions to Item 8 specify that the SEC will consider waiving this requirement in particular cases. [108] This is stricter than the requirements applicable to a U.S. issuer. [109]

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The principal difficulty with providing interim financial statements and thereby avoiding the "black-out" caused by financial statements that are outdated under the SEC's rules has been with preparing interim reconciliations to U.S. GAAP. As a result of the SEC's 2007 adoption of the amendments to eliminate U.S. GAAP reconciliation requirements for financial statements prepared under IFRS as issued by the IASB, issuers that no longer need to reconcile to U.S. GAAP should generally be able to avoid all or almost all of the obstacles that impede preparation of timely interim financial statements needed to satisfy SEC requirements. The acceleration of the 20-F annual report filing deadline to four months after the end of an issuer's fiscal year has also reduced the potential impact of these issues.

Finally, if a foreign issuer prepares and discloses to its shareholders or otherwise makes public interim financial information that is more current than the interim financial statement requirements described in this section, the registrant is required to include the more current interim financial information in its registration statement (but not in an annual report on Form 20-F). [110] This requirement covers any publication of financial information that includes, at a minimum, revenue and income information. Unless the foreign issuer prepares its financial statements in accordance with IFRS as issued by the IASB, this information must be accompanied by: (i) a description of any ways in which the accounting principles, practices and methods used in preparing the interim financial information vary materially from the principles, practices and methods accepted in the United States, and (ii) a quantification of any material variations, unless they are already quantified because they appear elsewhere in other financial statements included in the registration statement. [111]

For certain continuous offerings in which the effects of a "black-out" period as described above could be especially adverse, there is an instruction

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extending the periods from 15 months to 18 months for audited financial statements and from 9 months to 12 months for interim financial statements. [112] The offerings covered are (i) rights offerings, (ii) offerings pursuant to dividend or interest reinvestment plans and (iii) offerings pursuant to convertible securities or warrants issued by the issuer or an affiliate. The extension beyond 16 months for audited financial statements is no longer meaningful in light of the accelerated Form 20-F annual report deadline.

[3] Segment Information

Both U.S. and foreign issuers are required to include in their financial statements segment financial information. For issuers reporting under, or reconciling to, U.S. GAAP, the accounting standards on this topic are set forth in Accounting Standards Codification 280, Segment Reporting ("ASC 280") (formerly Statement of Financial Accounting Standards ("SFAS") No. 131). [113] For foreign issuers following IFRS as issued by the IASB, IFRS 8 applies.

A reportable operating segment is defined as (i) a component of a business enterprise the operating results of which are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, (ii) for which discrete financial information is available and (iii) that accounts for (a) 10% or more of the combined revenue of the enterprise (including both sales to external customers and inter-segment sales), (b) 10% or more of the operating profit or loss of all of the enterprise's operating segments or (c) 10% or more of the combined assets of all of the enterprise's operating segments. The definition under IFRS as issued by the IASB is substantially consistent. [114] For each reportable segment there must be provided a measure of segment profit or loss, certain specific revenue and expense items and segment assets. The following are the specific revenue and expense items that must be disclosed for each reportable segment if management includes them in measuring profit or loss: revenues from external customers; revenues from other operating segments; depreciation, depletion and amortization; and significant noncash items other than depreciation, depletion and amortization. [115]

[4] Currency in Which Financial Statements Are Reported

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Special rules applicable to foreign issuers govern the currency in which their financial statements must be presented. [116] Rule 3-20 of Regulation S-K permits a foreign issuer to state the amounts in its primary financial statements using any currency that it deems appropriate. [117] The reporting currency must be prominently disclosed on the face of the financial statements. [118] The rule requires specific disclosure in the financial statements if the currency in which the company expects to declare dividends is different from the reporting currency or there are material exchange restrictions or controls affecting the reporting currency, the currency of the issuer's domicile or the currency in which dividends are paid. [119]

[5] Required Financial Statements of Other Entities Under Regulation S-K

[a] Financial Statements Relating to Acquired Businesses

A registrant may be required to include in a Securities Act registration statement certain audited financial statements in connection with any "significant" business acquisition by the registrant. [120] The "significance" of an acquired business is evaluated based on (i) the amount of the registrant's investment in the acquired business, (ii) the total assets of the acquired business and (iii) the pre-tax income of the acquired business. Each of these is compared with the comparable item in the registrant's most recent audited financial statements. [121] In the case of an acquisition consummated within the preceding 75-day period or whose acquisition is probable at the time the final prospectus or prospectus supplement relating to the offering is completed, financial statements will be required only if the acquired business is "significant" at a 50% level—that is, if the issuer's investment in, or the assets or pre-tax income of, the acquired

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business equals at least 50% of the registrant's assets or income. [122] Beyond the 75-day period, the registrant must include one, two or three years of financial statements for an acquired business at 20%, 40% and 50% significance levels, respectively, and financial statements for any interim periods required under Rules 3-01 and 3-02 of Regulation S-K. [123] In addition, *pro forma* financial information is required by Article 11 of Regulation S-K to depict the effect of a business acquisition if the financial statements of the acquired business are required to be furnished under these standards. [124]

For purposes of applying the rules described above, the acquisition of "related businesses" (those under common ownership or management or whose acquisitions are conditional on each other or on a single common condition) are treated as a single business combination. [125] In addition, if the registrant has, since the date of its latest audited balance sheet, acquired businesses which, although unrelated and individually insignificant, are significant in the aggregate

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at a level exceeding 50%, one year of audited financial statements covering the substantial majority of such businesses must be included in the registration statement. [126]

[b] Financial Statements of Certain Unconsolidated Subsidiaries and Equity-

Method Investees

A registrant is required to file separate financial statements of any "significant" majority-owned subsidiary that is not consolidated with the registrant. [127] The "significance" of an unconsolidated subsidiary is evaluated based on (i) the amount of the registrant's investment in the subsidiary, (ii) the total assets of the subsidiary and (iii) the pre-tax income of the subsidiary. If any of these items exceeds a 20% significance level when compared with the comparable item in the registrant's most recent audited financial statements, the registrant must file separate financial statements of the subsidiary. [128]

Similarly, a registrant must file separate financial statements of any "significant" 50%-or-less owned investee that is accounted for by the equity method. [129] An investee will be deemed "significant" if either the first or third condition of the test above is met at the 20% significance level. [130]

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Where practicable, the financial statements of the subsidiary or investee required by these rules must be as of the same dates and for the same periods as the audited financial statements of the registrant. [131] However, the separate financial statements need only be audited for those fiscal years in which the relevant 20% significance test was met.

Where financial statements of two or more unconsolidated subsidiaries or two or more 50%-or-less owned investees are required, combined or consolidated financial statements of such persons may be included, subject to principles of inclusion or exclusion that clearly exhibit the financial position, cash flows and results of operations of the combined or consolidated group. [132]

[c] Financial Statements of Guarantors and Issuers of Guaranteed Securities

A Securities Act registration statement for an offering of guaranteed debt securities generally must include audited financial statements of both the issuer and the guarantor of the securities. [133] Rule 3-10 of Regulation S-K provides certain exceptions to this general rule where (i) the issuer is a parent company issuing securities guaranteed by one or more wholly owned subsidiaries, (ii) the issuer is a wholly owned subsidiary issuing securities guaranteed by its parent, or (iii) the issuer is a wholly owned subsidiary issuing securities guaranteed by its parent and one or more other wholly owned subsidiaries. [134] The exceptions allow the inclusion of condensed consolidating financial information in lieu of separate financial statements of a subsidiary issuer or subsidiary guarantor and, in certain cases, allow the omission altogether of separate financial information with respect to the relevant subsidiary.

The threshold requirements for each of the exceptions in Rule 3-10 [135] are that (i) the subsidiary issuer or subsidiary guarantor must be 100%-owned by its parent company (*i.e.*, all of its outstanding voting shares are owned, either

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directly or indirectly, by its parent company) [136] and (ii) the guarantee or guarantees must be full and unconditional. [137] Where these requirements are satisfied, the following exceptions are applicable.

Where the issuer is a finance subsidiary [138] issuing securities guaranteed only by its parent company, separate financial statements of the finance subsidiary are not required if the parent company's financial statements are filed and include a footnote stating that the issuer is a 100%-owned finance subsidiary and the parent company has fully and unconditionally guaranteed the securities. [139]

Where the issuer is an operating subsidiary [140] issuing securities guaranteed only by its parent company, separate financial statements of the operating subsidiary are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company and the subsidiary issuer. [141] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the guarantee is full and

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unconditional and any assets of subsidiaries other than the subsidiary issuer are minor. [142]

Where the issuer is a subsidiary issuing securities guaranteed, jointly and severally, by its parent company and one or more other subsidiaries of its parent company, separate financial statements of the subsidiaries are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company, the subsidiary issuer and the subsidiary guarantors. [143] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the subsidiary issuer is a 100%-owned finance company, the parent company and all of the parent company's other subsidiaries have guaranteed the securities jointly and severally and all of the guarantees are full and unconditional. [144]

Where the issuer is a parent company issuing securities guaranteed by a single subsidiary guarantor, separate financial statements of the subsidiary guarantor are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company and the subsidiary guarantor. [145] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the guarantee is full and unconditional and any subsidiaries other than the subsidiary guarantor are minor. [146]

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Where the issuer is a parent company issuing securities guaranteed, jointly and severally, by multiple subsidiary guarantors, separate financial statements of the subsidiary guarantors are not required if the parent company's financial statements are filed and include, in a footnote, condensed consolidating information for the parent company and the subsidiary guarantors. [147] Condensed consolidating information may be omitted if the financial statements include a footnote stating that the parent company has no independent assets or operations, the guarantees are full and unconditional and joint and several and any subsidiaries other than the subsidiary guarantors are minor. [148]

The SEC has adopted a special rule for recently acquired subsidiary issuers or subsidiary guarantors that would otherwise meet the conditions for omission of separate financial statements pursuant to one of the exceptions described above. [149] Where such a subsidiary (i) has not been included in the audited consolidated results of its parent company for at least nine months of the most recent fiscal year and (ii) has a net book value [150] or purchase price, whichever is greater, of 20% or more of the principal amount of the securities being registered, then separate audited financial statements of the subsidiary must be filed for the subsidiary's most recent fiscal year preceding the acquisition. In addition, unaudited interim financial statements must be filed for any interim period specified by Rules 3-01 and 3-02 of Regulation S-K.

In connection with the amendments to Rule 3-10 described above, the SEC has exempted from Exchange Act reporting requirements subsidiary issuers or subsidiary guarantors that (i) are permitted to omit separate financial statements by Rule 3-10 of Regulation S-K or (ii) would be permitted to omit financial statements under Rule 3-10 but are required to file pre-acquisition financial statements under Rule 3-10(g). [151]

[d] Financial Statements of Affiliates Whose Securities Collateralize Registered Securities and Financial Statements of Other Persons Where Material to an Investment Decision

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A registrant is required to file separate financial statements of any affiliate whose securities constitute a "substantial portion" of the collateral for any securities being registered. [152] For purposes of this rule, securities of an affiliate constitute a "substantial portion" of collateral if the aggregate principal amount, par value, book value or market value of such securities, whichever is greater, is equivalent to 20% or more of the principal amount of the secured class of securities. [153]

In addition, the SEC may require the inclusion of financial statements of other persons in any case where they are "necessary or appropriate for an adequate presentation of the financial condition of any person whose financial statements are required." [154] Regulation AB provides a special registration and disclosure regime for asset-backed securities, including disclosure requirements for assets meeting 10% and 20% concentration levels. [155]

The SEC also has required parent bank financial statements, prepared in accordance with IFRS as issued by the IASB or in accordance with or reconciled to U.S. GAAP, to be included in registration statements for offerings by special purpose subsidiaries of the bank intended to strengthen the bank's capital (and therefore not guaranteed by the bank) where payments on the securities depend exclusively on the income generated from assets acquired from the bank with the proceeds of the offering and bank regulators may require the bank to "claw back" those assets if certain financial regulatory events occur with respect to the bank. [156]

Under certain circumstances, the credit of a third party is so significant that the SEC has required the third party to become a co-registrant with the issuer and therefore to provide the complete business and financial information required by the applicable registration form. For example, where an issuer's business (typically a special purpose issuer) consists principally of purchasing securities from a third party (or affiliated third parties) with the proceeds from the sale of the securities to be registered under the Securities Act, the issuer will be deemed to

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be an underwriter of the securities of the third party, which in turn would be required to become a co-registrant with the issuer. [157]

[6] Accounting Topics

[a] Convenience Translations and Historical Exchange Rates

Financial statements in registration statements may include "convenience" translations of the issuer's home currency to U.S. dollars for the most recent fiscal year and any subsequent interim period, using for this purpose an exchange rate as of the date of the most recent balance sheet included in the filing or, if materially different, as of the most recent practicable date. [158] The filing must include the historical exchange rates between the financial reporting currency and U.S. dollars, including (i) the exchange rate at the latest practicable date, (ii) the high and low exchange rates during the previous six months and (iii) the average exchange rates for each of the five most recent fiscal years and any subsequent interim period. [159] If the filing relates to equity securities, it must also contain a five-year history of dividends declared per share in both the financial

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reporting currency and U.S. dollars (based on exchange rates in effect on the payment dates). [160]

[b] Accounting for Inflation Under Rule 3-20 of Regulation S-K

If the financial statements of a foreign company (i) are denominated in a currency of a country that has experienced cumulative inflationary effects exceeding 100% over the most recent three-year period and (ii) have not been recast or otherwise supplemented to include information on a historical cost/constant currency or current cost basis prescribed or permitted by generally accepted accounting principles, the issuer must present supplementary information to quantify the effects of changing prices upon its financial condition and results of operations. [161]

[c] Accounting for Operations in a Hyperinflationary Environment

Under U.S. GAAP, financial results of operations conducted in the currency of a country with a hyperinflationary environment must be measured in the issuer's reporting currency. [162] By contrast, most other accounting principles permit measurement in the local currency restated to reflect changing prices; that measurement is then translated into the reporting currency.

A "hyperinflationary environment" is defined as one that had cumulative inflation of approximately 100% or more over the most recent three-year period. [163] Under Items 17 and 18 of Form 20-F, the SEC does not require that an issuer in a hyperinflationary environment include a reconciliation that quantifies the effects on its financial statements under U.S. GAAP that result from its use of the restate-translate method so long as the methodology used is consistently applied and is in conformity with International Accounting Standard No. 21, The Effects of Changes in Foreign Exchange Rates, as amended in 1993 ("IAS 21"), using the historical cost/constant currency method. IAS 21 requires restatement of measurements in local currency to account for changing prices in accordance with International Accounting Standard No. 29, Financial Reporting in Hyperinflationary Economies, as amended in 2008, and then translation of such adjusted measurements to the reporting currency.

[d] Revenue Recognition

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SEC Staff Accounting Bulletin No. 104—Revenue Recognition ("SAB 104") (updating SEC Staff Accounting Bulletin No. 101—Revenue Recognition in Financial Statements ("SAB 101")) provides specific guidelines on revenue recognition, presentation and disclosure that registrants should follow in preparing their financial statements. [164] In SAB 104, the SEC staff indicated that "revenue should not be recognized until it is realized or realizable and earned." According to SAB 104, revenue generally is realized or realizable and earned when all of the following criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the seller's price to the buyer is fixed or determinable, and (iv) collection is reasonably assured. [165]

The specific guidelines provided in SAB 104 are aimed at limiting the discretion companies have in deciding when to recognize and report revenue in their financial statements. [166] SAB 101 was initially adopted in large part due to the SEC staff's concern that companies were prematurely and improperly recognizing revenue in an attempt to improve earnings reported in financial statements. [167] SAB 104 is one of three staff accounting bulletins aimed at addressing earnings management problems. [168]

Revenue recognition has also been an important area of focus in the IFRS and U.S. GAAP convergence efforts. The objective of the FASB and IASB revenue recognition joint project was to develop a common revenue standard for both U.S. GAAP and IFRS. On May 28, 2014, the IASB and FASB jointly issued a converged standard on the recognition of revenue from contracts with

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customers. [169] Although the general principles of revenue recognition were similar between IFRS and U.S. GAAP, the previous U.S. accounting standards contained significant detailed industry-specific requirements that previous IFRS standards did not have. [170] The new converged standard eliminates the industry-specific requirements under U.S. GAAP. In a joint press release, the IASB and FASB noted that the new converged standard will provide "substantial enhancements to the quality and consistency of how revenue is reported while also improving comparability in the financial statements of companies reporting using IFRS and U.S. GAAP." [171] As the new revenue recognition standard becomes effective for public companies, issuers should expect continued SEC scrutiny of their revenue recognition accounting and related disclosure. [172]

[e] Lease Accounting

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In 2016, both the IASB and the FASB issued new lease accounting standards to align lessor accounting with certain changes in the lessee model and the new revenue recognition standard. [173] In January 2016, the IASB issued IFRS 16, Leases, and in February 2016, the FASB issued Accounting Standards Update No. 2016-02, Leases ("ASU 2016-02"). Both standards require entities to reflect practically all leases on their balance sheet, but there are some differences. The IASB requires companies to present all leases (other than short-term leases or "small ticket" leases) in a way that is similar to prior accounting for financing leases, such that more of the lessee's expenses would be reflected up front. The FASB instead retained a dual model, including financing leases, similar to the prior standard's capital leases, and operating leases, with expenses recognized on a straight-line basis. Lessees will need to classify their leases under the FASB approach based on guidance similar to the classification model under current U.S. GAAP. [174]

ASU 2016-02 will become effective for public companies, certain not-for-profits and benefit plans for interim and annual reporting periods beginning after December 15, 2018. [175] IFRS 16 will become effective for annual reporting periods beginning on or after January 1, 2019. [176]

[f] Cheap Stock

Common stock or options or warrants relating to such stock are often issued as compensation for services or otherwise. Issuances of such securities proximate to a company's IPO may raise questions as to whether the securities were issued at a price below their fair value. If the securities were issued at a price below their fair value, the SEC staff will require the issuer to charge the difference between fair value and issuance price to its income statement under compensation expense and include the shares issued or, in the case of options or warrants, assumable in calculating earnings per share. The SEC staff has long focused, and has continued to focus, on this issue. A number of factors will be relevant in considering whether a company has such a "cheap stock" problem, perhaps the most important of which are the amount of time between the issuance and the company's IPO and the extent of the difference between the issuance price and the IPO price of the company's common stock. Issuances within one year prior to the IPO are presumed to raise this question. Historical financial

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statements prepared without recognition of this additional compensation expense and increase in outstanding shares will need to be revised if the SEC staff concludes that there is a "cheap stock" problem, possibly delaying the offering process and, in any event, reducing the company's operating and net income (or increasing its operating or net loss) and reducing earnings per share. Also, if vested stock were purchased for less than fair market value, the discount would be taxable income to the employee under U.S. tax law.

[g] Loss Contingencies

Under U.S. GAAP, Accounting Standards Codification 450, Contingencies ("ASC 450") (formerly SFAS No. 5) requires disclosure of contingent liabilities arising out of litigation, arbitration or regulatory actions if there is a "reasonable possibility" of a material loss with respect to such contingency. An accrual of an estimated loss is required if it is both "probable" that a material liability will be incurred and the amount of loss can be "reasonably estimated." [177] The required disclosures include a description of the nature of the loss contingency, an estimate of the loss or range of loss if reasonably estimable, and a statement that an estimate of the loss cannot be made if it is not reasonably estimable.

Under IFRS as issued by the IASB, International Accounting Standards, Provisions, Contingent Liabilities and Contingent Assets ("IAS 37") requires disclosure of contingent liabilities arising out of litigation, arbitration or regulatory actions if the obligation is possible and the likelihood of an outflow of resources is more than remote. [178] Like ASC 450, accrual is required under IAS 37 when payment is "probable" and a "reliable estimate can be made of the amount of the obligation," [179] but the definitions of probable differ. IAS 37 defines probable as "more likely than not to occur," [180] whereas, ASC 450 defines probable as "likely to occur." [181] Given that "likely" under U.S. GAAP is generally considered a higher threshold (*i.e.*, approximately 80%) than "more likely than not" under IFRS, which is typically considered to represent a greater than 50% probability, accrual of contingent liabilities is more likely under IAS 37. [182]

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The SEC staff remains focused on the adequate disclosure and accrual of loss contingencies and the Division of Corporation Finance has been issuing comment letters to both U.S. and foreign issuers seeking adequate disclosure of estimates of reasonably possible losses or ranges of reasonably possible losses under current ASC 450 or International Accounting Standard No. 37, Provisions, Contingent Liabilities and Contingent Assets, respectively. [183]

Footnotes

84 In response to § 108 of the Sarbanes-Oxley Act, which requires the SEC to recognize accounting principles established by a standard setting body as "generally accepted" accounting principles, the SEC designated the U.S. Financial Accounting Standards Board (the "FASB") as a standard setting body and confirmed that the FASB's financial accounting and reporting standards are "generally accepted" for purposes of the U.S. federal securities laws. *See* SEC Release No. 33-8879 (Dec. 21, 2007). The Sarbanes-Oxley Act requires the standard setting body to be organized as a private entity and to have a board of trustees, the majority of whom are not and have not been associated persons at a registered public accounting firm during the prior two years. It also requires the standard setting body to adopt procedures to ensure prompt consideration of necessary changes to accounting principles by a majority vote and to consider the need to keep standards current. *See* SEC Release No. 33-8221 (Apr. 25, 2003).

85 In reviewing the financial statements of registrants, the SEC staff will comment not only on the adequacy of U.S. GAAP reconciliation matters, but also on whether it believes that home-country principles or IFRS have been applied correctly. *See* Lynn E. Turner, Chief Accountant, SEC, Office of the Chief Accountant, Financial Reporting Issues Critical to European SEC Registrants/Users of U.S. GAAP (Apr. 8, 1999).

86 SEC Release No. 33-8879 (Dec. 21, 2007). This decision followed several years of coordinated efforts by the SEC and the FASB with the International Accounting Standards Committee (the "IASC") and its successor, the IASB, including through the International Organization of Securities Commissions (IOSCO), to develop a core set of international accounting standards for cross-border capital raising and listing purposes in all global markets. In 2000, the SEC issued a concept release, International Accounting Standards, SEC Release No. 33-7801 (Feb. 16, 2000), that sought, *inter alia*, to identify the important issues that would be raised by an acceptance of the IASC "core standards" program. The SEC expressed support for the core standards project, but indicated that there were three key elements that must be present if financial statements prepared under such standards were to be accepted in Securities Act registration statements without U.S. GAAP reconciliation: (i) they must include a core set of accounting pronouncements that constitutes a comprehensive, generally accepted basis of accounting, (ii) they must be of a high quality, resulting in comparability and transparency, and they must provide for "full disclosure," and (iii) they must be rigorously interpreted and applied. These elements have continued to be relevant to the SEC in its consideration of IFRS. Subsequently, in 2002 the IASB and the FASB agreed to a Memorandum of Understanding on convergence between their respective accounting standards and thereafter published a roadmap for developing common accounting standards and developed plans and milestone targets for completing the major Memorandum of Understanding projects in 2011. FASB and IASB Reaffirm Commitment to Memorandum of Understanding—A Joint Statement of the FASB and IASB (Nov. 5, 2009). On May 28, 2014, the IASB and FASB issued a converged standard of revenue recognition. *See* § 4.05[8][d]; *see also* News Release, IASB and FASB, IASB and FASB Seek to Reduce Differences in Classification and Measurement Models for Financial Instruments (Jan. 27, 2012).

87 EU companies listed on a regulated market have been required since 2005 to prepare their consolidated accounts in accordance with IFRS. As of December 2007 when the rules were adopted, the only difference

between IFRS as issued by the IASB and IFRS as adopted by the EU relates to International Accounting Standard No. 39, Financial Instruments: Recognition and Measurement ("IAS 39"), whereby IFRS as adopted by the EU offers greater flexibility with respect to hedge accounting for certain financial instruments than does IFRS as issued by the IASB. As a practical matter, this difference applies only to foreign financial institutions, and the vast majority of EU issuers listed in the United States do not make use of this carve-out available under the EU-endorsed IFRS. There are concerns, however, that EU issuers may not be able to establish compliance in the future if the timing of the EU's endorsement of new standards, or an EU decision not to endorse a standard, were to create differences between EU IFRS and IFRS as issued by the IASB such that compliance with EU IFRS necessarily precluded compliance with IFRS as issued by the IASB. *See* SEC Release No. 33-8879 (Dec. 21, 2007), 73 Fed. Reg. 986, 993 n.75 (Jan. 4, 2008). IAS 39 will be superseded by IFRS 9, Financial Instruments. IFRS 9 includes requirements for recognition and measurement, derecognition and hedge accounting. The final version of IFRS 9 was issued on July 24, 2014. The IASB has assigned a mandatory effective date of January 1, 2018, but the EU has not yet assigned a mandatory effective date.

The SEC made available temporary transition relief to European issuers that had already utilized the IAS 39 carve-out in financial statements previously filed with the SEC. These issuers were permitted to file financial statements for their first two fiscal years that ended after November 15, 2007 without U.S. GAAP reconciliation if their financial statements otherwise complied with IFRS as issued by the IASB and an audited reconciliation to IFRS as issued by the IASB was provided. European issuers were required to include reconciliations to U.S. GAAP or otherwise comply with the requirements in Item 18(a) for fiscal years after the transition period. *See* Form 20-F, Instructions to Item 18; *see also* SEC Release No. 33-8879 (Dec. 21, 2007).

88 In 2008, following issuance of a concept release seeking input as to whether U.S. issuers should be permitted to elect to prepare their financial statements in accordance with IFRS, the SEC proposed a roadmap for the potential use of financial statements prepared in accordance with IFRS as issued by the IASB by U.S. issuers for purposes of their filings with the SEC. *See* SEC Release Nos. 33-8831 (Aug. 7, 2007) and 33-8982 (Nov. 14, 2008). In February 2010, the SEC directed its staff to develop and execute a work plan related to the proposed roadmap and in May 2011, the SEC's Office of the Chief Accountant published a staff paper outlining a possible approach for incorporation of IFRS into the U.S. financial reporting system. On July 13, 2012, the SEC's Office of the Chief Accountant published its Final Staff Report on the work plan (the "Final Staff Report"), which included no decision or time frame regarding whether to allow U.S. companies to present financial statements according to IFRS. *See* SEC, Office of the Chief Accountant, Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers: Exploring a Possible Method of Incorporation (May 26, 2011); Final Staff Report (July 13, 2012). The Final Staff Report summarized the staff's key findings regarding the potential incorporation of IFRS into U.S. financial reporting, but did not make any recommendation to the SEC. The issues discussed in the report included the diversity in how accounting standards are interpreted and applied in various jurisdictions, the potential cost to U.S. issuers of adopting IFRS, investor education and governance.

89 James Schnurr, Chief Accountant (2014-2016), SEC, Remarks before the 2015 Baruch College Financial Reporting Conference (May 7, 2015).

90 James Schnurr, Chief Accountant (2014-2016), SEC, Remarks Before the 2015 AICPA National Conference on Current SEC and PCAOB Developments (Dec. 9, 2015).

91 Wesley R. Bricker, Chief Accountant, SEC, Keynote Address before the 2016 AICPA Conference on Current SEC and PCAOB Developments (Dec. 5, 2016).

92 *See* Notes 41, 124, 131.

93 Form 20-F, Item 18 (Item 18 requires disclosure of all information in Item 17 as well as certain additional information. *See* Item 17(c) for a description of the information referenced here).

94 SEC, Division of Corporation Finance, FINANCIAL REPORTING MANUAL, Topic 6410.2. If a foreign registrant's

financial statements are prepared in accordance with U.S. GAAP, audited statements of income and cash flows need only be provided for the last two complete fiscal years and not for the last three complete fiscal years required if the financial statements were prepared in accordance with home-country (or IFRS) accounting principles.

95 Form 20-F, Item 17(c)(2)(iii). Although there are differences between a cash flow statement prepared in accordance with IAS No. 7 and one prepared in accordance with U.S. GAAP, the SEC concluded that most of the differences involve classification and are readily apparent, and that the remaining differences should not significantly detract from an investor's understanding of the company's cash flows. Two other International Accounting Standards have been adopted by the SEC: (i) portions of International Accounting Standard No. 22, Business Combinations (as amended in 1993) (superseded by IFRS 3, *Business Combinations*, as amended by Annual Improvements to IFRSs 2010-2012 Cycle, which became effective on July 1, 2014), regarding the method of accounting for a business combination and the determination of the amortization period for goodwill and negative goodwill, and (ii) portions of International Accounting Standard No. 21, The Effects of Changes in Foreign Exchange Rates (as amended in 1993), regarding translation of amounts stated in a currency of an entity in a hyperinflationary economy.

96 *See* Form 20-F, Instruction 2 to Item 3.A.

97 A balance sheet as of the end of the earliest of the three years is not required, however, if that balance sheet is not required by a jurisdiction outside the United States. Form 20-F, Instruction 1 to Item 8.A.2.

98 Form 20-F, Item 8.A.4. In 2001, the SEC issued a release adopting a technical amendment to Item 8.A.4 of Form 20-F clarifying that the last audited financial statements must be annual financial statements and that an issuer cannot satisfy this requirement by filing interim audited financial statements. The amendment deletes language in Instruction 1 of Item 8.A.4 that incorrectly implied that audited financials for a period of less than a full year could be used to satisfy the 15-month rule. *See* SEC Release No. 34-44406 (June 11, 2001).

99 *See* Form 20-F, Item 3.A. Issuers may present the five years of selected financial data (or fewer than five years if an accommodation is available) required in the registration statement on the basis of their home-country GAAP rather than five years of U.S. GAAP selected financial data. *See* Form 20-F, Instruction 2 to Item 3.A. However, if the issuer uses a basis of accounting other than IFRS as issued by the IASB, it must include a reconciliation of the selected financial data to U.S. GAAP for (i) those periods for which the issuer is required to reconcile the primary annual financial statements in a filing under the Securities Act or the Exchange Act, and (ii) any interim periods. *See* Form 20-F, Instruction 2 to Item 3.A. The SEC will entertain a waiver for the earliest two years of the five-year period if an issuer is unable to provide such selected financial data. An issuer seeking a waiver must submit a required representation to the SEC before or at the time the form omitting such information is filed and disclose in the document that data for the earliest two years have been omitted and explain the reasons for the omission. Form 20-F, Instruction 2 to Item 3.A.

100 Similarly, the JOBS Act permits an EGC to cover only two years of financial information in the MD&A section of its IPO registration statement. *See* Chapter 3 for discussion of the JOBS Act, pursuant to which this accommodation was adopted, and other accommodations available to EGCs. However, underwriters may sometimes advise EGCs not to take advantage of certain aspects of the further disclosure relief given the potential usefulness of the additional financial information and data for marketing purposes. The JOBS Act's provisions modifying the selected financial data and MD&A disclosure requirements do not on their face apply directly to a foreign private issuer using Form 20-F or the Securities Act forms that refer to Form 20-F for their content; however, the SEC has indicated that a foreign private issuer that qualifies as an EGC may comply with the scaled disclosure provisions available to EGCs to the extent relevant to the form requirements for foreign private issuers. SEC, Division of Corporation Finance, Generally Applicable Questions on Title I of the JOBS Act (Sept. 28, 2012, May 3, 2012 and Apr. 16, 2012) ("SEC EGC FAQs") 8.

101 Form 20-F, Instruction 3 to Item 8.A.2; *see also* SEC Release No. 33-8567 (Apr. 12, 2005); *supra* Note 94 and accompanying text. *See also* SEC, Division of Corporation Finance, FINANCIAL REPORTING MANUAL,

Topic 6410.2(c).

102 *See* Form 20-F, General Instruction G. First-time adopters of IFRS must present (i) the note required by IFRS 1, First-Time Adoption of International Financial Reporting Standards, containing a reconciliation from the company's previous GAAP to IFRS, in a form and content sufficient to explain all material adjustments to the balance sheet and income statement and, if presented under the company's previous GAAP, the cash flow statement and (ii) to the extent the primary financial statements reflect the use of exceptions permitted or required by IFRS 1, identification of each exception used, including an indication of the items or class of items to which the exception was applied and a description of what accounting principle was used and how it was applied.

Management should not include in the MD&A any discussion relating to financial statements prepared in accordance with the company's previous GAAP unless the company has elected to include or incorporate by reference such previous GAAP financial information as permitted by the SEC's rules. Form 20-F, General Instruction G.

103 *See* SEC Release No. 33-8567 (Apr. 12, 2005); SEC Release No. 33-8879 (Dec. 21, 2007).

104 *See* SEC Release No. 33-8879 (Dec. 21, 2007) ("We believe that an issuer may rely on the provisions of General Instruction G if and only if that issuer has not previously stated its reliance on IFRS 1. Further, an issuer may only rely on the provisions of General Instruction G once.")

105 *See* Center for Audit Quality International Practices Task Force, Highlights (Nov. 24, 2009), at 11, https://www.iasplus.com/en/binary/usa/caq/0911caqinternational.pdf.

106 Form 20-F, Item 8.A.5. In a meeting with the AICPA SEC Regulations Committee's International Practices Task Force, the SEC staff has noted that when financial statements are updated in order to comply with the age of financial statements requirements set forth in Item 8 of Form 20-F, an issuer must also update other "financial" information, including MD&A, Quantitative and Qualitative Disclosure of Market Risk, financial statements required under Rule 3-10 of Regulation S-K and Selected Financial Data. *See* AICPA, SEC Regulations Committee's International Practices Task Force, Highlights, Item 2 (Mar. 9, 2004).

107 U.S. registrants generally are "blacked-out" earlier than foreign issuers, except in the case of IPOs, in which case the foreign issuer requirements are stricter, as described below.

108 To obtain such a waiver, the issuer must be able to represent adequately to the SEC that it is not required to comply with the 12-month requirement in any other jurisdiction outside the United States and that compliance is impracticable or involves undue hardship. The representation must be filed as an exhibit to the registration statement. If the SEC waives the 12-month requirement, the company must comply with the 15-month requirement instead. *See* Form 20-F, Instruction 2 to Item 8.A.4.

109 U.S. registrants must include audited financial statements no older than one year and 45 days at the date the registration statement becomes effective for registration statements filed under the Securities Act or filed on Form 10. *See* Rule 3-12 of Regulation S-K.

110 Form 20-F, Item 8.A.5.

111 If the published financial information is reconciled to U.S. GAAP, the SEC will generally require comparative prior period information to be included in the registration statement (even if the issuer provides the U.S. GAAP reconciliation voluntarily). Notably, if a foreign issuer prepares primary financial statements in accordance with U.S. GAAP and releases information in its local market based on local GAAP, the SEC will require such issuer to reconcile such information to U.S. GAAP unless the issuer provides a reverse reconciliation (from U.S. GAAP to local GAAP) for at least the most recent fiscal year. The SEC has noted that once a foreign issuer reconciles published financial information to U.S. GAAP, an MD&A is required with respect to both the current and comparative periods as well as, to the extent applicable, *pro forma* financial statements pursuant to Rule 11-02 of Regulation S-K. *See* SEC, Division of Corporation Finance, International Reporting and Disclosure Issues, Part III(C) (Nov. 1, 2004). Companies preparing their financial statements in accordance with IFRS as issued by the IASB need not provide either descriptive or quantified U.S. GAAP reconciling information under Item 8.A.5 of Form 20-F. *See* Form 20-F, Instructions to Item 8.A.5; *see also* SEC Release No. 33-8879 (Dec. 21, 2007); *supra* Note 86 and accompanying text.

112 *See* Form 20-F, Instruction 2 to Item 8.

113 *See infra* § 4.09, Note 492 and accompanying text for a discussion of non-GAAP financial measures and presentation of segment information.

114 *See* PwC, A PRACTICAL GUIDE TO SEGMENT REPORTING 5, 9 (Sept. 2008).

115 *See* ASC 280. If an issuer changes its segments after a given year end but before filing its annual report on Form 10-K or Form 20-F with respect to such year, the Form 10-K or Form 20-F segment disclosures should be based on the segments in place at the year end. However, if after changing segments the issuer were to conduct a registered offering, it would be required to include in the registration statement for the offering (or file on a Form 8-K, in the case of a U.S. issuer, or Form 6-K, in the case of a foreign issuer, and incorporate by reference) annual audited financial statements with a revised segment footnote to reflect the new reportable segments, together with business and MD&A disclosure reflecting the change (but no prior SEC filings would need to be amended).

116 Rule 3-20 of Regulation S-K.

117 Rule 3-20(a) of Regulation S-K. Rule 3-20 also provides that changes in reporting currency require the financial statements of periods prior to the change to be recast comprehensively as if the new reporting currency had been used. Rule 3-20(e) of Regulation S-K. The decision to make such a change and the reason for the change must be disclosed in a note to the financial statements. *See* § 4.05[8][c] for a discussion of the requirements relevant in hyperinflationary environments.

118 Rule 3-20(b) of Regulation S-K.

119 Rule 3-20(b) of Regulation S-K.

120 Rule 3-05 of Regulation S-K.

121 Rule 1-02(w) of Regulation S-K.

122 Rule 3-05(b)(2)(iv) and Rule 3-05(b)(4)(i) of Regulation S-K. If an issuer, other than a foreign issuer permitted to furnish reports on Form 6-K, omits the financial statements of an acquired business from the prospectus or prospectus supplement because the "significance" of the acquired business is less than 50%, the omitted financial statements and any *pro forma* financial information required by Article 11 of Regulation S-K must be furnished under cover of Form 8-K no later than 75 days after the consummation of the acquisition. Rule 3-05(b)(4)(ii) of Regulation S-K. *See also* Form 8-K, Item 9.01(a).

123 Rule 3-05(b)(2) of Regulation S-K. The annual financial statements must be audited in accordance with U.S. auditing standards. The financial statements must be presented in accordance with U.S. GAAP or, when the acquired business is a foreign private issuer, reconciled to U.S. GAAP. The financial statements of an acquired business need not, however, contain a reconciliation to U.S. GAAP if those financial statements are prepared using IFRS as issued by the IASB or if the business does not exceed the 30% significance level. *See* Form 20-F, Item 17(c)(2)(v); § 4.05[1].

124 *Pro forma* financial information may be required by Article 11 in connection with certain transactions other than acquisitions or business combinations, even if separate financial statements are not required under Rule 3-05. *See* Rule 11-01(a) of Regulation S-K.

The financial statement requirements of Rule 3-05 and the *pro forma* requirements of Article 11 of Regulation S-K do not apply to annual reports on Form 20-F or Form 10-K under the Exchange Act. *See* Form 20-F, Items 17(a) and 18; Form 10-K, Item 8. Both requirements do, however, apply to Securities Act registration statements and to Exchange Act registration statements, such as registration statements on Form 20-F, when being used to register securities under the Exchange Act in connection with a listing that does not involve a public offering. *See* Form F-1, Items 4 and 4A(b); Form F-3, Item 5(b); Form 20-F, Items 17(a) and 18; Form 10, Item 13.

In 2005, the SEC adopted rules that, subject to certain exceptions in the context of business combinations and change-of-domicile transactions, require the filing of a report on Form 20-F by an Exchange Act-reporting foreign issuer shell company in connection with entering into a transaction that causes it to cease being a shell company. The report is required to be filed within four business days of the completion of the transaction and must contain the same information (including financial information) that would be required in a registration statement on Form 20-F covering all classes of the registrant's securities that are subject to Exchange Act reporting obligations. *See* SEC Release No. 33-8587 (July 15, 2005); Form 20-F, General Instruction A(d).

125 Rule 3-05(a)(3) of Regulation S-K.

126 Rule 3-05(b)(2)(i) of Regulation S-K.

127 Rule 3-09(a) of Regulation S-K. The financial statement requirements of Rule 3-09 apply both to registration statements under the Securities Act and the Exchange Act and to annual reports under the Exchange Act.

128 For a registrant that has experienced a pre-tax loss in a given year, the foregoing "significance" test may have the effect of causing a subsidiary to be deemed "significant" despite its relative financial unimportance to the registrant. This is because the registrant would not be entitled to employ an income figure based on the average of its preceding five fiscal years when performing the "significance" calculations (in contrast to issuers with pre-tax income, as set out in the computational notes to Rule 1-02(w) of Regulation S-K), causing the "significance" test to be measured against the given year's pre-tax loss only, as measured in absolute terms and on a U.S. GAAP basis or, for issuers that report in accordance with IFRS as issued by the IASB, on that basis. Thus, a registrant that has pre-tax income of $100 in each of its four earliest fiscal years, followed by a pre-tax loss of $5 in the most recent fiscal year, would measure significance by reference to $5. If, on the other hand, the registrant had pre-tax income of $5 in the most recent fiscal year, significance would be measured by reference to $81 (the five-year income average). *See* Rule 1-02(w) of Regulation S-K, Computational Note 2.

129 Rule 3-09(a) of Regulation S-K.

130 For the purposes of making the calculations required in the significance tests, issuers that report their financial statements using U.S. GAAP or reconcile to U.S. GAAP must make calculations under the test using U.S. GAAP. Issuers that report using IFRS as issued by the IASB should make calculations under IFRS. *See* Note to paragraph (w) of Rule 1-02(w) of Regulation S-K. The financial statements of a 50%-or-less owned investee need not contain a reconciliation to U.S. GAAP if the registrant prepares its financial statements using IFRS as issued by the IASB or if the first and third conditions of the significance test do not exceed 30%. *See* Form 20-F, Item 17(c)(2)(vi).

131 *See* Rule 3-09(b) of Regulation S-K. Thus, interim financial statements of the subsidiary or investee are not required under Rule 3-09. Instead, under Rule 10-01(b)(1) of Regulation S-K, an issuer's interim financial statements should include summarized income statement information relating to each significant subsidiary or investee. However, such summarized information need not be furnished for a subsidiary or investee that would have qualified as a foreign issuer if it were a registrant.

132 Rule 3-09(c) of Regulation S-K.

133 Rule 3-10(a) of Regulation S-K ; *see also* SEC Release No. 33-7878 (Aug. 4, 2000). Under the Securities Act, guarantees of securities are themselves securities and in connection with an offering of guaranteed securities both the securities and the guarantees must be either registered or exempt from registration.

134 Rule 3-10(b), (c), (d), (e) and (f) of Regulation S-K ; *see* SEC Release No. 33-7878 (Aug. 4, 2000).

135 Rule 3-10(b), (c), (d), (e) and (f) of Regulation S-K.

136 The SEC declined to include an exception to this rule for companies organized in jurisdictions that require directors to own shares or that prescribe a minimum number of shareholders. The SEC has, however, granted no-action relief in a case in which the non-parent company ownership was at the minimum level required by law. *See Crown Cork & Seal Company, Inc*. (avail. Mar. 10, 1997). The SEC has indicated its intention to continue to recognize the exception presented in *Crown Cork & Seal Company, Inc.* and to consider future no-action requests based on substantially similar facts. SEC Release No. 33-7878 (Aug. 4, 2000); *see*, *e.g.*, *Melco Crown Entertainment Ltd.* (avail. Oct. 18, 2010); *Axtel, S.A. de C.V.* (avail. July 21, 2004); *Maxcom Telecommunicaciones, S.A. de C.V.* (avail. Oct. 31, 2001).

137 A guarantee is "full and unconditional" if, "when an issuer of a guaranteed security has failed to make a scheduled payment, the guarantor is obligated to make the scheduled payment immediately and, if it does [not], any holder of the guaranteed security may immediately bring suit directly against the guarantor for payment of all amounts due and payable." Rule 3-10(h)(2) of Regulation S-K. A guarantee can be full and unconditional even if it includes a "savings" clause to prevent the guarantee from being considered a fraudulent conveyance under U.S. law. SEC Release No. 33-7878 (Aug. 4, 2000), 65 Fed. Reg. 51,692, 51,696 (Aug. 24, 2000). A guarantee will be considered full and unconditional if the savings clause limits the guarantee to the highest amount that would not render it a fraudulent conveyance, but not if the guarantee is limited to a specified dollar amount or percentage of the guarantor's assets.

138 A subsidiary is a "finance subsidiary" if it has no assets, operations, revenues or cash flows other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company. Rule 3-10(h)(7) of Regulation S-K.

139 Rule 3-10(b)(4) of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

140 A subsidiary is an "operating subsidiary" if it is not a "finance subsidiary." Rule 3-10(h)(8) of Regulation S-K.

141 Rule 3-10(c)(4) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary issuer, (iii) any other subsidiaries of the parent on a combined basis, (iv) consolidating adjustments and (v) the total consolidated amounts.

142 Note 1 to Paragraph (c) of Rule 3-10 of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

143 Rule 3-10(d)(4) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary issuer, (iii) the guarantor subsidiaries of the parent company on a combined basis, (iv) any other subsidiaries of the parent on a combined basis, (v) consolidating adjustments and (vi) the total consolidated amounts.

If any of the subsidiary guarantees is not joint and several with the guarantees of the other subsidiaries, then each subsidiary guarantor whose guarantee is not joint and several need not include separate financial statements, but the condensed consolidating financial information must include a separate column for each subsidiary guarantor whose guarantee is not joint and several. Rule 3-10(i) of Regulation S-K ; *see* SEC Release No. 33-7878 (Aug. 4, 2000), 65 Fed. Reg. 51,692, 51,699 (Aug. 24, 2000).

144 Note 5 to Paragraph (d) of Rule 3-10 of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

145 Rule 3-10(e) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary guarantor, (iii) any other subsidiaries of the parent on a combined basis, (iv) consolidating adjustments and (v) the total consolidated amounts.

146 The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

147 Rule 3-10(f) of Regulation S-K. The condensed consolidating information must cover the same periods as the parent's financial statements with separate columns for (i) the parent company, (ii) the subsidiary guarantors on a combined basis, (iii) any other subsidiaries of the parent on a combined basis, (iv) consolidating adjustments and (v) the total consolidated amounts.

If any of the subsidiary guarantees is not joint and several with the guarantees of the other subsidiaries, then each subsidiary guarantor whose guarantee is not joint and several need not include separate financial statements, but the condensed consolidating financial information must include a separate column for each subsidiary guarantor whose guarantee is not joint and several. Rule 3-10(i) of Regulation S-K ; *see* SEC Release No. 33-7878 (Aug. 4, 2000), 65 Fed. Reg. 51,692, 51,699 (Aug. 24, 2000).

148 Note 1 to Paragraph (f) of Rule 3-10 of Regulation S-K. The footnote must also include certain narrative disclosures prescribed by Rule 3-10(i)(9) and (10) of Regulation S-K.

149 Rule 3-10(g) of Regulation S-K.

150 The significance test should be computed using the net book value of the subsidiary as of the most recent fiscal year preceding the acquisition. Rule 3-10(g)(3)(i) of Regulation S-K.

151 Rule 12h-5 under the Exchange Act. In the absence of this relief, the issuer and the guarantor would generally be required to file separate periodic reports under the Exchange Act pursuant to § 12 or § 15(d) thereof. 65 Fed. Reg. 51,692, 51,703–04 (Aug. 24, 2000).

152 Rule 3-16(a) of Regulation S-K. A parent registrant must continue to provide such financial statements in its subsequent annual reports on Form 10-K or Form 20-F, as applicable, together with all material changes to such financial statements in any subsequent registration statement filed by the parent registrant.

153 Rule 3-16(b) of Regulation S-K.

154 Rule 3-13 of Regulation S-K.

155 Subpart 1100 of Regulation S-K ; SEC Release No. 33-8518 (Dec. 22, 2004).

156 SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects, at 73 (Nov. 14, 2000).

157 Rule 140 under the Securities Act; *see also* SEC, Division of Corporation Finance, Current Issues and Rulemaking Projects, at 73 (Nov. 14, 2000) (stating that under certain circumstances the SEC staff may require co-registration in the context of structured financings to strengthen bank capital).

158 Rule 3-20(b) of Regulation S-K. In response to concerns that the literal application of Rule 3-20(b) could result in potentially misleading presentations when a currency has declined significantly after the most recent balance sheet date (for example, convenience translations could depict an issuer's debt level at a much lower U.S. dollar amount than the debt service requirements), the SEC staff will not object if an issuer uses the exchange rate at the date of the most recent balance sheet in preparing a convenience translation for inclusion in an annual report on Form 20-F or a registration statement, or if it omits a convenience translation. *See* SEC, Division of Corporation Finance, International Reporting and Disclosure Issues, Part VIII(D) (Nov. 1, 2004). The SEC staff has further stated that if convenience translations are presented in a registration statement that includes all required financial statements, such as Form F-1, the same exchange rate should be used for the most recent fiscal year presented and any subsequent interim period. If an issuer files a registration statement that incorporates by reference financial statements previously filed on Form 20-F, the staff will not require amendment of the previously filed financial statements to reflect a convenience translation based on a more current exchange rate. *See* SEC, Division of Corporation Finance, International Reporting and Disclosure Issues, Part VIII(D) (Nov. 1, 2004).

159 Form 20-F, Item 3.A.3. An issuer is permitted to use any reliable source for the exchange rates as long as it identifies the source. One example the SEC provides is the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York, which is published on the Board of Governors of the Federal Reserve website weekly. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Forms, Question 110.01.

160 Form 20-F, Item 3.A.2.

161 Rule 3-20(c) of Regulation S-K.

162 This is an exception to the general rule that the results of operations be measured in the currency of the "primary economic environment" in which business is conducted, with gain or loss then measured in the translation of that currency to the reporting currency. Rule 3-20(d) of Regulation S-K.

163 Rule 3-20(d) of Regulation S-K.

164 *See* SEC, Staff Accounting Bulletin No. 104 (Dec. 17, 2003), Fed. Sec. L. Rep. (CCH) ¶75,571; *see also* SEC, Staff Accounting Bulletin No. 101 (Dec. 3, 1999), Fed. Sec. L. Rep. (CCH) ¶75,565. SAB 104 (i) integrates the staff's interpretive guidance previously provided with respect to SAB 101, including as set forth in SEC, Office of the Chief Accountant, Frequently Asked Questions and Answers about Staff Accounting Bulletin No. 101—Revenue Recognition in Financial Statements (Oct. 12, 2000), Fed. Sec. L.

Rep. (CCH) ¶75,568 and (ii) recognizes the role of the Emerging Issues Task Force consensus on Issue 00-21, Accounting for Revenue Arrangements with Multiple Deliverables.

165 SAB 104.

166 *See* SAB 104.

167 In a fact sheet discussing the background to SAB 101, the SEC noted its concern that a substantial portion of financial reporting fraud cases brought by the SEC have involved improper revenue recognition. *See* SEC, Fact Sheet: Staff Accounting Bulletin No. 101—Revenue Recognition (Dec. 3, 1999); *see also infra* Note 180 (noting the staff's continued concern with revenue recognition policies).

168 The other two are Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, discussed in § 11.04[2][a], and Staff Accounting Bulletin No. 100 (Nov. 24, 1999), Fed. Sec. L. Rep. (CCH) ¶75,564.

169 *See* FASB, Project Updates: Revenue Recognition—Joint Project of the FASB and IASB (last updated June 3, 2014); *see also* FASB, ASU No. 2015-14 (Aug. 12, 2015) and IASB, "Effective Date of IFRS 15" (Sept. 11, 2015), deferring the effective dates of the new revenue recognition standard. For U.S. GAAP public companies, Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606), will become effective for annual periods beginning after December 15, 2017, including interim reporting periods therein, with early adoption permitted for annual reporting periods beginning after December 15, 2016. For U.S. GAAP non-public companies, the new standard will become available for annual periods beginning after December 15, 2018, with earlier adoption permitted for annual reporting periods beginning after December 15, 2016. For IFRS companies, the new standard will become effective for annual periods beginning on or after January 1, 2018, and early adoption is permitted. The new standards require U.S. and foreign public companies to adopt either a "full retrospective" or "modified retrospective" approach upon adoption. Under the full retrospective approach, companies will be required to apply the new standards retrospectively to each prior reporting period. If a company selects the modified retrospective approach, it will be required to apply the new standards only to the current period, but it will need to recognize the cumulative effect of initially applying the new standards as an adjustment to the opening balance of retained earnings. Given the scale of the required restatement, companies will need to determine their retrospective presentation well in advance of issuing their first set of financials after adopting these new standards. *See* AICPA, *New Revenue Recognition Accounting Standard—Learning and Implementation Plan*, Financial Reporting Center (Sept. 2016); Ernst & Young, A CLOSER LOOK AT THE NEW REVENUE RECOGNITION STANDARD (updated Sept. 2016).

170 *See* Ernst & Young, U.S. GAAP VS. IFRS—THE BASICS (Nov. 6, 2013).

171 News Release, IASB and FASB, IASB and FASB Issue Converged Standard on Revenue Recognition (May 28, 2014).

172 Wesley R. Bricker, then-SEC Deputy Chief Accountant, Remarks before the 2016 Baruch College Financial Reporting Conference (May 5, 2016) (noting that "[b]ecause of its importance, the SEC staff has been, and will likely continue to be, focused on the reporting of revenue arrangements and the related disclosures.").

Private securities class action filings that allege faulty revenue recognition have also been significant in recent years. For example, the percentage of such filings was 42% in 2015, 38% in 2014 and 39% in 2013. *See* PricewaterhouseCoopers LLP, 2015 SECURITIES LITIGATION STUDY (Apr. 2016); PricewaterhouseCoopers LLP, 2014 SECURITIES LITIGATION STUDY (Apr. 2015); PricewaterhouseCoopers LLP, 2013 SECURITIES LITIGATION STUDY (Apr. 2014).

173 *See* PwC, LEASES 1-2 (Mar. 31, 2016).

174 *See* PwC, LEASES 1-3–1-4 (Mar. 31, 2016).

175 *See* PwC, LEASES 10-2 (Mar. 31, 2016).

176 *See* PwC, LEASE ACCOUNTING—KEY DEVELOPMENTS IN LEASE ACCOUNTING.

177 If the reasonable estimate is a range, an accrual of the best estimate is required, unless no amount within the range is a better estimate than any other amount, in which case the minimum amount in the range must

be accrued. ASC 450. *But see* IAS 37 (requiring accrual of the mid-point of the range when no amount within a range of best estimates is the better estimate).

178 Deloitte, *International Financial Reporting Standards: Provisions, pensions and share based payments*, The Ohio State University, 13 (Apr. 1, 2011).

179 Paragraph 14 of IAS 37.

180 Paragraph 23 of IAS 37.

181 *See* ASC 450-20-20.

182 Deloitte, *Contingencies: Key differences between U.S. GAAP and IFRSs* (IASPlus), http://www.iasplus.com/en-us/standards/ifrs-usgaap/contingencies.

183 *See Financial Reporting Alert 11-1, SEC's Focus on Compliance With Loss Contingency Disclosures* (Deloitte, 2011); *see also SEC Comment Letters—Including Industry Insights Constructing Clear Disclosures* (Deloitte, Dec. 5, 2013); *SEC Comment Letters on Foreign Private Issuers Using IFRSs—A Closer Look* (Deloitte, 2012).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.06, MD&A DISCLOSURE

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 § 4.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Each registration statement and Form 20-F filing is required to contain an MD&A for the periods covered by the financial statements included in the filing, including interim periods. [184] The MD&A is a discussion of results of operations, liquidity, capital resources and other information necessary to an understanding of a company's financial condition, changes in financial condition and operating results. The MD&A requirements are intentionally general, reflecting the SEC's view that a flexible approach elicits more meaningful disclosure and avoids boilerplate discussions.

The MD&A is intended to provide, in one section of the filing, narrative disclosure of material historical and prospective information that enables investors to assess the financial condition and results of operations of the issuer, with particular emphasis on its future prospects. The SEC requires a narrative explanation of the financial statements, because it believes the numerical presentation and accompanying footnotes contained in financial statements may be insufficient for an investor to judge the quality of an issuer's earnings and the likelihood that past performance is indicative of future performance.

The SEC has designed the MD&A requirement to give investors an opportunity to look at the company through the eyes of management. For that reason, management is required to identify and analyze qualitative and quantitative factors necessary for an understanding and evaluation of an issuer's history and prospects, in both the short term and long term. Since the SEC considers the MD&A requirement one of the most significant disclosure requirements, it

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reviews a company's response carefully and often issues comments seeking clarification or further explanation. [185]

[1] General SEC Interpretive Guidance on MD&A—Presentation and Content

Because of the flexible and general nature of the MD&A disclosure requirement, the SEC has provided continued guidance on what information

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should be disclosed and how to present such information to most effectively convey material items to investors. In particular, the SEC interpretive releases from May 1989 and December 2003 provided guidance on the presentation, content and form of MD&A disclosures the SEC requires. A focus of each release was how issuers should incorporate disclosures about prospective information, the reasonably likely material results of trends, and how to disclose when current results are not indicative of expected future results.

[a] 1989 Interpretive Guidance

In 1988, the SEC commenced a review of certain filings to evaluate compliance with the MD&A requirements. In 1989, the SEC published a release summarizing the results of the project and explaining its views on several areas of

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disclosure required in the MD&A. [186] In particular, the SEC determined that interpretive guidance was needed regarding treatment in the MD&A of prospective information, analysis of long- and short-term liquidity and capital resources, material changes in financial statement line items, required interim period disclosure, analysis of what constitutes a segment, participation in high yield financings, highly leveraged transactions or noninvestment grade loans and investments, the effects of U.S. federal financial assistance upon the operations of financial institutions and preliminary merger negotiations. With respect to prospective information, the SEC distinguished between (i) "currently known trends, events, and uncertainties that are reasonably expected to have material effects" [187] and (ii) "future trend[s] or event[s] or … less predictable impact[s] of a known event, trend or uncertainty." [188] If an issuer's management cannot determine that a currently known trend, event or uncertainty will not materialize, the management must assume that the trend, event or uncertainty will eventuate and must disclose its reasonably likely and material effects on the issuer's financial condition or operations. An issuer need not, but may, disclose other forward-looking information, such as future trends and events. [189]

Statements in filings with the SEC that (i) project an issuer's revenues or other financial items, (ii) delineate management's plans and objectives for future operations, (iii) contain statements about an issuer's future economic performance in the MD&A discussion or (iv) disclose the assumptions underlying or relating to any statement in categories (i) through (iii) will generally fall within a safe-harbor exemption for forward-looking information in the SEC's rules from the civil liability provisions of the Securities Act and the Exchange Act. In order to qualify for the exemption, such statements must be made with a reasonable basis and disclosed in good faith. [190] This safe harbor applies to both prospective information the SEC requires and prospective information an issuer voluntarily discloses.

The Private Securities Litigation Reform Act of 1995 [191] created a statutory safe harbor for any forward-looking statement that is identified as such and accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." [192] In part because of an absence of guidance as to what

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would constitute "meaningful cautionary statements" and certain other difficulties with respect to the interpretation and application of the safe harbor, [193] the willingness of registrants to include forward-looking disclosure in SEC filings, which generally has been limited to filings in connection with mergers and acquisitions, remains limited. The statutory safe harbor also does not apply to certain transactions, including, in particular, IPOs or tender offers. Further, it does not apply to information contained in financial statements prepared in accordance with generally accepted accounting principles.

As noted, however, certain forward-looking information may be required, especially in MD&A. The SEC, through the comment process and otherwise, has encouraged the inclusion of forward-looking information or suggested it is required as part of MD&A.

[b] 2003 Interpretive Guidance

[i] *Presentation of MD&A*

The SEC's 2003 MD&A Interpretive Guidance provided new guidance on the presentation, content and focus of MD&A disclosure. [194] In the 2003 MD&A Interpretive Guidance, the SEC stated that MD&A is often unnecessarily lengthy, difficult to understand and confusing. In order to make the MD&A more clear and understandable, the SEC recommends the following:

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- tabular presentations of relevant financial or other information; [195]
- headings to assist its flow and understanding;
- introductory sections or overviews; [196] and

- a "layered" approach to emphasize the most important information and analysis. [197]

The SEC favors an introduction or overview that provides a balanced, executive-level discussion identifying the most important themes or other significant matters that management is concerned with when evaluating a company's financial condition and operating results. According to the 2003 MD&A Interpretive Guidance, a good introduction or overview would:

- include economic or industry-wide factors relevant to the company;
- serve to inform investors about how the company earns revenues and income and generates cash;
- to the extent necessary or useful to convey this information, discuss the company's lines of business, locations of operations and principal products and services; and
- provide insight into material opportunities, challenges and risks, such as those presented by known material trends and uncertainties, on which the company's executives are most focused for both the short and long term, as well as the actions they are taking to address these opportunities, challenges and risks. [198]

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Because these matters do not generally remain static from period to period, the SEC expects the introduction to change over time to remain current. As with all sections of the MD&A, the SEC does not consider boilerplate disclaimers and other generic language generally to be helpful in providing useful information or achieving balance, and stated in the 2003 MD&A Interpretive Guidance that such disclosure detracts from the purpose of an introduction or overview. [199] The SEC also expects an introduction's discussion and analysis of financial condition and operating performance to address both past and prospective matters. [200]

[ii] *Content of MD&A*

The SEC reaffirmed general disclosure principles in the 2003 MD&A Interpretive Guidance by stating that companies could improve MD&A disclosure by focusing on their most important information. Disclosure should emphasize material information that is required, or promotes understanding, and de-emphasize (or, if appropriate, delete) immaterial information that is not required and does not promote understanding. [201] Although any particular MD&A will turn upon company-specific facts and circumstances, the 2003 MD&A Interpretive Guidance presents the SEC's view of generally applicable MD&A practice.

A theme of the 2003 MD&A Interpretive Guidance is that the MD&A should not be limited to financial information given that non-financial measures may be key indicators of a company's financial condition and operating performance. Examples of relevant non-financial measures could include interest rates or economic growth rates and their anticipated trends, and may include company or common industry specific measures. Importantly, non-financial key measures may be contained outside a company's SEC filings— *e.g.*, in earnings releases or

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financial analysts' calls—and, accordingly, companies should consider all their communications to determine what information is material. The SEC also encouraged companies to consider non-financial measures when determining whether disclosable material trends or uncertainties have developed. [202]

Following on from the SEC's earlier guidance, a further theme of the 2003 MD&A Interpretive Guidance is prospective disclosure. Companies are required to disclose known material events and uncertainties that could cause reported financial information not to be necessarily indicative of future operating performance or future financial condition. [203] The 2003 MD&A Interpretive Guidance encourages disclosure of forward-looking information where it "will provide useful material information for investors that promotes understanding." [204] Importantly, the 2003 MD&A Interpretive Guidance appears to recommend quantitative prospective disclosure, stating that such disclosure "can promote understanding" and "should be considered and may be required to the extent material if … reasonably available." [205]

The SEC paid particular attention in the 2003 MD&A Interpretive Guidance to intermediate effects of trends, events, demands, commitments and uncertainties in terms of the MD&A's required "analysis." The SEC cites as an example company financial statements that reflect materially lower revenues resulting from a decline in the volume of products sold when compared to a prior period. In this instance, the SEC stated that the MD&A should not only identify the decline in sales volume, but should also analyze the reasons for the decline when the reasons are material and determinable (such as difficulties in manufacturing processes, declines in product quality, loss of competitive position and market share, or a combination of factors). [206]

The 2003 MD&A Interpretive Guidance further cautioned companies to consider MD&A disclosure in light of any reasonable likelihood that reported financial information is not indicative of future financial condition or future operating performance due, for example, to the levels of subjectivity and judgment necessary to account for highly uncertain matters and the susceptibility of such matters to change. [207] For example, if a change in an estimate has a materially favorable impact on earnings, the change and the underlying reasons should be disclosed so that investors do not incorrectly attribute the effect to operational improvements. In addition, if events and transactions reported in the financial statements reflect material unusual or non-recurring items, aberrations

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or other significant fluctuations, the SEC directed companies to consider the extent of variability in earnings and cash flow, and provide disclosure where necessary for investors to ascertain whether past performance is indicative of future performance. Companies also should consider whether the economic characteristics of any of their business arrangements, or the methods used to account for them, materially impact their results of operations or liquidity in a structured or unusual fashion, where disclosure would be necessary to understand the amounts depicted in their financial statements. [208]

[2] Critical Accounting Policies

Generally speaking, with respect to critical accounting policy disclosures, the SEC expects issuers to disclose the role of subjectivity and importance of judgment in the preparation of financial statements. In particular, the SEC has noted that although financial reports may appear to be precise and objective, and to suggest continuity from one period to the next, in reality they turn on judgments and estimates that may be subject to significant uncertainty and rapid change. As a result of such factors, reports representing a correct application of GAAP may nonetheless fail to communicate important information unless accompanied by disclosure about the company's financial status and the possibility, likelihood and implication of changes to the company's financial and operating status. [209]

To remedy this deficiency, the SEC has cautioned issuers to provide full, plain English explanations [210] of their critical accounting policies, the judgments

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and uncertainties affecting the application of those policies and the likelihood that if different conditions or different assumptions were applicable to the reports, materially different results would be reported. [211] The SEC understands critical accounting policies to be those policies that are the most important to the portrayal of a company's results and financial condition and those that require management's "most difficult, subjective or complex judgments." [212]

In 2001, the SEC cautioned management, auditors, audit committees and advisers to provide investors with full transparency of critical accounting policies and their effects and, in 2002, proposed rules to require companies to make extensive disclosures in filings about the application of critical accounting policies. [213] While the 2002 proposed rules were never adopted, the cautionary advice, together with later interpretive guidance issued by the SEC, [214] provides insight into the SEC's expectations with respect to critical accounting policy disclosure. [215]

In addition, it is clear from the proposals that the SEC's attention on critical accounting policies focused at least in part on those policies that involved critical estimates. The SEC believes estimates are critical if (i) they require the company to make assumptions about highly uncertain matters and (ii) the financial statements would be materially affected by different estimates the company reasonably could have used, or by changes in the estimates that are reasonably likely to occur. [216] Furthermore, it is clear from the proposed rules that the SEC

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was concerned, in particular, about newly adopted and recently changed accounting policies, to the extent such policies have a material impact on the company's financial statements. The SEC has also emphasized selectivity by companies in making this disclosure (suggesting that the vast majority of companies would have somewhere in the range of three to five critical accounting estimates). [217]

In December 2003, the SEC provided interpretive guidance that reaffirmed its prior statements on critical accounting policy disclosure, stating that companies should consider enhanced discussion and analysis of critical accounting estimates and assumptions that (i) supplements, but does not duplicate, the description of accounting policies in the notes to the financial statements and (ii) provides greater insight into the quality and variability of information regarding financial condition and operating performance. With respect to the former, the SEC stated that while the notes to the financial statements generally describe the method used to apply an accounting principle, the MD&A disclosure should present a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time. With respect to the latter, the SEC stated that a company should address specifically the risk that its accounting estimates or assumptions may change (*e.g.*, because there is an uncertainty attached to the estimate or assumption or simply because the estimate or assumption is difficult to measure). [218]

The SEC expects the evaluation of critical accounting policies to be the subject of particular focus by each company's management and auditors, with auditors gaining an understanding of the judgments management has made in selecting and applying accounting principles and methods, and management being able to defend the quality and reasonableness of such policies. Auditors, in turn, must be assured of the selection, application and disclosure of such policies. [219]

[3] Liquidity, Capital Resources, Debt, Funding and Short-Term Borrowings

The bulk of MD&A for most companies addresses results of operations. The SEC has consistently sought to obtain enhanced disclosures about liquidity,

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capital resources and debt in MD&A disclosures. The SEC has been particularly focused on these disclosures during and following market downturns over the past decade, as disclosures about liquidity and related matters are of heightened importance during such periods, particularly in the event of a sudden liquidity crisis, as occurred during the most recent financial crisis.

In 2002, following a petition by major accounting firms for interpretive guidance regarding disclosure areas of particular concern brought to light by the collapse of Enron Corp., the SEC issued a statement calling for better quality disclosure in several areas of the MD&A (the "2002 MD&A Statement"). [220] In the 2002 MD&A Statement, the SEC suggested that MD&A should, among other things, contain enhanced disclosure with respect to liquidity and capital resources (including off-balance sheet arrangements and contractual obligations). [221] Although the 2002 MD&A Statement did not establish new legal requirements, it clarified the SEC's views regarding existing disclosure obligations, and suggested specific formats for disclosing certain kinds of information. The SEC's 2003 MD&A Interpretive Guidance provided additional clarification concerning liquidity and capital resources disclosure. In September 2010, the SEC proposed rules and provided interpretive guidance relating to disclosures of short-term borrowings after concern that, during the preceding financial crisis, issuers had failed to disclose short-term borrowing obligations sufficiently and, at times, used financing structures to mask their financial condition. [222] All of these actions evidence the SEC's ongoing concern with disclosures relating to liquidity and related risks.

[a] SEC 2002 Statement Regarding Better Quality MD&A and the 2003 Interpretive Guidance

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[i] *Sources of Liquidity and Related Risks*

With respect to sources of liquidity and related risks, the 2002 MD&A Statement cautioned issuers against MD&A disclosure that is "overly general." The SEC noted, for example, that it is not enough for an issuer to merely state that it "has sufficient short-term funding to meet its liquidity needs for the next year." Instead, issuers should describe their sources of short-term funding and disclose the circumstances that are reasonably likely to affect those sources of liquidity. Similarly, issuers were encouraged to provide informative disclosure concerning matters that could affect the extent of funds needed over the short and long term. [223]

In the 2002 MD&A Statement, the SEC cited three examples to illustrate factors that issuers should consider in evaluating risks that could impair access to sources of liquidity:

- issuers that rely on operating cash flows as their principal source of liquidity should consider the extent to which declines or fluctuations in demand for their products could reduce liquidity;
- issuers that rely on commercial paper as a principal source of liquidity should consider disclosing how such facilities could be affected by ratings downgrades or declines in financial ratios or other measures of financial performance; and
- if an issuer's liquidity is dependent on off-balance sheet arrangements, such as securitization of receivables or obtaining access to assets through special purpose entities, the MD&A should include a discussion of factors that are reasonably likely to affect the company's ability to continue to use this source of financing. [224]

The 2003 MD&A Interpretive Guidance further directed issuers to provide disclosure on historical financing arrangements and their importance to cash flows, including material information not included in the financial statements. The SEC stated that such disclosure could consist of a discussion and analysis of:

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- external debt financing arrangements;
- off-balance sheet arrangements;
- issuances or purchases of derivative instruments linked to a company's stock;
- the use of stock as a form of liquidity; and
- the potential impact of known or reasonably likely changes in credit ratings or ratings outlook (or the inability to achieve changes). [225]

In addition to these historical items, the SEC stated in the 2003 MD&A Interpretive Guidance that discussion and analysis of the types of financing that are, or that are reasonably likely to be, available (or that a company would want to use but that are, or are reasonably likely to be, unavailable), and the impact on the company's cash position and liquidity, should be considered and may be required. For example, where a company has decided to raise material equity or debt financing, or if it is reasonably likely to do so in the future, discussion and analysis of the amounts involved, the nature and terms of the financing and the impact on the company's cash position and liquidity (as well as on results of operations in the case of factors such as interest payments) should be considered and may be required. [226]

The SEC has also reminded issuers that they must disclose and objectively evaluate the consequences of any known trend, demand, commitment, event or uncertainty that could materially affect liquidity, unless management can determine that such circumstances are not reasonably likely to occur. [227] This determination must be objectively reasonable, as viewed at the time when made. In particular, the SEC called upon issuers in the 2002 MD&A Statement to evaluate

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carefully the terms of their financing and other contracts to identify circumstances that could adversely impact liquidity. The SEC singled out the following factors as matters requiring close scrutiny:

- provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity or the creation of an additional financial obligation (triggers could include adverse changes in the issuer's credit rating, financial ratios, earnings, cash flows or stock price, or changes in the value of underlying, linked or indexed assets);
- circumstances that could impair the issuer's ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential, or that could render that activity commercially impracticable (these may include the inability to maintain a specified investment grade credit rating, level of earnings, earnings per share, financial ratios or collateral);
- factors specific to the issuer and its markets that it expects to be given significant weight in the determination of its credit rating or will otherwise affect the issuer's ability to raise short- and long-term financing;
- guarantees of debt or other commitments to third parties; and
- written options on non-financial assets (for example, real estate puts). [228]

[ii] *Cash Requirements and Uses of Cash*

The 2003 MD&A Interpretive Guidance also emphasized the need for attention to disclosure of cash requirements. In order to identify and disclose known material cash requirements, the SEC directed companies to consider whether the following information would have a material impact on liquidity (cautioning that discussion of immaterial matters, and especially generic or boilerplate disclosure, should be avoided):

- funds necessary to maintain current operations, complete projects underway and achieve stated objectives or plans;
- commitments for capital or other expenditures; and

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- the reasonably likely exposure to future cash requirements associated with known trends or uncertainties, and an indication of the time periods in which resolution of the uncertainties is anticipated. [229]

For example, if a company has incurred debt in material amounts, it should explain the reasons for incurring that debt and the use of the proceeds, and analyze how the incurrence of that debt fits into its overall business plan, in each case to the extent material. [230] Where debt has been incurred for general working capital purposes, the anticipated amount and timing of working capital needs should be discussed, to the extent material. [231]

The SEC does not intend for a company's discussion and analysis of its cash flows to be a mere recitation of changes and other information evident from its cash flow statement. To that end, the SEC recommended in the 2003 MD&A Interpretive Guidance a discussion of operating cash flows that goes beyond the face of the statement of cash flows and addresses material changes in underlying drivers (for example, cash receipts from the sale of goods and services and cash payments to acquire materials for manufacture or goods for resale). In this regard, an appropriately detailed MD&A would contain more than a mere description of reconciling items, in the case of the indirect method of presenting cash flows, by additionally presenting primary drivers and other material factors necessary to an understanding of a company's cash flows and the indicative value of historical cash flows. The SEC directed companies to consider further whether the MD&A should be expanded to address the cash requirements of, and the cash provided by, reportable segments and other subdivisions of a company's business, including issues related to foreign subsidiaries, as well as the indicative nature of those results. [232]

[iii] *Debt Instruments, Guarantees and Related Covenants*

The 2003 MD&A Interpretive Guidance provided two scenarios for companies to consider whether discussion and analysis of material covenants related

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to outstanding debt (or guarantees or other contingent obligations) may be required. [233]

First, companies that are, or are reasonably likely to be, in breach of such covenants must disclose material information about that breach and analyze the impact on the company if material. That analysis should include, as applicable and to the extent material:

- the steps the company is taking to avoid the breach;
- the steps the company intends to take to cure, obtain a waiver of or otherwise address the breach;
- the impact or reasonably likely impact of the breach (including the effects of any cross-default or cross-acceleration or similar provisions) on the company's financial condition or operating performance; and
- alternate sources of funding to pay off resulting obligations or replace funding. [234]

Second, the 2003 MD&A Interpretive Guidance directed companies to consider the impact of debt covenants on their ability to undertake additional debt or equity financing. Examples of these covenants include, but are not limited to, debt incurrence restrictions, limitations on interest payments, restrictions on dividend payments and various debt ratio limits. If these covenants limit, or are reasonably likely to limit, a company's ability to undertake financing to an extent that has a material impact, a company would be required to discuss the covenants in question and the consequences of the limitation on the company's financial condition and operating performance. Disclosure of alternate sources of funding and, to the extent material, the consequences (including but not limited to the cost) of accessing such sources should also be considered and may be required. [235]

[b] Short-Term Borrowings: “Dear CFO” Letters, the 2010 Interpretive Guidance and the September 2010 Proposed Rules

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During the recent financial crisis, the SEC increasingly employed a new tool — "Dear CFO" Letters — to comment on disclosure practices, remind CFOs of specific disclosure obligations and elicit information from company CFOs. [236] "Dear CFO" Letters differ from prior SEC practice as they are neither formal interpretive guidance—a tool the SEC has often used in the past to comment on disclosure practices of concern—nor comments on the specific disclosures of any particular company (as an issuer might receive in a comment letter), but instead provide, in a publicly available format, more informal guidance about disclosure practices of concern to the SEC staff. Nonetheless, despite their more informal nature, "Dear CFO" letters alert companies to the SEC's expectations as to what is required in the disclosures under existing standards and highlight specific

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aspects of certain disclosures upon which a company should focus. The SEC has also used "Dear CFO" Letters to elicit information about disclosure practices in certain areas and used the information to inform its rulemaking efforts. [237]

One of the "Dear CFO" letters published in March 2010 focused on disclosures of short-term borrowing practices. Following the release of the Lehman Brothers' Examiner report that described Lehman Brothers' use of "Repo 105" transactions to reduce the assets and liabilities on its balance sheet by as much as $50 billion at a time in 2007 and 2008, [238] the SEC sent a "Dear CFO" Letter to certain public companies seeking information regarding how those companies treated repurchase agreements, securities lending transactions and other similar transactions involving transfers of assets with an obligation to repurchase. The letter particularly sought information on the accounting treatment for such transactions, and asked for a detailed analysis of such transactions that were accounted for as sales. [239]

Following the collection of information provided from responses to the Repo Dear CFO Letter, on September 17, 2010, the SEC proposed new disclosure rules regarding short-term borrowing practices ("Short-Term Borrowing Proposed Rules") and published interpretive guidance (the "2010 MD&A Interpretive Guidance") on the SEC's current MD&A disclosure requirements related to liquidity and capital resources. [240] The purpose of these actions was in part to prevent undisclosed "window dressing" of balance sheets by companies, which

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might otherwise have incentives to decrease the amount of their short-term borrowings at each quarter's end in order to present a better liquidity picture to investors.

The 2010 MD&A Interpretive Guidance is designed to emphasize and implement the SEC's position that companies may not use financing structures to mask their financial condition. The guidance notes that, for example, if a company's borrowings during the reporting period were materially different than the period-end amounts recorded in the financial statements, disclosure about the intra-period variations would be required. [241] It also clarifies the appropriate manner of presentation of leverage and other financial ratios [242] and reminds registrants of existing obligations regarding disclosure of known trends and uncertainties. For example, the release highlighted examples of trends relating to liquidity companies might consider discussing in their MD&A, including difficulties accessing the debt markets, reliance on commercial paper or other short-term financing arrangements, maturity mismatches between borrowing sources and the assets funded by those sources, changes in terms requested by counterparties, changes in the valuation of collateral and counterparty risk. [243]

Short-term borrowings are used by many companies as a regular part of their financing activities and may include borrowing from the Federal Reserve or commercial banks, commercial paper or repurchase agreements. Currently, bank holding companies must annually disclose the daily average amount outstanding, the month-end maximum amounts outstanding and the average weighted interest rates of their short-term borrowings, according to the terms of SEC Industry Guide 3. [244] The SEC proposed additional rules regarding short-term borrowing in 2010 that would have required public reporting companies to provide increased quantitative and qualitative disclosure of their short-term borrowings on a quarterly basis and would have expanded the universe of companies required to provide disclosure regarding their short-term borrowings, which is currently limited to bank holding companies. The SEC withdrew the Short-Term Borrowing Proposed Rules from its agenda in July 2013, however, because the SEC did not consider it likely that it would consider the proposed rules in the following 12 months, although it may do so in the future. [245]

[4] Fair Value MD&A Disclosure

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SFAS No. 157, Fair Value Measurements ("SFAS No. 157") (which was later codified in Accounting Standards Codification 820 ("ASC 820"), Fair Value Measurements and Disclosures), became effective for financial statements issued for fiscal years beginning after November 15, 2007. [246] SFAS No. 157 introduced a single definition of fair value for GAAP purposes (to replace the various definitions that preceded SFAS No. 157), established a framework for measuring fair value and expanded required disclosures about fair value measurements. The statement created a three-level fair value hierarchy that prioritizes the use of market-based data obtained from sources independent of the issuer (so-called "observable inputs") over the use of the issuer's own assumptions about market participant assumptions based on the best information available in the circumstances (so-called "unobservable inputs"). As a result, SFAS No. 157 required issuers in certain circumstances to switch from using valuations based on internal models to valuations based on market data, generating substantial accounting losses in some cases, particularly during the recent financial crisis.

Because of the difficulty of estimating fair value in periods of market stress and the potential importance of fair value disclosures and related losses by certain financial institutions during the recent financial crisis, the SEC paid particular attention to such disclosures during that period. In particular, during 2008, the Division of Corporation Finance made public two "Dear CFO" letters it sent to a number of public companies identifying various disclosure issues associated with SFAS No. 157 for the issuers to consider in connection with preparing MD&A for their then-upcoming quarterly reports. [247] The first, sent in March 2008, among other things, reminded issuers that actual market prices (*i.e.*, observable inputs) should be used in making fair value measurements, even when the market for the relevant asset or liability was less liquid than it had been historically and that unobservable inputs should be relied upon only in the absence of observable inputs. In light of the credit crisis then prevailing, the letter noted that current market conditions could well require the use of significant unobservable inputs. The Division emphasized the need for detailed disclosure in connection with fair value measurements, including in respect of values based on unobservable inputs. The second letter, sent in September 2008, followed a review conducted by the SEC of fair value disclosures. The letter focused on disclosures of how credit risk affected fair value measurements, explanations of how market illiquidity was factored into fair value determinations and the use of brokers or pricing services in developing fair value measurements.

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The virtues of the fair value accounting standards under SFAS No. 157 have been a continuing subject of debate. [248] During the financial crisis, some critics asserted that these standards contributed to the instability of financial markets and to the failure of certain financial institutions. Partially in response to such critiques but also to provide practical guidance, the SEC and FASB took various steps in late September and early October of 2008 to clarify how SFAS No. 157 should be applied to the fair value measurement of financial instruments when there is no active market for a security. [249]

As part of the Emergency Economic Stabilization Act of 2008, the SEC was mandated to conduct a study of mark-to-market accounting standards under SFAS No. 157. [250] In its December 30, 2008 report, the SEC concluded that fair value accounting standards should be improved but not suspended. [251] The study recommended reconsidering the accounting for impairments under fair value standards and developing additional guidance for determining fair value of investments in inactive markets, including situations where market prices are not readily available. [252]

The 2002 MD&A Statement called for greater transparency regarding trading in OTC commodity contracts accounted for at fair value, especially with respect to methods used to determine fair value. In the absence of market quotations for such contracts, companies often have significant discretion in determining their value using fair value estimation methods. The SEC suggested that

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issuers consider furnishing information, quantified to the extent practicable, which does the following:

- disaggregates realized and unrealized changes in fair value;
- identifies changes in fair value attributable to changes in valuation techniques;
- disaggregates estimated fair values at the latest balance sheet date based on whether fair values are determined directly from quoted market prices or are estimated; and

- indicates the maturities of contracts at the latest balance sheet date (*e.g.*, within one year, within years one through three, within years four and five and after five years). [253]

[5] Off-Balance Sheet Arrangements and Contractual Obligations

In 2003, the SEC adopted rules to implement § 401(a) of the Sarbanes-Oxley Act that require each U.S. and non-U.S. reporting company, with limited exceptions, [254] to include specified MD&A disclosures on off-balance sheet arrangements and contractual obligations in registration statements, annual reports and proxy or information statements. [255]

[a] Disclosure of Off-Balance Sheet Arrangements

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An off-balance sheet arrangement is any transaction, agreement or other contractual arrangement [256] to which an entity unconsolidated with the issuer is a party, under which the issuer has:

- any obligation under a guarantee contract that meets certain criteria specified in FIN 45; [257]
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for those assets;
- any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument but for the fact that it is both indexed to the issuer's own stock and classified as stockholders' equity in the issuer's balance sheet; [258] or

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- any obligation, including a contingent obligation, arising out of a "variable interest" in an unconsolidated entity that is held by, and material to, the issuer, where that entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the issuer. [259]

Contingent liabilities arising out of litigation, arbitration or regulatory actions are excluded from the definition of off-balance sheet arrangements for purposes of the rules. [260]

In 2009, FASB issued statements No. 166 (Accounting for Transfers of Financial Assets) and No. 167 (Amendments to FASB Interpretation No. 46(R)), [261] which substantially changed the standards under U.S. GAAP for determining whether entities are consolidated and assets and liabilities are carried on- or off-balance sheet. These standards became effective for fiscal years beginning after November 15, 2009 (or January 1, 2010 for companies with calendar year-ends) and are particularly relevant with regard to accounting for securitizations and special-purpose entities.

Statement No. 166 requires greater transparency about transfers of financial assets and a company's continuing involvement in transferred financial assets. Under Statement No. 167, the quantitative approach previously used to determine the primary beneficiary of a variable interest entity based on receipt of a majority of an entity's expected residual returns was replaced with a qualitative analysis that identifies the primary beneficiary based on a qualitative analysis of the entities that have the power to direct the activities of a variable interest entity and the obligation to absorb losses or the right to receive benefits from a variable interest entity. Statement No. 167 requires ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity, while historically reconsideration of whether an enterprise is the primary beneficiary of a variable interest entity was only required when specific events occurred.

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The terms "guarantee contract" and "variable interest" are defined in the rules by reference to U.S. GAAP, and the SEC has emphasized that foreign issuers whose primary financial statements are prepared in accordance with home-country GAAP are required to refer to U.S. GAAP for the purpose of determining which guarantee contracts and variable interests are required to be disclosed. [262] On the other hand, the rules permit such foreign issuers to apply home-country GAAP for the purpose of determining which obligations indexed to the issuer's own stock are classified as stockholders' equity and therefore must be disclosed as off-balance sheet arrangements under the new rules. The SEC has reminded foreign issuers that their MD&As, while generally permitted to focus on the primary financial statements, also are required to include a discussion of U.S. GAAP-reconciled information (if U.S. GAAP reconciliation is required) to the extent necessary to an understanding of the financial statements as a whole. [263] The SEC has further called attention to the fact that this general requirement must be considered in connection with off-balance sheet arrangements disclosed on the basis of determinations made under non-U.S. GAAP. [264]

[i] *Disclosure Threshold*

The rules require a discussion of any off-balance sheet arrangements of an issuer that have or are reasonably likely to have a current or future effect on the issuer's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. [265] When it adopted the rules, the SEC reiterated its long-standing positions that (i) a determination by management of an issuer as to whether an arrangement is reasonably likely to have a material effect must be

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objectively reasonable, viewed as of the time the determination is made and (ii) "reasonably likely" is a lower threshold than "more likely than not." [266]

[ii] *Specific Disclosure Requirements*

With respect to any arrangements that fall within the definition of "off-balance sheet arrangement" and cross the "reasonably likely" disclosure threshold, the rules require disclosure of the following items to the extent necessary to an understanding of the arrangements and their effect on the specified financial statement-related matters:

- the nature and business purpose to the issuer of the arrangement (*e.g.*, reduction of the liabilities recognized on the face of the balance sheet); [267]
- the importance to the issuer of the arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits (*e.g.*, how often it securitizes financial assets, whether it has materially increased or decreased securitizations from past periods and, if so, why);
- the amounts of revenues, expenses and cash flows of the issuer arising from the arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the issuer (*e.g.*, the amount of securities issued by the issuer to the off-balance sheet entity or the amounts of guarantees, lines of credit or similar arrangements); and the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the issuer arising from the arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; [268]
- any known event, demand, commitment, trend or uncertainty that will result or is reasonably likely to result in the termination, or material reduction in availability to the issuer, of its off-balance sheet arrangements that provide

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  material benefits to it, and the course of action that the issuer has taken or proposes to take in response to any such circumstances; [269] and

- such other information as the issuer believes is necessary to an understanding of the arrangements and their effect on the specified financial statement-related matters. [270]

[iii] *Presentation*

The rules require issuers to aggregate off-balance sheet arrangements in groups or categories that provide material information in an efficient and understandable manner, with repetition or disclosure of immaterial information avoided. Effects that are common or similar with respect to a number of off-balance sheet arrangements must be analyzed in the aggregate to the extent aggregation increases understanding. Distinctions in arrangements and their effects must be discussed to the extent the information is material, but the discussion should avoid repetition and disclosure of immaterial information. [271] Repetition in the MD&A of information contained in the notes to the financial statements is not required, so long as the MD&A includes a cross-reference to that information and integrates the substance of the notes into the discussion in a manner designed to inform readers of the significance of that information. [272]

The SEC has cautioned issuers, however, to ensure that the quality of the discussion of off-balance sheet arrangements is not diminished as a result of cross-referencing to the financial statements. [273]

The disclosure in annual reports required by the rules generally must cover the most recent fiscal year, but it also should discuss changes from the previous year where such a discussion is necessary to an understanding of the disclosure. [274]

[b] Tabular Disclosure of Known Contractual Obligations

The SEC's rules with respect to contractual obligations require tabular disclosure in the MD&A with respect to the issuer's known contractual obligations as of the latest balance sheet date. [275] The rules mandate certain disclosure categories but permit issuers to disaggregate the specified categories, so long as all obligations of the issuer that fall within the specified categories are included in the tabular presentation. Appropriate footnote disclosure about provisions that create, increase or accelerate obligations, or other pertinent data, may accompany the table to the extent necessary to an understanding of the timing and amount of the specified contractual obligations. [276]

The rules define "long-term debt," "capital lease obligations," "operating leases" and "other long-term liabilities" by reference to U.S. GAAP for U.S. domestic issuers, while foreign issuers are instructed to base their disclosures about these categories of contractual obligations on the classifications used in the GAAP under which they have prepared their primary financial statements. [277] For

both U.S. domestic and foreign issuers, the term "purchase obligations" is defined directly in the rules rather than by reference to accounting standards. [278]

The 2010 MD&A Interpretive Guidance addressed discrepancies in the way public companies satisfied requirements regarding the presentation of contractual obligations, contingent liabilities and commitments by reminding them of the purpose of the table. [279] The SEC noted it has not issued general guidance on the disclosures in this area as questions tend to be fact-specific and closely related to a registrant's particular business and circumstances. [280]

[c] Applicability of Statutory Safe Harbor for Forward-Looking Statements

The rules governing disclosure of off-balance sheet arrangements and contractual obligations provide that all forward-looking statements made in such disclosures will have the benefit of the statutory safe harbor exemptions from the civil liability provisions of the Securities Act and Exchange Act to the same extent as other forward-looking statements, and that all information provided in response to the rules, except for historical facts, will be deemed to constitute "forward-looking statements" within the meaning of the safe harbor. [281] In addition, the rules provide that disclosure about off-balance sheet transactions is deemed to satisfy the "meaningful cautionary statements" element of the safe harbor if it satisfies all of the requirements of the rules. On the other hand,

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forward-looking statements made in required disclosures about contractual obligations are not automatically deemed to satisfy the "meaningful cautionary statements" element of the safe harbor solely by reason of compliance with the requirements of the rules. Issuers, therefore, must ensure that those disclosures otherwise contain such "meaningful cautionary statements" as are necessary in the circumstances. [282]

Footnotes

184 According to published highlights of a meeting of the AICPA SEC Regulations Committee's International Practices Task Force, the SEC staff has noted that when financial statements are updated in order to comply with the age of financial statements requirements applicable to registration statements as set forth in Item 8 of Form 20-F, an issuer must also update other "financial" information, including its MD&A. *See* AICPA, SEC Regulations Committee's International Practices Task Force, Highlights, Item 2 (Mar. 9, 2004).

185 The SEC has initiated proceedings against issuers with respect to their MD&A disclosure. In 1998, the SEC brought proceedings against Sony Corporation in which the SEC found that Sony and an officer of Sony responsible for disclosure matters had violated SEC reporting requirements by failing to describe, in Sony's annual report on Form 20-F and in its periodic earnings reports on Form 6-K, losses suffered by one of its subsidiaries, Sony Pictures. *In the Matter of Sony Corporation*, SEC Release No. 34-40305 (Aug. 5, 1998). The SEC found that Sony failed to identify greater-than-anticipated losses at Sony Pictures, which Sony had acquired in late 1989. Although it is unclear whether Sony was technically required under SFAS No. 14 to report the results of Sony Pictures as a separate business segment, the SEC found that Sony failed to discuss a "known trend" involving cumulative losses of more than $1 billion through June 30, 1994 attributable to Sony Pictures. These losses led Sony to announce in November 1994 the write-off of $2.7 billion of goodwill associated with the acquisition of Sony Pictures. No mention of a possible write-off had been included in the 6-K reports regarding earnings filed in June and early September 1994 or in the Form 20-F filed in late September 1994. In fact, according to the SEC, these filings included conspicuously positive statements about various aspects of Sony Pictures' performance. Pursuant to an SEC order and the settlement of a related civil action brought by the SEC, Sony agreed, among other things, to provide an independent auditor's report on the MD&A included in its Form 20-F for the fiscal year ending March 31, 1999, to ensure that its chief financial officer would be primarily responsible for the accuracy of Sony's public financial disclosures and its compliance with applicable legal and accounting requirements, and to pay a fine of $1 million. *SEC v. Sony Corp.*, SEC Litigation Release No. 15832 (Aug. 5, 1998).

In 1992, the SEC brought proceedings against Caterpillar, Inc., finding Caterpillar to have presented an inadequate MD&A discussion in its 1989 annual report on Form 10-K and its quarterly report on Form 10-Q for the first quarter of 1990. Caterpillar gained an unusually large percentage of its 1989 overall profit from its operation in Brazil. The impact of the Brazilian operation on overall results was not evident from the company's financial statements, which were presented on a consolidated basis. Although the fact that the Brazilian operation had a significant impact on 1989 profits and the 1990 forecast was discussed extensively in several meetings of the company's board of directors prior to the filing of the two reports, there was no mention of it in the MD&A section of either report. The SEC found that information about the impact of the company's Brazilian subsidiary was necessary to an understanding of the company's performance in 1989 and its prospects in 1990 and therefore should have been included in the MD&A sections of both the 1989 Form 10-K and the Form 10-Q for the first quarter of 1990. *In the Matter of Caterpillar, Inc.*, SEC Release No. 34-30532 (Mar. 31, 1992).

In 2014, the SEC announced a settled cease-and-desist proceedings against Bank of America Corporation for failing to disclose "known uncertainties" in the MD&A sections of its quarterly reports on Form 10-Q. Between 2004 and the first half of 2008, Bank of America and certain subsidiaries sold approximately $2.1 trillion of mortgage loans and residential mortgage backed securities. Some of the loans were securitized and some of the securitized loans contained credit enhancements provided by monoline insurers. In connection with these securitizations and credit enhancements, Bank of America made representations and warranties regarding the underlying mortgage loans. If a purchaser of securitized loans or a monoline insurer determined that these representations and warranties were breached, the purchaser or the monoline insurer could demand that Bank of America repurchase the related mortgage loan at its outstanding unpaid principal balance. Between the third quarter of 2008 and the third quarter of 2009, there was a significant increase in the amount of claims for repurchase by the Federal National Mortgage Association ("Fannie Mae"), which was one of the primary government-sponsored enterprises that purchased mortgage loans from Bank of America. During the same period, claims for repurchase by the monoline insurers had also steadily increased. As a result, the SEC claimed that, during the second and third quarters of 2009, there was a known uncertainty as to whether Bank of America's increasing obligation to repurchase the mortgage loans from Fannie Mae and the monoline insurers would have a material effect on its future income and continuing operations. According to the SEC, by failing to disclose these known uncertainties in the MD&A sections of its quarterly reports on Form 10-Q for the second and third quarters of 2009, Bank of America violated § 13(a) of the Exchange Act and Rules 12b-20 and 13a-13 thereunder. Bank of America agreed to settle by paying a $20 million penalty and admitting the facts set out by the SEC. *In the Matter of Bank of America Corporation*, SEC Release No. 34-72888 (Aug. 21, 2014).

See also In the Matter of the PNC Financial Services Group, Inc., SEC Release No. 34-46225 (July 18, 2002) (finding violations of, among others, the financial reporting and antifraud provisions of the federal securities laws, including with respect to MD&A disclosure, owing to PNC's failure to account properly for certain transactions with special purpose entities); *In the Matter of The Coca-Cola Company*, SEC Release No. 34-51565 (Apr. 18, 2005) (announcing a settled cease-and-desist proceeding against The Coca-Cola Company relating to its failure to disclose, including in MD&A, certain quarter-end sales practices used to meet earnings expectations).

The SEC can also bring proceedings against individual officers for inadequate MD&A disclosure. In 2005, the SEC filed civil charges against two former top Kmart executives for materially false and misleading disclosures about the company's liquidity and related matters in the MD&A section of Kmart's Form 10-Q, and in an earnings conference call with analysts and investors. *SEC v. Conaway*, SEC Litigation Release No. 19344 (Aug. 23, 2005); *see also In the Matter of Timothy E. Nolan*, SEC Release No. 34-47802 (May 6, 2003) (finding violations of § 13(a) of the Exchange Act and Rules 13a-13 and 12b-20 thereunder, including with respect to inadequate MD&A disclosure).

186 SEC Release No. 33-6835 (May 18, 1989) (the "1989 MD&A Release").

187 1989 MD&A Release, 54 Fed. Reg. 22,427, 22,429 (May 24, 1989).

188 1989 MD&A Release, 54 Fed. Reg. 22,427, 22,429 (May 24, 1989).

189 1989 MD&A Release, § III.B, 54 Fed. Reg. 22,427, 22,428–30 (May 24, 1989).

190 Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act; *see* § 11.03[5].

191 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

192 § 27A(c)(1)(A)(i) of the Securities Act and § 21E(c)(1)(A)(i) of the Exchange Act. Statements included in a financial statement prepared in accordance with generally accepted accounting principles, however, are not covered by the safe harbor. *See* § 27A(b)(2)(A) of the Securities Act and § 21E(b)(2)(A) of the Exchange Act.

193 *See* § 11.03[5] for a discussion of various issues arising in connection with the statutory safe harbor.

194 SEC Release No. 33-8350 (Dec. 19, 2003), 68 Fed. Reg. 75,056 (Dec. 29, 2003) (the "2003 MD&A Interpretive Guidance"). The 2003 MD&A Interpretive Guidance reiterated the SEC's concerns with those issues previously addressed in its 2002 review of the annual reports of Fortune 500 companies. During that review, the SEC noted that it had (i) requested clarification on how such companies recognize revenue, (ii)

asked such companies to justify or explain more fully their accounting for restructuring charges, and to expand their disclosure of such matters in the financial statements and MD&A, (iii) issued a significant number of comments related to impairment charges, focusing on charges related to long-lived assets, securities held for investment and goodwill, (iv) asked such companies to explain the assumptions used to determine their amount of pension income or expense, (v) issued a significant number of comments on determination of operating segments in financial statements and MD&A, (vi) requested greater detail on the use of non-GAAP measures, securitization transactions and off-balance sheet arrangements and (vii) requested expanded disclosure on environmental and product liability issues. SEC, Division of Corporation Finance, Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Feb. 27, 2003).

195 This might include a tabular comparison of a company's results in different periods, which could include line items and percentage changes, as well as other information determined by the company to be useful, followed by a narrative discussion and analysis of known changes, events, trends, uncertainties and other matters; or a tabular presentation, in one location, of a company's various material interest and discount rate assumptions to assist in fair value calculations or discounted cash flow figures. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

196 As a general matter, an introduction or overview would presumably include the most important matters on which a company's executives focus in evaluating financial condition and operating performance and provide the context for the discussion and analysis of the financial statements. Accordingly, the SEC cautions that an introduction or overview should not be a duplicative layer of disclosure that merely repeats the more detailed discussion and analysis that should follow. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

197 Using an overview or introduction is one example of a layered approach. Another is to begin a section containing detailed analysis, such as an analysis of period-to-period information, with a statement of the principal factors, trends or other matters that are the principal subjects covered in more detail in the section. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

198 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

199 The SEC further stated that the introduction or overview, by its very nature, cannot disclose everything and should not be considered by itself in determining whether a company has made full disclosure. The SEC further stated that the failure to include disclosure of every material item in an introduction or overview should not trigger automatically the application of the "buried facts" doctrine, in which a court would consider disclosure to be false and misleading if its overall significance is obscured because material is "buried," such as in a footnote or an appendix. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

200 With respect to prospective matters, Form 20-F, Item 5.D requires disclosure of material trends and uncertainties.

201 In the 2003 MD&A Interpretive Guidance, the SEC asked companies to evaluate whether information in the MD&A is still material and useful, or whether it should be deleted (*e.g.*, when there has been a change in a company's business or the information has become stale). The 2003 MD&A Interpretive Guidance continued by recommending that companies consider the materiality of segment data, avoid excessively duplicative or unnecessary line item disclosure and assess the extent to which materiality standards for annual and quarterly report disclosure may differ. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

202 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,060 (Dec. 29, 2003).

203 *See* Form 20-F, Item 5.D.

204 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,059 (Dec. 29, 2003).

205 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,062 (Dec. 29, 2003).

206 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,062 (Dec. 29, 2003).

207 The SEC has also addressed this concern in connection with critical accounting policy disclosure. *See* § 4.06[2].

208 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,062 (Dec. 29, 2003).

209 SEC Release No. 33-8040 (Dec. 12, 2001), 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001) ("2001 Cautionary Advice"). *See also* 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064–65 (Dec. 29, 2003).

210 In a 2002 rule proposal discussed further below, the SEC extended its cautionary advice by proposing that a quantitative sensitivity analysis of reasonably possible changes in critical accounting estimates or underlying assumptions be included in MD&A. The sensitivity analysis would require, for each critical accounting estimate, (i) a quantitative discussion of the effect of certain changes on the company's overall financial performance and, to the extent material, individual line items in the financial statements and the company's liquidity or capital resources and (ii) a quantitative and qualitative discussion of any material changes made to each critical accounting estimate in the past three years, including the reasons for the changes and the effect on the company's overall financial performance and on individual line items in the financial statements. SEC Release No. 33-8098 (May 10, 2002). While no specific rules providing for quantitative sensitivity analysis have been adopted, the 2003 MD&A Interpretive Guidance affirmed the SEC's continued interest in quantitative disclosure of critical accounting estimates. In that guidance, the SEC stated that companies should provide quantitative disclosure where the information is reasonably available and will be material to investors. For example, if reasonably likely changes in the long-term rate of return used in accounting for a company's pension plan would have a material effect on the financial condition or operating performance of a company, the impact that could result given the range of reasonably likely outcomes should be disclosed and, because of the nature of estimates of long-term rates of return, quantified. *See* 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,065 (Dec. 29, 2003).

211 The SEC has reminded issuers that, to a certain extent, such disclosure is required by (i) pre-existing accounting standards that require financial statements to include information regarding accounting principles and methods used by the company and the risks and uncertainties inherent in certain estimates and (ii) existing rules governing MD&A requiring disclosure about trends, events or uncertainties known to management that would have a material impact on reported financial information. *See* 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001).

212 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001).

213 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001); SEC Release No. 33-8098 (May 10, 2002). Also in December 2001, the SEC issued cautionary advice on the use of so-called *pro forma* financial measures (or non-GAAP financial measures), which was later superseded by rules implementing § 401(b) of the Sarbanes-Oxley Act. *See* § 4.09.

214 *See* 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064–65 (Dec. 29, 2003).

215 In addition, following its 2002 review of Form 10-Ks filed by Fortune 500 companies, the SEC noted the need for greater disclosure on critical accounting policies relating to: (i) revenue recognition, (ii) restructuring charges, (iii) impairments, (iv) depreciation and amortization, (v) income tax liabilities, (vi) retirement and post retirement liabilities, (vii) pension income and expense, (viii) environmental liabilities, (ix) repurchase obligations, (x) stock-based compensation, (xi) insurance loss reserves and (xii) inventory reserves and allowances for doubtful accounts. SEC, Division of Corporation Finance, Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies (Feb. 27, 2003).

216 *See* SEC Release No. 33-8098 (May 10, 2002), 67 Fed. Reg. 35,620, 35,621 (May 20, 2002).

217 *See* SEC Release No. 33-8098 (May 10, 2002), 67 Fed. Reg. 35,620, 35,626 (May 20, 2002).

218 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,065 (Dec. 29, 2003).

219 2001 Cautionary Advice, 66 Fed. Reg. 65,013, 65,013 (Dec. 17, 2001). Rules adopted by the SEC to implement the auditor independence and related provisions of the Sarbanes-Oxley Act independently

require public accounting firms to report to audit committees, among other things, all critical accounting policies and practices used by an issuer and all alternative treatments within GAAP for policies and practices related to material items that have been discussed with an issuer's management. *See* § 5.03.

220 SEC Release No. 33-8056 (Jan. 22, 2002), 67 Fed. Reg. 3746, 3751 (Jan. 25, 2002).

221 Rules passed by the SEC to implement § 401(a) of the Sarbanes-Oxley Act thereafter codified and superseded the 2002 MD&A Statement with respect to off-balance sheet arrangements and contractual obligations, and are discussed in § 4.06[5] below. The 2002 MD&A Statement had also called for enhanced disclosure on contingent liabilities and commitments. The SEC stated, however, that meaningful disclosure of such items may not necessarily be accomplished by its previously proposed aggregated disclosure format, and, among other things, rules adopted to implement § 401(a) of the Sarbanes-Oxley Act, together with the implementation of FASB Interpretation No. 45 (Nov. 2002), Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others ("FIN 45"), and FASB Interpretation No. 46 (revised Dec. 2003), Consolidation of Variable Interest Entities ("FIN 46(R)"), could be expected to obviate the need for such disclosure. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5986–87 (Feb. 5, 2003). Nevertheless, the SEC stated that it would continue to assess the costs and benefits of such a disclosure requirement and suggested that issuers continue to refer to the 2002 MD&A Statement to consider whether it would be beneficial to investors to include the tabular disclosure of contingent liabilities and commitments proposed therein. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5987 (Feb. 5, 2003). In practice, this tabular disclosure has not been used.

222 SEC Release No. 33-9143 (Sept. 17, 2010). On July 1, 2013, the SEC withdrew the proposal from its agenda of rulemaking actions. SEC, Regulatory Flexibility Agenda, 78 Fed. Reg. 44,408 (July 23, 2013). *See* § 4.06[3][b].

223 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002).

224 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002).

225 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064 (Dec. 29, 2003). Although the Dodd-Frank Act eliminated former Rule 436(g) under the Securities Act, under which an issuer that referred to a credit rating in a Securities Act registration statement or prospectus for a registered offering did not need to file the consent of the rating agency, an issuer not subject to Regulation AB disclosure requirements may still disclose changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant or the terms of agreements that refer to credit ratings, and therefore should be able to disclose the adverse effect that a hypothetical downgrade would have, in the liquidity portion of the MD&A. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 233.04 (July 27, 2010); *see also* § 3.02[7], Note 396.

226 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064 (Dec. 29, 2003). The SEC noted in the 2003 MD&A Interpretive Guidance that it believes disclosure satisfying its MD&A requirements can be made consistent with the restrictions on gun-jumping in § 5 of the Securities Act. *See*, *e.g.*, Rule 135c under the Securities Act (discussed in § 7.02[3][b]). 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,064 n.54 (Dec. 29, 2003).

227 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002). The SEC has clarified that "reasonably likely" is a lower threshold than "more likely than not."

228 2002 MD&A Statement, 67 Fed. Reg. 3746, 3748 (Jan. 25, 2002).

229 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 (Dec. 29, 2003). The SEC recommended its required tabular disclosure of known contractual obligations as a starting point for this disclosure. *See* § 4.06[5][b].

230 As an example, the SEC cites debt issued to fund the construction of a new plant, which will allow a company to expand its operations into a specific geographic area. Understanding that relationship and the expected commencement date of plant operations puts the cash requirement for the debt into an appropriate context to understand the hypothetical company's liquidity. 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 n.47 (Dec. 29, 2003).

231 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 (Dec. 29, 2003).

232 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063–64 (Dec. 29, 2003). *See also* Item 303(a) of Regulation S-K under the Securities Act.

233 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063 (Dec. 29, 2003). *See also In the Matter of America West Airlines, Inc.*, SEC Release No. 34-34047 (May 12, 1994) (holding that a company failed to discuss uncertainties regarding its ability to comply with covenants). Companies also must take a similar approach to discussion and analysis with respect to mandatory prepayment provisions, "put" rights and other similar provisions.

234 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063–64 (Dec. 29, 2003).

235 2003 MD&A Interpretive Guidance, 68 Fed. Reg. 75,056, 75,063–64 (Dec. 29, 2003).

236 The SEC maintains sample letters on its website, which are available at https://www.sec.gov/divisions/corpfin/cfdisclosure.shtml. *See* SEC, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) (Mar. 2008) ("Fair Value Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements) (Sept. 2008) ("Fair Value Dear CFO Letter Addendum"); SEC, Sample Letter Sent to Public Companies on MD&A Disclosure Regarding Provisions and Allowances for Loan Losses (Aug. 2009) ("Loan Losses Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies Asking for Information Related to Repurchase Agreements, Securities Lending Transactions, or Other Transactions Involving the Transfer of Financial Assets (Mar. 2010) ("Repo Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies on Accounting and Disclosure Issues Related to Potential Risks and Costs Associated with Mortgage and Foreclosure-Related Activities or Exposures (Oct. 2010) ("Foreclosures Dear CFO Letter"); SEC, Sample Letter Sent to Public Companies Regarding XBRL Requirement to Include Calculation Relationships and Staff Observations of Custom Tag (July 2014).

The Fair Value Dear CFO Letter and Fair Value Dear CFO Letter Addendum are discussed in more detail in § 4.06[4].

The Loan Losses Dear CFO Letter focused on the disclosures of certain public companies in MD&A regarding provisions and allowances for loan losses. The letter highlighted that the economic environment at the time might require companies to reassess the accounting and disclosures they made with respect to allowances for loan losses, and noted that additional information about higher-risk loans might be useful to an understanding of the risks associated with the company's loan portfolio and to evaluating any known trends or uncertainties that could have a material impact on results of operations. The letter also gave several examples of the types of information about higher-risk loans that a company might consider disclosing. In addition, the letter reminded CFOs that it would be "inconsistent with GAAP" if a company were to delay recognizing credit losses that could be estimated based on current information and events.

The Foreclosures Dear CFO Letter sent in October 2010 reminded certain public companies of their disclosure obligations in light of continued concerns about potential risks and costs associated with mortgage and foreclosure-related activities or exposures. The letter focused on obligations relating to various representations and warranties made in connection with securitization transactions and whole loan sales, intended in part to address ASC 450 disclosure with respect to any related litigation contingencies.

237 *See* Repo Dear CFO Letter, discussed in § 4.06[3][b].

238 Report of Examiner Anton R. Valukas, *In re Lehman Brothers Holdings, Inc.* at 732 (Mar. 2010). In a "repo" transaction, one party transfers securities to another as collateral for a short-term borrowing of cash, while simultaneously agreeing to repay the cash and take back the securities at a specific time in the future. When the repo matures, the borrower repays the funds it borrowed plus an agreed interest payment and takes back the securities it transferred as collateral. The securities transferred typically represent more than 100% of the value of the cash borrowed, the overcollateralization typically referred to as the "haircut" (the "haircut" providing security to the institution lending cash in the event the value of the collateral declines and the borrowing institution fails to repurchase the securities). In the "Repo 105" transactions, the haircut

employed by Lehman was 5%, higher than typically used in other similar repo transactions. Although more like a collateralized loan, Lehman Brothers treated such arrangements as a sale. In doing so, the securities sold in "Repo 105" transactions were temporarily taken off Lehman's balance sheet and the obligation to repurchase was not recorded as a liability, as would have been the case with a collateralized loan or similar transaction. Lehman would use the cash from the "Repo 105" transaction to pay down liabilities, thereby reducing the leverage it reported on its quarterly reports. A few days after the end of a quarter or year end, Lehman would borrow money again to repurchase the securities and pay interest on the loan of money. Often these "Repo 105" transactions were employed at the end of a reporting period, temporarily removing securities from Lehman's balance sheet, and gave investors a "materially misleading" picture of its financial condition. Report of Examiner Anton R. Valukas, *In re Lehman Brothers Holdings, Inc.* at 747 (Mar. 2010).

239 *See* Repo Dear CFO Letter.

240 *See* SEC Release No. 34-62932 (Sept. 17, 2010); SEC Release No. 34-62934 (Sept. 17, 2010).

241 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,895 (Sept. 28, 2010).

242 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,895–96 (Sept. 28, 2010).

243 *See* 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,894–95 (Sept. 28, 2010). Some of these topics had been addressed previously in the 2002 MD&A Statement and the 2003 MD&A Interpretive Guidance. *See* § 4.06[3][a].

244 *See* § 4.07[8].

245 SEC, Regulatory Flexibility Agenda, 78 Fed. Reg. 44,408 (July 23, 2013).

246 SFAS No. 157.

247 Fair Value Dear CFO Letter; Fair Value Dear CFO Letter Addendum.

248 *See*, *e.g.*, Andrew Ross Sorkin, *Are Bean Counters to Blame?*, NY TIMES, July 1, 2008; Louise Story, *A Values Debate (Not the Political Kind)*, N.Y. TIMES, May 16, 2008.

249 On September 30, 2008, the SEC and FASB staffs issued a joint press release clarifying various issues related to fair value measurements. *See* Press Release, SEC, SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting (Sept. 30, 2008). Soon after, on October 10, 2008, the FASB issued guidance on the matter and provided an example that illustrated the key considerations for issuers to consider when determining the fair value of a financial asset that did not have an active market. *See* FASB Staff Position 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (Oct. 10, 2008).

250 *See* § 133(a) of the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Division A, 122 Stat. 3765, 3798 (2008).

251 SEC, Report and Recommendations Pursuant to § 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting (Dec. 30, 2008).

252 Following the financial crisis, the FASB has continued to implement various amendments to fair value accounting standards. As part of the convergence of U.S. GAAP and IFRS, various revisions to fair value guidance were adopted in May 2011. *See* FASB ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. For many of the requirements, the FASB stated that it does not intend for the amendments to result in a change in the application of the requirements in ASC 820. Areas covered by the guidance include clarification as to how a principal market for a security is determined under U.S. GAAP, addressing the fair value measurement of instruments with offsetting market or counterparty credit risks and the concept of valuation premise and highest and best use, extending the prohibition on blockage factors to all three levels of the fair value hierarchy and requiring additional disclosures.

253 The 2002 MD&A Statement included examples of two tables that could be used together to accomplish this result. The first is a table that reconciles fair value at the beginning of the period to fair value at the end of the period. The table shows changes in fair value according to category depending on the source of the change in fair value and includes a category for changes due to changes in valuation methods. The second

table breaks down contracts by the source of the fair value estimation (prices actively quoted, prices from external sources, prices based on models and other valuation methods) and by maturity period (within one year, within years one through three, within years four and five and after five years). 2002 MD&A Statement, 67 Fed. Reg. 3746, 3750 (Jan. 25, 2002).

254 The rules apply to all reporting companies under the Exchange Act, but do not apply to investment companies registered under § 8 of the Investment Company Act, which are exempt from § 401 of the Sarbanes-Oxley Act. In addition, while the rules do apply to annual reports on Form 40-F filed by eligible Canadian companies under the U.S.-Canadian multijurisdictional disclosure system discussed in Chapter 13, they do not apply to Securities Act registration statements filed under that system. *See* SEC Release No. 33-8182 (Jan. 28, 2003).

255 Items 303(a)(4) and 303(a)(5) of Regulation S-K under the Securities Act; Form 20-F, Items 5.E and 5.F; Form 40-F, General Instructions B.(11) and B.(12). The Sarbanes-Oxley Act applied the off-balance sheet requirements to Exchange Act filings. The Rules adopted by the SEC extend § 401(a)'s mandate to include registration statements filed under the Securities Act.

256 The rules provide that a disclosure obligation would arise in respect of an off-balance sheet transaction only when a definitive agreement that is unconditional or subject only to customary closing conditions exists or, if there is no such agreement, when settlement of the transaction occurs. Form 20-F, Instruction 1 to Item 5.E.

257 Specifically, an "off-balance sheet arrangement" would include any guarantee contract that has any of the characteristics identified in paragraph 3 of FIN 45 and that is not excluded from the initial recognition and measurement provisions of FIN 45 pursuant to paragraph 6 or 7 thereof. The types of contracts that are described in paragraph 3 of FIN 45 are (i) certain contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in an "underlying" (as defined in FIN 45) that is related to an asset, a liability or an equity security of the guaranteed party, (ii) contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement, (iii) indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an "underlying" that is related to an asset, a liability or an equity security of the indemnified party, or (iv) indirect guarantees of the indebtedness of others, which arise under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events, under certain conditions.

Examples of the types of contracts covered by FIN 45 include financial standby letters of credit, market value guarantees, performance guarantees and keepwell agreements.

Paragraphs 6 and 7 of FIN 45 exclude a number of narrowly defined types of guarantees from the application of FIN 45, including among others product warranties, a parent's guarantee of a subsidiary's debt to a third party and a subsidiary's guarantee of a parent's or affiliated company's debt to a third party.

Although Form 20-F still references FIN 45, FIN 45 is now codified in Accounting Standards Codification 460, Guarantees.

258 Contracts having these characteristics are excluded from the scope of Accounting Standards Codification 815, Derivatives and Hedging ("ASC 815"), and therefore are not necessarily disclosed in the financial statements or notes thereto.

259 Form 20-F, Item 5.E.2. The term "variable interest" is used in the rules as referenced in FIN 46(R).

260 Form 20-F, Instruction 3 to Item 5.E. For a discussion of accounting matters regarding contingent liabilities arising out of litigation, arbitration or regulatory actions, *see* § 4.05[7].

261 FASB Statement No. 166 ("FAS 166") is contained in ASU No. 2009-16, which amends Accounting Standards Codification 860, Accounting for Transfers of Financial Assets. FASB Statement No. 167 ("FAS 167") is contained in ASU No. 2009-17, which amends Accounting Standards Codification 810, Improvements to Financial Reporting by Enterprises Involved with VIEs. FAS 166 and FAS 167 were codified as ASU No. 2009-16 and ASU No. 2009-17, respectively, when FASB reorganized and codified its

existing U.S. accounting and reporting standards issued by the FASB and other related private-sector standard setters in late 2009.

262 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5992 (Feb. 5, 2003). Foreign issuers whose primary financial statements are prepared in accordance with IFRS as issued by the IASB are not asked to look to U.S. GAAP in the same way, but they are asked in Instruction 5 to Item 5 of Form 20-F to "provide disclosure that satisfies the objective of the Item 5 disclosure requirements" regarding off-balance sheet arrangements when providing information that refers to pronouncements of the FASB.

263 *See*, *e.g.*, Form 20-F, Instruction 2 to Item 5.

264 In addition to affecting the off-balance sheet disclosures, FAS 166 and 167 affect financial statement disclosure regarding off-balance sheet transactions. *See supra* Note 86 and accompanying text for a discussion of the SEC's decision to accept financial statements of foreign companies prepared in accordance with IFRS as issued by the IASB without requiring a reconciliation to U.S. GAAP. As a general matter, issuers filing financial statements that comply with IFRS as issued by the IASB are instructed to, when responding to paragraphs in Item 5 that refer to FASB pronouncements, provide disclosure that satisfies the objective of the Item 5 disclosure requirement and need not repeat information contained in the IFRS financial statements. Form 20-F, Instruction 5 to Item 5.

265 Form 20-F, Item 5.E.1.

266 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5988 n.99 (Feb. 5, 2003).

267 This disclosure should explain to investors why the issuer engages in off-balance sheet arrangements and provide the information that investors need to understand the business activities advanced through those arrangements. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003).

268 While the adopting release with respect to the rules, SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003), did not mention any specific examples of such "triggering events," the proposing release indicated that adverse changes in the issuer's credit rating or financial ratios or changes in the value of underlying or indexed assets were potential examples. SEC Release No. 33-8144 (Nov. 4, 2002), 67 Fed. Reg. 68,054, 68,061 (Nov. 8, 2002).

269 If, for example, a specified decline in the issuer's credit ratings would give rise to an obligation to purchase assets from, or assume liabilities of, an unconsolidated entity, the adopting release with respect to the rules indicates that they would require the issuer to discuss known circumstances that are reasonably likely to cause the specified decline in ratings and its material consequences. SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003).

270 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5989 (Feb. 5, 2003); Form 20-F, Item 5.E.1. In December 2007, the Division of Corporation Finance made public an illustrative letter that it sent to a number of public companies using non-consolidated conduits, structured investment vehicles and off-balance sheet collateralized debt obligation structures for financing purposes. The division highlighted a number of specific items for possible disclosure, including: the categories, ratings and weighted-average life of the off-balance sheet assets; the forms of funding and weighted-average life of the funding held by an off-balance sheet entity; any material difficulties an off-balance sheet entity has experienced in issuing its commercial paper or other financing; any material write-downs or downgrades of assets held by an off-balance sheet entity; the issuer's obligations under liquidity facilities related to the off-balance sheet arrangements; and the potential impact on debt covenants, capital ratios, credit ratings or dividends should the issuer be required to consolidate an off-balance sheet entity or incur significant losses associated with it. SEC, Division of Corporation Finance, Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities) (Dec. 2007).

271 Form 20-F, Instruction 2 to Item 5.E.

272 Form 20-F, Instruction 5 to Item 5.E.

273 *See* SEC, Office of the Chief Accountant, Office of Economic Analysis and Division of Corporation Finance,

Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers at 98 (June 15, 2005). The report noted that a greater proportion of issuers report off-balance sheet arrangements in the notes to the financial statements, as compared to the off-balance sheet section of the MD&A. While recognizing that there may be a good reason for this in the case of FIN 45 guarantees (not all of which are covered by the MD&A line-item requirements), the staff nevertheless observed that issuers may not have identified all of the off-balance sheet arrangements that are required to be discussed in the off-balance sheet section of the MD&A.

274 Form 20-F, Instruction 4 to Item 5.E.

275 Unlike the required disclosures on off-balance sheet arrangements, the required tabular disclosure on contractual obligations is not required to appear in a separately captioned section of the MD&A. Form 20-F, Item 5.F.

276 Form 20-F, Item 5.F.1.

277 *See* Form 20-F, Instruction 2 to Item 5.F. If the GAAP used in the primary financial statements does not distinguish between capital (finance) leases and operating leases, all leases should be presented under a single category.

278 "Purchase obligation" is defined as "an agreement to purchase goods or services that is enforceable and legally binding on the registrant that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction." Item 303(a)(5)(ii)(D) of Regulation S-K under the Securities Act; Form 20-F, Item 5.F.2. The adopting release with respect to the rules provides that, among other things, if any purchase obligation is subject to variable price provisions, the issuer must provide estimates of payments due and footnote disclosure identifying payments subject to market risk (if material). SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5991 (Feb. 5, 2003).

279 In the 2010 MD&A Interpretive Guidance, the SEC noted that the "obligations table is to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements" and that "registrants should prepare the disclosure consistent with that objective." *See* 2010 MD&A Interpretive Guidance, 75 Fed. Reg. 59,894, 59,896 (Sept. 28, 2010).

280 For U.S. domestic issuers, Item 303(a)(5) of Regulation S-K requires a tabular disclosure of contractual obligation. In the Fast Act Report, the SEC staff recommended replacing such table with a hyperlink to the relevant financial statement notes that provide substantially similar disclosure.

281 Form 20-F, Item 5.G; *see also* § 4.06[1][a] (discussing safe harbor provisions under the Securities Act and the Exchange Act for forward-looking statements contained in MD&A). The statutory safe harbor provisions would not apply in all instances, including with respect to forward-looking statements contained in MD&As for IPOs. *See* SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5993 n.146 (Feb. 5, 2003).

282 SEC Release No. 33-8182 (Jan. 28, 2003), 68 Fed. Reg. 5982, 5993 & n.148 (Feb. 5, 2003).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.07, OTHER SIGNIFICANT DISCLOSURE ISSUES IN SEC FILINGS

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 § 4.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Plain English Principles

In 1998, the SEC issued a release (the "Plain English Release") [283] adopting a number of rules and rule amendments intended to reduce the complexity and enhance the clarity of prospectus disclosure. The Plain English Release requires companies to use "Plain English" principles in writing the front and back cover pages, summary and risk factor sections of prospectuses. [284] The Plain English Release identifies six such "Plain English" principles: active voice; short sentences; definite, concrete, everyday language; tabular presentation and "bullet lists" for complex material whenever possible; no legal jargon or highly technical business terms; and no multiple negatives. [285] In addition to these specific requirements, the Plain English Release amended Rule 421(b) under the Securities Act to require the general use of "Plain English" drafting techniques throughout a prospectus. [286] The SEC has since adopted "Plain English" principles for certain other documents. [287]

Many practitioners believe the "Plain English" initiative has improved disclosure. However, in its early years the "Plain English" initiative sometimes led to delays in SEC staff review of registration statements as "Plain English" comments were made and responded to. The number of such comments has declined significantly, and delays attributable to "Plain English" comments have essentially disappeared.

[2] Risk Factors

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Form 20-F requires foreign registrants to include material risk factors that are specific to the company, its industry and, in the case of an offering, the securities being offered. [288] Unlike Item 503(c) of Regulation S-K, which requires disclosure of risk factors for U.S. registrants and is silent on the ordering of risk factors, Form 20-F specifically encourages the companies to list the risk factors according to priority. The illustrative list of factors listed in Form 20-F includes:

- the nature of the business in which it is engaged or proposes to engage;
- factors relating to the countries in which it operates;
- the absence of profitable operations in recent periods;
- the financial position of the company;
- the possible absence of a liquid trading market for the company's securities;
- reliance on the expertise of management;
- potential dilution;
- unusual competitive conditions;
- pending expiration of material patents, trademarks or contracts; or
- dependence on a limited number of customers or suppliers.

The SEC has also encouraged companies to include a risk factor covering cybersecurity, if such risk is material to the investors in the company. [289] Under the Plain English Release, companies are required to draft risk factors in plain English. Although Form 20-F is not explicit on these points, foreign registrants should refer to Item 503(c) of Regulation S-K for guidance, which requires the use of subcaptions to describe the categories of risks factors and cautions against including generic risk factors that apply to any issuer or any offering. Further, the SEC staff has often commented that any language in a risk factor that mitigates the risk it covers should be removed. The SEC staff also often asks registrants to separate different risks into multiple risk factors instead of bundling them into one.

[3] Special Corporate Governance Rules

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Once companies become public in the United States, they also become subject to various substantive corporate governance requirements. These include the Exchange Act's requirement to maintain an adequate system of internal controls and certain other requirements imposed by the Sarbanes-Oxley Act with respect to corporate governance, management accountability and auditor independence, among others. The Dodd-Frank Act also imposes a number of substantive requirements on reporting companies, especially with respect to executive compensation and compensation committees, although foreign issuers are generally excluded from these requirements. Separately, NYSE and Nasdaq rules impose certain corporate governance requirements on listed companies. A more detailed discussion of these requirements is included in Chapter 5.

[4] Mine Safety Disclosure Requirements

Section 1503 of the Dodd-Frank Act [290] requires every reporting company that is an operator, [291] or has a subsidiary [292] that is an operator, of coal or other mines in the United States to make certain health- and safety-related disclosures in periodic reports and, for domestic companies covered by the rule, in current reports on Form 8-K. [293] These provisions thus apply to foreign issuers that operate or have subsidiaries that operate mines in the United States. The required disclosures include information about certain orders, violations and citations regarding mine safety and health standards under the Mine Act, proposed assessments from the U.S. Labor Department's Mine Safety and Health Administration ("MSHA") under the Mine Act, mining-related fatalities and pending legal actions before MSHA. The SEC's form requirements implementing § 1503 clarify that the disclosure must be provided for each mine and that no aggregation is permitted, and they confirm that all orders, violations or citations received

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during a period must be disclosed, even if they have subsequently been dismissed, reduced or settled or are contested by the company. [294]

Most of the disclosures must be included as an exhibit to the annual report on Form 10-K, Form 20-F or Form 40-F and to quarterly reports on Form 10-Q. [295] Some disclosures of U.S. issuers must also be made in current reports on Form 8-K within four business days of triggering events, while the Form 8-K requirements do not apply to foreign issuers. [296] In the Mine Safety Adopting Release, the SEC noted that it was "mindful of concerns that the disclosure requirement should be as equal as possible in order to avoid disadvantaging U.S. issuers in comparison to foreign issuers," but the final rule does not require foreign issuers to disclose mine safety information in current reports on Form 6-K that correspond to domestic issuers' requirements for disclosures on Form 8-K. No particular format is required for the disclosures, although the SEC encourages presentation in tabular format. EXtensible Business Reporting Language ("XBRL") format reporting of the disclosures is not currently required. [297]

Unlike the disclosures relating to conflict minerals, mine safety disclosures are automatically incorporated by reference in registration statements on Form S-3 (or F-3) under the Securities Act, but such information is not required in a long-form registration statement on Form S-1 (or F-1). [298]

[5] Oil and Gas Disclosure Requirements

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Major revisions to the SEC's rules governing disclosures about oil and gas activities took effect for Securities Act registration statements filed on or after January 1, 2010 and annual reports on Forms 10-K or 20-F for fiscal years ending on or after December 31, 2009. [299] The previously applicable special oil and gas disclosure rules for foreign issuers were eliminated, so foreign issuers are now subject to the same disclosure regime as U.S. domestic issuers (though this change does not affect Canadian issuers that file with the SEC pursuant to the Multi-Jurisdictional Disclosure System). [300] The revised rules, together with the oil- and gas-related disclosure requirements previously contained in Industry Guide 2, are now codified in new Subpart 1200 of Regulation S-K. [301]

In adopting the revised rules, the SEC recognized that its prior rules, adopted more than 25 years earlier, had not kept pace with subsequent significant developments in the oil and gas industry. These changes included major advances in the technology used to assess oil and gas reserves, substantially increased volatility in oil and gas prices, the rapidly growing importance of non-traditional sources of oil and gas and the increasingly geographic diversification of the industry (including significant growth both in the number of major non-U.S. oil and gas companies that file reports with the SEC and in the percentage of U.S. and non-U.S. oil and gas companies' reserves that are located outside the United States). [302]

The revised rules changed the pricing methodology used to determine the economic producibility of reserves. The price that is required to be used now is a 12-month average price, calculated based on the first day of each month, whereas a single-day period-end price was previously required. [303] This change addressed criticism that the single-day period-end price is not the preferable price to establish economic producibility of reserves since it is particularly subject to volatility and seasonality. Thus, it is expected that a 12-month average price will result in improved reserves estimates while maintaining comparability. Although the SEC acknowledged that historical prices are less useful than expected future prices in determining the fair value of a company's reserves, it did not permit

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use of expected future prices as a pricing methodology. The SEC believes reserves estimates are intended to permit comparison of reserves and not the fair value of reserves. [304] In addition, using future prices could require subjective judgments and result in diminished comparability due to differing assumptions. [305] Regardless of the pricing methodology used, price volatility leads to uncertainty and unintended consequences for disclosure and financial statements. This affects not only the value of the reserves but also the existence of economically producible reserves. The revised rules permit, but do not require, companies to provide a sensitivity analysis table to address this issue. [306]

Other changes will also affect determination of reserves. The revised rules permit the determination of reserves to be based on new technologies (other than just actual production or flow tests), so long as such technologies are empirically demonstrated to be reliable indicators of reserves volumes. [307] The revised rules also permit the calculation of reserves estimates using both deterministic and probabilistic methods, as well as the inclusion of analogous reservoirs in reserves calculations. [308]

Prior to the revised rules, disclosure of any reserves estimates other than proven reserves was prohibited. The revised rules permit (but do not require) the disclosure of probable and possible reserves. [309] Under the old rules, oil and gas

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companies widely disclosed amounts of probable and possible reserves by means other than through filings with the SEC, including through press releases and on their Internet websites. The revised rules recognized this market practice and the fact that investors seem to find this information helpful in assessing a company's reserves position. Many commenters opposed this disclosure and raised the issue of potential liability to the companies that may arise from including such information in SEC filings. [310] Underwriters will also be exposed to heightened liability if a company includes, or incorporates by reference, probable or possible reserves information in Securities Act filings. While liability issues might not be dispositive in the context of necessary or useful communications with investors and the market, in this case issuers have successfully followed the widely established market practice of disseminating this information outside SEC filings.

The revised rules introduced new definitions that are consistent with those used in the Petroleum Resources Management System ("PRMS") developed by the Society of Petroleum Engineers ("SPE") and other major industry organizations. [311] The definition of undeveloped proved reserves changes the "certainty" standard for non-adjacent undeveloped reserves to a "reasonable certainty" standard. The term "reasonable certainty" follows the PRMS definition and provides that for probabilistic methods reasonable certainty requires at least a 90% probability that quantities recovered will equal or exceed the estimate. [312] The definition also contains an "elaboration," which is consistent with the staff's prior position, to the effect that reasonable certainty embodies the concept that estimated ultimate recovery is much more likely to increase or remain constant than to decrease over time. [313] Moreover, in connection with the SEC's abandonment

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of its long-standing prohibition on disclosure of probable and possible reserves in SEC filings, the terms probable and possible reserves are now defined, consistent with the PRMS definitions.

The revised pricing methodology also applies to the accounting for oil and gas reserves by companies that follow the successful efforts method, as Accounting Standards Codification 932, Extractive Activities—Oil and Gas, as amended, refers to Regulation S-K definitions. This change allows consistency between the new reserves disclosure requirements and the U.S. GAAP accounting presentation of reserves. The SEC clarified that the pricing change should be applied prospectively only and does not require retroactive application. [314]

In response to the SEC's revised disclosure rules about oil and gas activities, in January 2010 FASB issued Accounting Standards Update No. 2010-03, Oil and Gas Reserve Estimation and Disclosures ("ASU 2010-03") to align its requirements for estimation and disclosure of oil and gas reserves under U.S. GAAP with the new SEC rules. ASU 2010-03 became effective for annual reporting periods ending on or after December 31, 2009.

The SEC acknowledged in the Oil and Gas Release the importance of providing consistency of standards and stated that it is communicating with the FASB and the IASB on these matters. [315] However, uncertainties exist in connection with IFRS. The IASB published a discussion paper on extractive activities in April 2010, [316] but it effectively discontinued this project in December 2012, in favor of a broader research project on intangible assets. A new discussion paper is expected to be published. [317]

Under the revised SEC rules, resources such as bitumen from oil sands and oil and gas from coal and shale are required to be disclosed as oil and gas activities instead of mining activities. [318] The SEC indicated that accounting changes as a result of non-traditional resources being accounted for under oil and gas accounting rules and not mining industry rules should be applied prospectively only and do not require retroactive application.

Finally, new Subpart 1200 of Regulation S-K imposed several new disclosure requirements relating to reserves, including principally the following:

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- more detailed geographic breakdowns of reserves information; [319]
- technologies used in estimation of reserves; [320]
- registrants' internal controls over the reserves estimation process; [321]

- the qualifications of the technical person at each registrant who is primarily responsible for reserves estimation; [322] and
- the filing of third-party reports comprising reserves audits or process reviews, if the issuer represents that a third party prepared or audited the reserves estimates or conducted a process review. [323]

The filed report can be a summary rather than the full report, and it must (in the case of a report on a reserves audit or third-party preparation of a reserves estimate) contain specified information. [324] In addition, where a report is included in or incorporated into a Securities Act registration statement, the third party must file a consent and is an "expert" for Securities Act purposes. [325]

[6] 2010 Interpretive Release on Disclosure of Climate Change Matters

On February 2, 2010, the SEC issued an interpretive release to provide guidance on existing SEC disclosure requirements as they apply to climate change. [326] In issuing the Climate Change Release, the SEC stated that its objective is to provide clarity on disclosure relating to climate change, including in an issuer's risk factors, business description, legal proceedings and MD&A. The SEC emphasized that the Climate Change Release does not impose any new legal requirements or modify existing ones. [327] In particular, the Climate Change

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Release does not, in and of itself, require an issuer to disclose its carbon footprint or the steps it is taking to reduce emissions. Although the Climate Change Release states that it is not intended to impose new disclosure requirements, the contemplated analyses appear in some cases to go beyond existing norms. For example, the Climate Change Release calls for extensive assessment of the prospects for and possible impacts of potential future climate change requirements, whether resulting from U.S. legislation or regulation or international accords. The SEC also emphasizes that, as this is a rapidly developing area, issuers should regularly assess their disclosure obligations. [328]

After generally summarizing the disclosure requirements of Regulation S-K and Regulation S-K of potential relevance for environmental matters, the Climate Change Release highlights four topics as examples in which climate change may trigger disclosure requirements. The Climate Change Release notes that while disclosure obligations of foreign issuers are governed by Form 20-F and not Regulation S-K, most of the disclosure requirements applicable to domestic issuers under Regulation S-K have parallels under Form 20-F. [329] In particular, the Climate Change Release highlights Item 3.D (material risks), Item 4.B.8 (material effects of government regulation), Item 4.D (environmental issues that may affect company utilization of its assets), Item 5 (MD&A) [330] and Item 8.A.7 (legal proceedings) as those under Form 20-F that might require disclosure concerning climate change matters material to an issuer's business. [331]

[a] Impact of Legislation and Regulation

The Climate Change Release notes that the financial impacts of legislation and regulation regarding climate change may implicate the following disclosure obligations, among others [332]:

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- Risk factor disclosure. According to the Climate Change Release, a company should consider the specific risks faced by the company or its industry sector and "avoid generic risk factor disclosure that could apply to any company." [333]
- MD&A disclosure. The Climate Change Release sets out a two-step analysis to the effect that a known uncertainty, such as pending climate change legislation or regulation, requires disclosure unless management determines either that the pending legislation or regulation is not reasonably likely to be enacted or that, if enacted, it would not be reasonably likely to have a material effect on the issuer, its financial condition or results of operations. [334]

The Climate Change Release also references various possible consequences of pending legislation and regulation that issuers should assess. [335]

[b] Impact of International Accords

The Climate Change Release states that an issuer should consider, and disclose when material, the risks or effects on its business of international accords and treaties relating to climate change (*e.g.*, the Paris Agreement, the Kyoto Protocol, the European Union Emission Trading Scheme and other international activities) just as it should do for U.S. legislation and regulation. [336]

[c] Indirect Consequences of Regulation or Business Trends

The Climate Change Release notes that indirect consequences or risks relating to climate change may need to be disclosed as risk factors, in MD&A or, if significant enough, in the business description. As examples, the Climate Change Release highlights the following possible indirect consequences or opportunities to be considered:

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- decreased demand for goods that produce significant greenhouse gas emissions;
- increased demand for goods that result in lower emissions than competing products;
- increased competition to develop innovative new products;
- increased demand for generation and transmission of energy from alternative energy sources;
- decreased demand for services related to carbon-based energy sources, such as drilling services or equipment maintenance services; and
- reputational damage related to the public's perception of any publicly available data relating to an issuer's greenhouse gas emissions. [337]

[d] Physical Impacts of Climate Change

The Climate Change Release states that issuers whose businesses may be vulnerable to severe weather or climate events should consider disclosure of material risks or consequences. Examples include property damage and operational disruptions to facilities in coastal areas; indirect effects from the impact of severe weather on suppliers or customers; for insurance companies, increased claims and liabilities; decreased agricultural production; and increased insurance costs or decrease in the availability of coverage. [338]

[7] Disclosure of Preliminary Merger Negotiations

There is some uncertainty as to the circumstances in which companies must disclose the existence of preliminary merger negotiations. In particular, companies question whether they must make such disclosure when they are filing registration statements or annual reports or at other times. In its release on MD&A disclosure, the SEC noted that its forms for periodic reporting under the Exchange Act generally do not require *pro forma* financial information in connection with material mergers and acquisitions or require disclosure of such transactions, until definitive agreement is reached or upon completion. [339]

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When a company registers securities under the Securities Act, however, the SEC requires disclosure in the registration statement of probable material acquisitions and dispositions of businesses, including in certain cases the financial statements of each business to be acquired as well as certain *pro forma* financial information. [340] When the proceeds from the sale of the securities being registered are to be used to finance an acquisition of a business, the registration statement must also disclose the intended use of proceeds. Companies are, however, permitted to omit from registration statements disclosure of the identity of the parties and the nature of the business sought, if the acquisition is immaterial or not yet probable and the board of directors determines that including such disclosure would threaten completion of the acquisition. Nevertheless, if financial statements are required to be included under the relevant rules, a more detailed description of the business to be acquired must be included. [341]

When disclosure is not otherwise required by these filing requirements, and has not otherwise been made, the MD&A in a registration statement or an annual report need not contain a discussion of the impact of preliminary merger negotiations if, in the issuer's view, inclusion of such information would threaten completion of the transaction. When disclosure is otherwise required or has otherwise been made by or on behalf of the issuer, the negotiations become subject to the same disclosure standards in the MD&A as any other known trend, commitment, event or uncertainty. [342]

[8] Guide 3 Disclosure Requirements for Bank Holding Companies

SEC Industry Guide 3 provides guidelines for statistical disclosures by foreign banks and bank holding companies in SEC filings. [343] It is intended to elicit information concerning the risks and uncertainties in banking operations to enable prospective investors to assess the issuer's financial condition and to differentiate among issuers in terms of income sources and risk exposure. Guide 3

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requires detailed disclosures concerning a foreign bank's assets, liabilities and equity accounts, interest rates and interest spreads, investment portfolio, loan portfolio, loan maturities, loan sensitivity to changes in interest rates, problem loans, loan concentrations, loan loss experience, other earning assets, deposits and return on equity and assets.

Because an issuer is required to disclose in a filing not only all required information concerning its operations and financial condition but also all material information necessary to make what is disclosed not misleading, disclosure may in certain circumstances have to go beyond the requirements of Guide 3. Moreover, the SEC has historically permitted some deviation from the specific requirements of the Guide if more meaningful disclosure with respect to a particular issue would thereby be provided. The disclosure requirements of Guide 3 are applicable to foreign companies to the extent the requested information is available. If the information is unavailable and cannot be compiled without unwarranted or undue burden or expense, this situation should be brought to the attention of the SEC staff at an early stage in the process of preparing for registration. If possible, reasonably comparable data should be furnished instead. In addition, while the SEC staff may allow an initial filing by a foreign issuer to be made without full compliance with Guide 3, the staff may condition such relief on more complete compliance in connection with filings for subsequent periods.

[9] Beneficial Ownership of Shares by, and Compensation of, Directors and Officers

A U.S. issuer is required to include in a registration statement or an annual report (or in a proxy statement if the Part III information of Form 10-K is incorporated by reference therefrom) a tabular disclosure of beneficial ownership of each class of equity securities of the issuer or its parents or subsidiaries by each of the directors (including director nominees) and named executive officers [344] and all directors and executive officers as a group. [345] A foreign issuer is subject to a similar requirement to disclose in a registration statement or an annual report information as to share ownership in the company by the directors and members

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of the administrative, supervisory or management bodies and options granted to them on the foreign issuer's shares. [346] This information must be provided on an individual basis [347] and include disclosure of the number of shares, percentage of shares of such class outstanding, any special voting rights and, with respect to options, the exercise and purchase prices, together with the expiration date(s) of the options. The term "beneficial ownership" for this purpose is defined in Rule 13d-3 under the Exchange Act for U.S. issuers and in General Instruction E of Form 20-F for foreign private issuers.

A U.S. issuer is also required to provide in a registration statement or an annual report (or in a proxy statement as described above) information about the individual compensation of each of its named executive officers and directors. [348] In contrast, foreign issuers may provide information concerning the remuneration of directors and members of its administrative, supervisory or management bodies in an aggregate amount in an SEC filing, unless the issuer is required to provide individual disclosure in its home jurisdiction or has otherwise made such data public. [349] A discussion of certain disclosure requirements related to shareholders that beneficially own 5% or more of an issuer's shares or control an issuer is included in § 6.03[2].

[10] Interested Party Transactions

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A U.S. issuer is required to describe in a registration statement any transaction between the issuer, on the one hand, and its management or any holder of more than 5% of the issuer's voting securities, on the other hand, involving an amount in excess of $120,000. [350] Foreign companies are also required to provide disclosure regarding interested party transactions, but only those that are material to the company or the interested party (or that are unusual), except that loans by the company to or for the benefit of an interested party must be disclosed regardless of amount. [351] If more detailed information is required to be disclosed by the foreign company's home jurisdiction or a market in which its securities are listed or traded or otherwise made publicly available, it should be disclosed pursuant to Item 404 of Regulation S-K. [352]

In the SEC's 2002 MD&A Statement calling for better-quality disclosure in several areas of the MD&A, the SEC also called for better-quality disclosure regarding related-party and similar transactions, noting that additional disclosure may be required when there are transactions involving parties, whether or not classified as related parties under applicable accounting regulations, that have relationships that enable them to negotiate terms of material transactions that might not be available on an arm's-length basis from clearly independent third parties. [353] Examples of such parties could include entities established by former senior management or by persons who have some other current or former relationship with the issuer.

The SEC has suggested that issuers consider including disclosure regarding all material transactions with such parties, together with a discussion of any terms that differ from those that would be available on an arm's-length basis. In describing these relationships, the SEC cautioned issuers to include information regarding the business purpose, the persons involved, how transaction prices were determined, how the transaction was evaluated for fairness (if such evaluation is stated to have been made) and any ongoing contractual or other commitments resulting from the arrangement.

[11] Derivatives Disclosure

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In 1997, the SEC adopted amendments to a number of rules and forms that imposed significant disclosure requirements on both domestic and foreign issuers with respect to derivatives and other financial instruments. [354] The amendments came in response to the substantial growth in the use of derivative instruments as a tool for managing market risk and the perceived deficiencies in companies' disclosure about their exposures to such risks, as well as the significant and well publicized losses experienced in recent years by some companies in market risk-sensitive instruments due to changes in, among other things, interest rates, foreign currency exchange rates and commodity prices.

The disclosure required under the 1997 rules is both specific and extensive. First, enhanced descriptions must be supplied in the footnotes to the financial statements with respect to accounting policies for derivative instruments. [355] Seven specified items must be considered, and must be addressed in the footnotes to the extent material. [356] Second, disclosure outside the financial statements must be made of both qualitative and quantitative information about derivative and other financial instruments. With respect to quantitative information about market risk associated with such instruments, registrants are generally required to present information as of the end of the latest fiscal year and to elect one of three alternatives: (i) tabular presentation of fair value information and contract terms relevant to determining future cash flows, categorized by expected maturity dates, (ii) sensitivity analysis expressing the potential loss in future earnings, fair values or cash flows from selected hypothetical changes in market rates and prices, or (iii) value-at-risk disclosures expressing such potential losses over a selected period of time with a selected likelihood of occurrence. [357] In preparing this quantitative information, registrants must group separately those

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instruments entered into for trading purposes and those entered into for other purposes and must, within each such group, present separate quantitative information for each market risk exposure category (*i.e.*, interest rate risk, foreign currency exchange rate risk, commodity price risk, etc.). [358] Different disclosure alternatives may be used for each of the separate disclosures. With respect to qualitative information, the requirements include a narrative discussion of a registrant's primary market risk exposures and how the registrant manages those exposures, as well as any changes in either of these areas relative to the most recent prior reporting period and what is known or expected in future periods. [359]

These derivatives disclosure provisions apply to a greater or lesser extent to all foreign registrants. Under Item 18 of Form 20-F, foreign issuers are required to provide all information required by Regulation S-K, including the footnote disclosure regarding derivatives accounting policies required by Rule 4-08 of Regulation S-K. Item 11 of Form 20-F, meanwhile, requires disclosure by all foreign issuers of the quantitative and qualitative information about market risk described above. As a practical matter, a foreign company whose portfolio includes significant derivative instruments and other financial instruments will almost certainly require sophisticated internal staff or sophisticated assistance from third parties in order to comply with these disclosure requirements. In addition to the cost of such assistance, the time that may be required to produce the necessary disclosure will need to be considered in planning any U.S.-registered offering. [360]

[12] Disclosure Regarding ADR Fees

Under Item 12D.3 of Form 20-F, an issuer is required to disclose in its annual report the fees and charges holders of ADRs may have to pay. The issuer

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must also disclose (i) any fees or charges for "general depositary services, particularly those charged on an annual basis" and (ii) whether the depositary has the right to collect fees and other charges by offsetting them against dividends or against deposited securities. [361] Item 12D.4 of Form 20-F also requires disclosure in registration statements and annual reports about payments from the depositary to the issuer. [362]

[13] Global Security Risk Disclosure; OFAC Sanctions; Section 13(r) (Iran)

In 2004, the SEC's Division of Corporation Finance established the Office of Global Security Risk. [363] The stated objectives of the Office of Global Security Risk are to (i) identify companies whose activities raise concern about global security risks that are material to investors, (ii) obtain appropriate disclosure where merited and (iii) share information as necessary and appropriate with other key government agencies responsible for tracking terrorist financing. The Office of Global Security Risk is charged with focusing on "asymmetric risk" by assisting SEC review staff in considering whether a U.S. or foreign company has operations or other exposure in areas of the world that may subject the company and its investors to material risk, trends or uncertainties. This consideration would include whether a company has operations in a country or area of activity where political, economic or other risks exist that are material, or whether the company faces public or government opposition, boycotts, litigation or similar circumstances that are reasonably likely to have a material adverse impact on its financial condition or results of operations. [364] The Office of Global Security Risk is required to provide quarterly reports on its activities to Congress. [365]

In June 2007, the SEC established a website in which it listed reporting companies that, based on disclosure in their annual reports, engaged in business

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in Cuba, Iran, North Korea, Sudan and Syria. The website also included links to the relevant sections of the companies' annual reports. [366]

Substantial criticism followed that the website did not fulfill its purpose of informing investors as to companies supporting the specified countries. In particular, it was suggested that some of the companies listed had disclosures to the effect that they were engaged in "negligible" activities or had even stopped their activities. The disclosures by the SEC on the website were characterized as "unfair and perhaps counterproductive." [367] The SEC took the website down in July 2007 and issued a concept release seeking comments as to whether and how the SEC should provide easier access to companies' disclosures concerning their business in or with countries designated as state sponsors of terrorism. [368] No further action on this subject followed the concept release. The staff continues to make comments seeking disclosure or additional details regarding issuers' activities that may implicate global security risk issues.

The SEC indicated in May 2001 that the staff would attempt to review all registration statements of foreign issuers engaged in material business activities in or with countries, governments or persons subject to sanctions administered by the U.S. Treasury Department's Office of Foreign Assets Control (the "OFAC Sanctions"). Under the OFAC Sanctions, dealings by U.S. persons (and, in some cases, the non-U.S. subsidiaries of U.S. persons) with such countries, governments and persons are restricted. [369]

Foreign issuers must apply traditional materiality standards when determining whether disclosure of operations or relationships with countries, governments or entities subject to OFAC Sanctions is necessary. If such disclosure is made, the SEC can be expected to review subject registration statements and request detailed explanations of relevant transactions. [370]

On August 10, 2012, President Obama signed the Iran Threat Reduction and Syria Human Rights Act of 2012 ("ITRA") into law. [371] Section 219 of ITRA added § 13(r) to the Exchange Act, under which any issuer of securities that is required to file quarterly or annual reports under § 13(a) of the Exchange Act

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must make specific disclosure in its public filings if it or an affiliate [372] has knowingly engaged in certain activities listed in § 13(r). [373] Disclosure must include: (i) the nature and extent of the activity; (ii) the gross revenues and net profits attributable to the activity; and (iii) whether the issuer or affiliate intends to continue the activity. The issuer is also obligated to file a separate notification of the disclosures to the SEC concurrently with the report. [374] As a result, while it is not per se illegal for non-U.S. companies listed in the United States to engage in business with U.S.-sanctioned parties linked to Iran, failure to make the disclosures required by § 13(r) will now constitute a violation of U.S. securities law and may result in civil and criminal penalties. [375]

[14] Interactive Data

In January 2009, the SEC adopted rules (the "XBRL Rules") requiring issuers reporting under U.S. GAAP or IFRS as issued by the IASB to provide financial statements to the SEC in XBRL. [376] The XBRL Rules currently apply only to foreign issuers that prepare their financial statements in accordance with U.S. GAAP or IFRS as issued by the IASB. Interactive data files will be filed as exhibits that supplement, but do not replace, the financial statements otherwise required to be filed. XBRL is an interactive data format that makes a company's financial statements machine-readable so they can be analyzed and compared

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using other software applications. Interactive data filing is designed to improve the usefulness of financial information submitted to the SEC by making it possible to download financial data directly into spreadsheets and other applications. Although many foreign countries have voluntary or pilot XBRL programs, the SEC is among the first to make XBRL filing mandatory. [377] Foreign issuers that file financial statements in accordance with IFRS as issued by the IASB were not required to file XBRL interactive data until the SEC publishes a taxonomy for IFRS on its website, which it did on March 1, 2017. They will now be required to file XBRL interactive data beginning with fiscal periods ending on or after December 15, 2017. [378]

Under the XBRL Rules, an electronic filer is required to submit an interactive data file exhibit with annual reports on Form 20-F and reports on Form 6-K that include updated or revised financial statements. [379] Electronic filers will also be required to submit interactive data files as exhibits to their Securities Act registration statements that include financial statements that are not incorporated by reference. [380] In such cases, the interactive data exhibit will not be required until a price or price range has been determined and will be required for later amendments only if the financial statements have changed. Registration statements for an IPO will not be required to include an interactive data file. Similarly, issuers will not be required to include an interactive data file when using Forms 10, 20-F or 40-F to register under the Exchange Act.

Issuers have incurred additional expenses in connection with filings of interactive data, and the time necessary to prepare interactive data files has put additional time pressure on at least some issuers, who have effectively been required to finalize their filings up to several days before what would otherwise have been the case, in order to accommodate the preparation of interactive data

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files. It is also not clear whether the utility of interactive data files to investors or regulators has justified burdens to date.

[15] Cybersecurity Disclosure

On October 13, 2011, the SEC's Division of Corporation Finance issued disclosure guidance on cybersecurity. [381] Although this guidance is not a rule or regulation, it provides the Division's view on adequate disclosure relating to cybersecurity risks and cyber incidents in light of recent highly publicized cyber-attacks on companies. The guidance uses the materiality standard to determine whether any cybersecurity disclosure is required. [382] For example, the guidance explains that cybersecurity risks should be disclosed as a risk factor if such risk is one of the "most significant factors that make an investment in the company speculative or risky." The guidance also suggests that a company should disclose cybersecurity risks or cyber incidents in the MD&A section, if such risks or incidents are reasonably likely to have a material impact on the company's financial results and operations. Other specific areas covered by the guidance include description of business, legal proceedings, financial statement disclosure, and disclosure controls and procedures. Lastly, companies are cautioned against providing generic "boilerplate" disclosure related to cybersecurity and are encouraged to provide meaningful disclosure that specifically applies to a particular company or industry.

Footnotes

283 SEC Release No. 33-7497 (Jan. 28, 1998).

284 SEC Release No. 33-7497 (Jan. 28, 1998), 63 Fed. Reg. 6370, 6370 (Feb. 6, 1998).

285 SEC Release No. 33-7497 (Jan. 28, 1998), 63 Fed. Reg. 6370, 6371 (Feb. 6, 1998).

286 SEC Release No. 33-7497 (Jan. 28, 1998), 63 Fed. Reg. 6370, 6371 (Feb. 6, 1998).

287 *See* Rules 13a-20 and 15d-20 under the Exchange Act and SEC Release No. 33-8732A (Aug. 29, 2006) (requiring the use of plain English in executive and director compensation, related-person transaction, beneficial ownership and corporate governance disclosures); *see also* Rule 14a-16(g) under the Exchange

Act, SEC Release No. 34-55146 (Jan. 22, 2007) and SEC Release No. 34-56135 (July 26, 2007) (requiring the use of plain English in the notice of Internet availability of proxy materials).

288 Form 20-F, Item 3.D.

289 SEC, Division of Corporation Finance, CF Disclosure Guidance: Topic No. 2 (Oct. 13, 2011). *See* § 4.07[15].

290 15 U.S.C. 78m-2. While § 1503 is not a part of and does not add provisions to the Exchange Act, it provides that a violation of § 1503 or any rules therein still be treated in the same manner as violations of the Exchange Act or rules thereunder.

291 The term "operator" has the meaning given to the term in § 3 of the Federal Mine Safety and Health Act of 1977, Pub. L. No. 91-173, 83 Stat. 742 (1969), as amended by Pub. L. No. 95-164, 91 Stat. 1290 (1977) (the "Mine Act"). *See* § 1503(e)(3) of the Dodd-Frank Act; 15 U.S.C. § 78m-2(e)(3).

292 The statute does not define the term "subsidiary," which would mean that the applicable definition would be the one in Item 1-02(x) of Regulation S-K.

293 Only mines subject to the Mine Act are covered. *See* § 1503(e)(2) of the Dodd-Frank Act; 15 U.S.C. § 78m-2(e)(2).

294 Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,765, 81,768 (Dec. 28, 2011). Under the final rule, a company may, however, provide additional information to give context. For example, a company could indicate that orders, violations or citations received during the year were subsequently dismissed, reduced or otherwise resolved. Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,768 (Dec. 28, 2011).

295 *See* § 1503(a) of the Dodd-Frank Act. Initially, many companies had made such disclosures in the report itself, but the final rule requires that the disclosures be made in an exhibit. Under the final rule, the body of the report includes a brief disclosure and refers to the exhibit with a cross reference. *See* Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,766 (Dec. 28, 2011). Of course, issuers should consider whether material information in the exhibits should be covered in other areas of the annual or quarterly report, *e.g.*, Risk Factors, MD&A, Description of Business or Legal Proceedings.

296 Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,775 (Dec. 28, 2011). Triggering events for an 8-K filing for a U.S. issuer include (i) an imminent danger order under the Mine Act, (ii) written notice from the MSHA of a pattern of violations of mandatory health or safety standards that are of such nature as could have significantly and substantially contributed to the cause and effect of coal or other mine health or safety hazards under the Mine Act and (iii) written notice from the MSHA of the potential to have a pattern of such violations. The SEC confirmed in the final rule that the untimely filing of required mine safety disclosures on Form 8-K will not result in loss of Form S-3 eligibility. *See* Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,776 (Dec. 28, 2011). Items reported on Form 8-Ks must be repeated in a company's next Form 10-Q or 10-K. *See* § 3.02[1][b] for a discussion of the eligibility criteria for an issuer to use Form F-3.

297 *See* Mine Safety Adopting Release, 76 Fed. Reg. 81,762, 81,767 (Dec. 28, 2011).

298 Mine Safety Adopting Release, 76 Fed. Reg. 81,767 (Dec. 28, 2011). *See* § 4.08 for a discussion of conflict minerals.

299 SEC Release No. 33-8995 (Dec. 31, 2008) ("the Oil and Gas Release"); *see also* SEC Release No. 33-8935 (June 26, 2008) (the "Oil and Gas Proposing Release"); SEC Release No. 33-8870 (Dec. 12, 2007) (Concept Release).

300 *See* Chapter 13 for discussion of the Multi-Jurisdictional Disclosure System.

301 *See* Items 1201 to 1208 of Regulation S-K under the Securities Act. The definitions adopted under the Oil and Gas Release are codified in Rule 4-10(a) of Regulation S-K.

302 *See* Oil and Gas Release, 74 Fed. Reg. 2157 (Jan. 14, 2009).

303 Rules 4-10(a)(22) and 4-10(c)(8) of Regulation S-K. In the Oil and Gas Proposing Release, the SEC proposed changing the disclosure rules to a 12-month average price, while maintaining the use of a single-day period-end price in the accounting rules.

304 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2160–61 (Jan. 14, 2009).

305 The Oil and Gas Release also notes that natural gas is sold through longer-term contracts in many situations and parts of the world where observable market inputs are not widely available. In such situations, comparability among different companies would differ depending on their assumptions, as those assumptions would be inherent in estimating future prices. In these situations, comparability between reserve estimates would be reduced if future prices were used. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2162 (Jan. 14, 2009).

306 Oil and Gas Release, 74 Fed. Reg. 2157, 2173–74 (Jan. 14, 2009). The SEC also reminded companies in the adopting release that Item 303 of Regulation S-K under the Securities Act for domestic companies (the "MD&A" section) and Item 5 of Form 20-F for foreign companies (the "Operating and Financial Review and Prospects" section) require discussion of known trends and uncertainties, which may include changes in prices and costs. In addition, companies should also consider whether to address price volatility risks in the form of risk factors. To determine the scope of the necessary disclosure, the standard a company should apply is whether the information it provides contains an untrue statement of a material fact or omits to state a material fact necessary to make what is disclosed not misleading. *See* §§ 11 and 12(a)(2) of the Securities Act and Rules 10b-5 and 12b-20 under the Exchange Act.

307 In adopting this standard, the SEC did not adopt provisions from the Oil and Gas Proposing Release that would have required the technology used to (i) be "widely accepted" as that standard would have excluded technologies developed internally that are proven to be reliable or (ii) have been proven empirically to lead to correct conclusions in 90% or more of its applications as such standard would have been difficult to verify and maintain. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2166 (Jan. 14, 2009).

308 Oil and Gas Release, 74 Fed. Reg. 2157, 2168 (Jan. 14, 2009).

309 *See* Instruction 2 to paragraph (a)(2) of Item 1202 of Regulation S-K under the Securities Act. "Probable reserves" are additional reserves that are less certain to be recovered than proved reserves but are as likely as not to be recovered. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2167 (Jan. 14, 2009). "Possible reserves" include additional reserves that are less certain to be recovered than probable reserves. *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2167 (Jan. 14, 2009). Nevertheless, disclosures of estimates of oil and gas resources other than reserves are still prohibited in any document publicly filed with the SEC unless the information is required to be disclosed by foreign or state law. Companies may still make this information available outside public filings, and they may still disclose this information publicly in filings related to acquisitions, mergers and other consolidations if the target in such transaction previously made those estimates available to the acquiror. Oil and Gas Release, 74 Fed. Reg. 2157, 2173 (Jan. 14, 2009); *see* Item 102 of Regulation S-K.

310 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2172–73 (Jan. 14, 2009).

311 PRMS was developed in 2007 by SPE in collaboration with the World Petroleum Council, the American Association of Petroleum Geologists, and the Society of Petroleum Evaluation Engineers. *See* SPE, Petroleum Resources Management System (Mar. 2007); *see also* Oil and Gas Release, 74 Fed. Reg. 2157, 2160, n.15 (Jan. 14, 2009).

312 Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009).

313 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009). In the Oil and Gas Proposing Release, the SEC proposed defining "reasonable certainty" as "much more likely to be achieved than not" but adopted the PRMS standard of "high degree of confidence that the quantities will be recovered." *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009). The SEC believes these two standards have the same meaning.

314 Oil and Gas Release, 74 Fed. Reg. 2157, 2164 (Jan. 14, 2009).

315 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2179–80, 2187 (Jan. 14, 2009).

316 For more information, *see* International Accounting Standards Board, DISCUSSION PAPER: EXTRACTIVE ACTIVITIES (Apr. 2010).

317 Deloitte, Extractive activities – Comprehensive project (IASPlus), http://www.iasplus.com/en/projects/completed/assets/extractives.

318 These activities are now included in the definition of "oil and gas producing activities." *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2163 (Jan. 14, 2009); *see also* Rule 4-10(a)(16) of Regulation S-K for the amended definition of "oil and gas producing activities."

319 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2170–71 (Jan. 14, 2009).

320 Item 1202(a)(6) of Regulation S-K under the Securities Act. Such disclosure is only required when the company has not previously disclosed reserves estimates in a filing with the SEC or is disclosing material additions to its reserves estimates.

321 Item 1202(a)(7) of Regulation S-K under the Securities Act.

322 Item 1202(a)(7) of Regulation S-K under the Securities Act.

323 Item 1202(a)(8) of Regulation S-K under the Securities Act.

324 *See* Oil and Gas Release, 74 Fed. Reg. 2157, 2175–76 (Jan. 14, 2009).

325 *See* § 11.03[1][c] for a discussion of "expertized" portions of disclosure documents and § 11 liability standards with respect to such disclosures.

326 SEC Release No. 34-61469 (Feb. 2, 2010), 75 Fed. Reg. 6290, 6295 (Feb. 8, 2010) (the "Climate Change Release").

327 The Climate Change Release notes that Rule 408 under the Securities Act and Rule 12b-20 under the Exchange Act require a registrant to disclose, in addition to the information expressly required by SEC regulation, "such further material information, if any, as may be necessary to make the required statements, in light of the circumstances under which they are made, not misleading." *See* Rule 408 under the Securities Act and Rule 12b-20 under the Exchange Act.

328 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

329 Climate Change Release, 75 Fed. Reg. 6290, 6295 (Feb. 8, 2010).

330 The SEC has indicated that although the wording in Item 5 of Form 20-F and Item 303 of Regulation S-K under the Securities Act (the item requiring MD&A disclosure for U.S. domestic companies) is not identical, the SEC interprets Item 5 as requiring the same disclosure as Item 303. *See* SEC Release No. 34-62932, 75 Fed. Reg. 59,866, 59,875 n.65 (Sept. 28, 2010).

331 Climate Change Release, 75 Fed. Reg. 6290, 6295 (Feb. 8, 2010).

332 The Climate Change Release also cites disclosure obligations under Item 101 of Regulation S-K under the Securities Act on disclosure of material estimated capital expenditures for environmental control facilities. Form 20-F does not include a specific Item requiring this precise disclosure, but, as noted above in Note 327, disclosure of material information is required if its omission would render what is disclosed misleading.

333 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

334 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

335 These factors include: (i) costs to purchase, or profits from sales of, allowances or credits under a "cap and trade" system, (ii) costs required to improve facilities and equipment to reduce emissions in order to comply with regulatory limits or to mitigate the financial consequences of a "cap and trade" regime, (iii) changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold, and (iv) favorable consequences, including new business opportunities and potential sale of allowances or offset credits. Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

336 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

337 Climate Change Release, 75 Fed. Reg. 6290, 6296 (Feb. 8, 2010).

338 Climate Change Release, 75 Fed. Reg. 6290, 6296–97 (Feb. 8, 2010).

339 U.S. companies that are subject to the reporting requirements of the Exchange Act must file certain

information within four business days after any acquisition or disposition of a significant amount of assets. Foreign companies that are subject to the reporting requirements of the Exchange Act also may be required to furnish such information to the SEC in a report on Form 6-K promptly after the information is otherwise made public. *See* the discussion of periodic reports in § 4.02[3][c]; *cf.* SEC Release No. 33-8400 (Mar. 16, 2004) (adopting rules to expand the events triggering Form 8-K filing requirements applicable to U.S. issuers, including the entry into a definitive material agreement, and shortening the filing deadline generally to four business days after a disclosable event).

340 *See* § 4.05[5][a].

341 1989 MD&A Release, § III.F.4, 54 Fed. Reg. 22,427, 22,435–36 (May 24, 1989).

342 1989 MD&A Release, § III.F.4, 54 Fed. Reg. 22,427, 22,436 (May 24, 1989); *see also Basic Inc. v. Levinson*, 485 U.S. 224 (1988). For a general discussion of the disclosure obligations of an SEC-reporting company under the U.S. securities laws, *see* § 4.02[3][a].

343 As discussed in § 3.05[2], securities issued or guaranteed by U.S. banks or U.S. branches of foreign banks are exempt from registration under § 3(a)(2) of the Securities Act. Thus, this guide applies only to obligations that must be registered, which are typically obligations of the holding company or a nonbank subsidiary or securities issued by a foreign bank (but not its U.S. branch). *But see* § 3.05[2] for a discussion of the Comptroller's securities offering disclosure rules for national banks and federal branches and agencies of foreign banks.

344 Item 402(a)(3) of Regulation S-K defines "named executive officers" as (1) all individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (2) all individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (3) the registrant's three most highly compensated executive officers other than the persons covered by clauses (1) and (2) who were serving as executive officers at the end of the last completed fiscal year; and (4) up to two additional individuals for whom disclosure would have been provided pursuant to clause (3) but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year.

345 Item 403(b) of Regulation S-K under the Securities Act.

346 Form 20-F, Item 6.E. General Instruction F of Form 20-F notes that for purposes of determining who to include among the group of persons covered by the term "administrative, supervisory or management bodies," an issuer should look to the meaning given to that phrase by such issuer's host country.

347 If any of the directors or members of the administrative, supervisory or management bodies beneficially own less than 1% of the class of shares and the individual ownership of such person has not been previously disclosed publicly, instead of disclosing the individual share ownership for that person, the foreign issuer may include an asterisk and an explanatory footnote that the person beneficially owns less than 1%.

348 Item 402 of Regulation S-K under the Securities Act; *see supra* Note 345.

349 Form 20-F, Item 6.B. Foreign issuers are required to file an employment or compensatory plan with management or directors (or portion of such plan) only when the foreign issuer either is required to publicly file the plan (or portion of it) in its home country or has otherwise publicly disclosed the plan. *See* Form 20-F, Instruction 4(c)(v) as to Exhibits; SEC Release No. 33-8732A (Aug. 29, 2006).

The adequacy of disclosure concerning director and officer compensation and related-party transactions was highlighted in the SEC's cease-and-desist order relating to the Walt Disney Company. The SEC found that, between 1999 and 2001, Disney failed to disclose relationships between the company and its directors that were required to be disclosed in its proxy statements and annual reports filed with the SEC. *See* Press Release, SEC, SEC Charges the Walt Disney Company for Failing to Disclose Relationships Between Disney and Its Directors; Disney Consents to a Cease-and-Desist Order (Dec. 20, 2004). In September 2004, the General Electric Corporation consented to the entry of an order that it cease and desist from violating the proxy solicitation and periodic reporting provisions of the federal securities laws. The SEC found that GE's 1997 to 2002 proxy statements and annual reports failed to fully and accurately disclose substantial retirement benefits provided to GE's former chief executive officer and chairman. *See* Press Release, SEC, General Electric Settles SEC Action for Disclosure Failures in Connection with Its Former CEO's Benefits Under His Employment and Retirement Agreement (Sept. 23, 2004). As indicated by these proceedings and the 2006 rule changes relating to executive compensation disclosure, the adequacy of director and officer compensation is a key regulatory focus of the SEC, and foreign issuers should take special care to ensure that the disclosure requirements concerning director and officer remuneration in Form 20-F are met.

350 Item 404(a) of Regulation S-K under the Securities Act.

351 Form 20-F, Item 7.B; *see also* § 402 of the Sarbanes-Oxley Act (prohibiting both U.S. and foreign issuers from directly or indirectly extending, maintaining, renewing or arranging for an extension of credit in the form of a personal loan to or for any executive officer or director of a subject issuer, as discussed in greater detail in § 5.04[2]).

352 Instruction 2 to Item 404 of Regulation S-K under the Securities Act; *see also* SEC Release No. 33-8732A (Aug. 29, 2006).

353 SEC Release No. 33-8056 (Jan. 22, 2002), 67 Fed. Reg. 3746, 3751 (Jan. 25, 2002).

354 SEC Release No. 33-7386 (Jan. 31, 1997) (the "Derivatives Disclosure Release"). Additional interpretive guidance is provided by the SEC staff's Questions and Answers about the New "Market Risk" Disclosure Rules (July 31, 1997). Rules adopted by the SEC to implement § 401(a) of the Sarbanes-Oxley Act further enhanced derivatives and financial instrument disclosure by requiring off-balance sheet arrangements to be disclosed in periodic reports and registration statements of subject issuers. *See* § 4.06[5][a].

355 Rule 4-08 of Regulation S-K ; ASC 815.

356 Such items include the various methods used to account for derivatives, the types of derivatives accounted for under each method and the criteria required to be met for each such accounting method to be used. When assessing materiality for this purpose, the SEC expects registrants to consider the financial statement effects of all derivatives, including those not recognized in the statement of financial position, and the relative effects of using the accounting method selected as compared to the other methods available. *See* Derivatives Disclosure Release, 62 Fed. Reg. 6044, 6047 (Feb. 10, 1997).

357 Form 20-F, Item 11(a). According to published highlights of a meeting of the AICPA SEC Regulations Committee's International Practices Task Force, the SEC staff has noted that when financial statements are updated in order to comply with the age of financial statements requirements as set forth in Item 8 of Form 20-F applicable to registration statements, an issuer must also update other "financial" information including its Qualitative and Quantitative Disclosure of Market Risk. *See supra* Note 106.

358 Derivatives Disclosure Release, 62 Fed. Reg. 6044, 6048 (Feb. 10, 1997).

359 Derivatives Disclosure Release, 62 Fed. Reg. 6044, 6051 (Feb. 10, 1997); Form 20-F, Item 11(b). Item 11 expressly provides that forward-looking disclosures made pursuant to its requirements are within the statutory safe harbors provided by § 27A of the Securities Act and § 21E of the Exchange Act. *See* §§ 4.06[5][c] and 11.03[5]. Moreover, the item makes clear that the safe harbors are, in this connection, available to all types of issuers and transactions (even though the safe harbors are generally not available to, for example, first-time registrants or in the case of an IPO), and state that the "meaningful cautionary statements" requirement of the safe harbors, which has proved difficult to apply in other contexts, will be deemed to be satisfied in the case of quantitative disclosures under Item 11(a) so long as the registrant satisfies the requirements of those Items.

360 In addition to complying with the derivative disclosures discussed in the text, a foreign issuer will have to take into account, in connection with its U.S. GAAP reconciliation (where such reconciliation is required), the accounting standard for derivatives, ASC 815.

361 *See* 2008 Form 20-F Reporting Enhancement Release, 73 Fed. Reg. 58,300, 58,311–13 (Oct. 6, 2008).

362 Payments from the depositary to the issuer, often but not always formulated as reimbursements of the

issuer's expenses, have been a common practice for many years, and, in our experience, they appear to have increased in recent years, at least for some issuers.

363 *See* H.R. Rep. No. 108-221, at 151 (2003) (directing the SEC to establish the Office of Global Security Risk).

364 *See* William H. Donaldson, Chairman, SEC, Testimony Before the Subcommittee on Commerce of the U.S. House of Representatives Committee on Energy and Commerce, Testimony Concerning Fiscal 2005 Appropriations Request for the U.S. Securities and Exchange Commission (Mar. 31, 2004).

365 H.R. Rep. No. 108-221, at 151 (2003).

366 *See* Press Release, SEC, SEC Adds Software Tool for Investors Seeking Information on Companies' Activities Known to Sponsor Terrorism (June 25, 2007).

367 *See* Letter from Barney Frank, Chairman, House Committee on Financial Services, to Christopher Cox, Chairman, SEC, Regarding SEC List of Terrorist-Financing States (June 12, 2007); Adam Sterling and Todd M. Malan, *The SEC's Flawed Terror List*, WALL ST. J., July 5, 2007, at A15; Jeremy Grant, *Outrage over SEC Terrorism 'Blacklist,'* FINANCIAL TIMES, June 28, 2007, at 1.

368 SEC Release No. 33-8860 (Nov. 16, 2007).

369 *See* § 9.08[1].

370 *See* § 9.08 for a detailed discussion of the OFAC Sanctions and other sanctions.

371 Iran Threat Reduction and Syria Human Rights Act of 2012, Pub. L. No. 112-158, 126 Stat. 1214 (2012) (§ 219 codified at 15 U.S.C. § 78m(r)).

372 On December 4, 2012, the SEC staff published an interpretation stating that the term "affiliate," for purposes of disclosure made pursuant to Exchange Act § 13(r), is used as defined in Exchange Act Rule 12b-2. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Forms, Question 147.03 (Dec. 4, 2012). *See also* Rule 12b-2 under the Exchange Act.

373 These activities include: (1) sanctionable activities under the 1996 Iran Sanctions Act (as amended), including provisions relating to the Iranian oil and gas industry, financial services, weapons of mass destruction ("WMD") and other activities; (2) sanctionable activities under the provisions of the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 and the Iranian Financial Sanctions Regulations relating to activities by foreign financial institutions; (3) sanctionable activities relating to goods, services or technologies likely to be used for human rights abuses; (4) any transactions or dealings with Specially Designated Nationals ("SDNs"), regardless of nationality, designated for their support of WMD proliferation or terrorist activity (*i.e.*, SDNs designated as "[SDGT]" (Specially Designated Global Terrorist) or "[WMD]"); or (5) any transaction or dealing with the "Government of Iran" as defined in OFAC Sanctions regulations, including the Iranian government, entities it owns or controls directly or indirectly, persons who are, or there is reasonable cause to believe are, acting on behalf of the foregoing, and any SDNs designated as "[IRAN]."

374 The SEC has created a new EDGAR form type, "IRANNOTICE," for filing such notification.

375 15 U.S.C. § 78ff(a). Any person who willfully violates the Exchange Act can be fined up to $5 million and/or imprisoned for up to 20 years. If such person is an entity, the fine may be up to $25 million.

376 *See* SEC Release No. 33-9002 (Jan. 30, 2009) (the "XBRL Release"). The SEC has created a website to provide detailed information about XBRL.

377 The XBRL Release lists Australia, Belgium, Canada, China, Denmark, France, Germany, Ireland, Israel, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Singapore, Spain, Sweden, Thailand and the United Kingdom as countries with such voluntary or pilot programs.

378 *See* SEC, SEC Posts Notice of Availability of IFRS Taxonomy (Mar. 1, 2017), available at https://www.sec.gov/news/pressrelease/2017-58.html ; *The Center for Audit Quality* (avail. Apr. 8, 2011). A "taxonomy" is an electronic glossary that allows issuers to "tag" information in their financial statements so the information converts into various interactive formats (charts, excel tables, *etc.*). *See* XBRL Glossary.

379 For a foreign issuer, this would apply when it files a Form 6-K with interim financial statements incorporated by reference into a Securities Act registration statement to meet the nine-month updating requirement of Item 8.A.5 of Form 20-F, but would not apply when a foreign issuer files a Form 6-K with interim financial statements that are not otherwise required to be filed. *See* Form 6-K, General Instruction C.6. For U.S. public companies, filings are required with annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

380 Where the financial statements are incorporated by reference, the related interactive data file will be filed as an exhibit to the report containing the incorporated financial statements. XBRL Release, 74 Fed. Reg. 6776, 6780 n.74 (Feb. 10, 2009).

381 SEC, Division of Corporation Finance, CF Disclosure Guidance: Topic No. 2 (Oct. 13, 2011).

382 The guidance notes that "material information regarding cybersecurity risks and cyber incidents is required to be disclosed when necessary in order to make other required disclosures, in light of the circumstances under which they are made, not misleading."

U.S. Regulation of the International Securities and Derivatives Markets, § 4.08, SPECIAL DISCLOSURES ON CONFLICT MINERALS AND RESOURCE EXTRACTION PAYMENTS

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 § 4.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Conflict Minerals

Section 1502 of the Dodd-Frank Act, requiring disclosures regarding "conflict minerals," was intended by Congress to further the humanitarian goal of ending the extremely violent conflict in the Democratic Republic of the Congo (the "DRC"), particularly sexual and gender-based violence, which has been partially financed by the exploitation and trade of conflict minerals originating in specified "covered countries." [383] Section 1502 directed the SEC to adopt new

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disclosure requirements under the securities laws to further this objective. In 2012, to implement this mandate, the SEC adopted Rule 13p-1 under the Exchange Act and Form SD. [384] These require disclosures by any reporting company [385] that manufactures or contracts to manufacture products for which conflict minerals are necessary to those products' functionality or production. Reporting foreign issuers, smaller reporting companies and voluntary filers are all subject to the rule; registered investment companies are not. [386] Suppliers (whether or not reporting companies) are also affected, as a reporting company needs extensive information from its suppliers to be able to prepare the required disclosure. [387] The SEC noted, when it adopted the rule, that "Congress chose to use the securities laws' disclosure requirements to bring greater public awareness of the source of the issuers' conflict minerals and to promote the exercise of due diligence on conflict mineral supply chains." [388]

"Conflict minerals" are defined in the rule as cassiterite, columbite-tantalite (coltan), gold and wolframite, and three derivatives of these minerals: tin, tantalum and tungsten (the "3Ts"). [389] These minerals and their derivatives are widely used in various types of products, including electronics, lighting, electrical and heating applications, and jewelry.

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Disclosures concerning conflict minerals are filed on Form SD and are subject to the liability provisions of § 18 of the Exchange Act, [390] in addition to the general antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder. [391] Form SD is not deemed incorporated by reference into any Securities Act filing, however, unless the company specifically incorporates it by reference. The conflict minerals disclosure must be filed annually on Form SD no later than May 31 (or, if May 31 is not a business day, on the next business day), [392] covering products manufactured in the prior calendar year by the issuer and its consolidated subsidiaries. If a subsidiary of the issuer also has reporting obligations under the Exchange Act, the issuer may file a single Form SD covering it and its consolidated subsidiaries. Disclosures must also be posted on the company's website and maintained there for at least one year. Notably, the Conflict Minerals FAQs clarified that failure to timely file a Form SD would not affect an issuer's eligibility to use Form F-3. [393]

An issuer that obtains control over a company that manufactures or contracts for the manufacturing of products with necessary conflict minerals, where the acquired company previously was not obligated to file a Form SD with respect to its conflict minerals, may delay reporting on the acquired company's products until the end of the first reporting calendar year that begins no sooner than eight months after the effective date of the acquisition. [394]

The conflict minerals rule adopted by the SEC in 2012 was almost immediately challenged in federal court by industry groups, which argued that the rule should be modified or set aside in whole or in part. [395] After extensive litigation, in April 2014 the petitioners prevailed on appeal in only one of their arguments, contending that the Dodd-Frank Act and the rule violate the First Amendment to the extent that they may require an issuer to report to the SEC and state on its website that any of its products have "not been found to be ‘DRC conflict free.’" [396] As a result of that decision, which was reaffirmed in August 2015, [397] and as discussed more fully below, the SEC provided guidance that an issuer

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covered by the rule is still required to file its Form SD by the applicable deadline in accordance with the rule in all respects, except that the filer is permitted not to identify any of its products with the descriptors "DRC Conflict Free," "DRC conflict undeterminable" or "not found to be ‘DRC conflict free.’" [398]

[a] Three-Step Process for Determining Scope of Disclosure

A reporting company subject to the conflict minerals disclosure requirements must inquire into the provenance of any conflict minerals necessary to the functionality or production of any product manufactured or contracted to manufacture by the company and its consolidated subsidiaries and disclose the results of that inquiry. This inquiry involves a three-step process: [399]

- *Step One* — The company must determine whether it manufactures or contracts to manufacture any products for which conflict minerals are necessary to the functionality or production of those products. If not, the company is not required to file Form SD or to make any disclosures. If so, it must proceed to Step Two.
- *Step Two* — The company must conduct a "reasonable country of origin inquiry" to determine whether its necessary conflict minerals originated in the covered countries or came from recycled or scrap sources. [400] If the company determines that (i) its necessary conflict minerals did not originate in a covered country or it has no reason to believe otherwise or (ii) its necessary conflict minerals came from recycled or scrap sources or it reasonably believes that to be the case, it must disclose its determination and briefly describe the reasonable country of origin inquiry and the results of the inquiry. The disclosure must be provided on Form SD and on the company's website. If the company determines or has reason to believe that any of its necessary conflict minerals originated in a covered country and are not from recycled or scrap sources, it must proceed to Step Three.
- *Step Three* — The company must conduct due diligence on the source and chain of custody of the conflict minerals. The due diligence must conform to a nationally or internationally recognized due diligence framework, if one is available. If the company's due diligence determines that a product does not

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contain necessary conflict minerals that directly or indirectly finance or benefit armed groups in a covered country, that product is considered "DRC conflict free." [401] The company must also prepare a detailed "Conflict Minerals Report," file it as an exhibit to Form SD and post it on the company's website. In certain circumstances described below, the company may also be required to obtain an independent private sector audit ("IPSA") of its Conflict Minerals Report. [402]

[b] Conflict Minerals Report

The Conflict Minerals Report, if required, must include a detailed description of the company's due diligence on the source and chain of custody of its conflict minerals (including the IPSA, if required), a statement that the company has obtained the IPSA if one is required, the name of the relevant auditor and the audit report, a description [403] of the products manufactured or contracted to be manufactured by the company that have not been found to be "DRC conflict free," the facilities used to process the conflict minerals used in those products, the country of origin of those minerals and the company's efforts to determine the mine or location of origin with the greatest possible specificity. [404] The company's due diligence measures do not need to be carried out constantly throughout the year; the measures can also begin before or extend beyond the calendar year covered by the Form SD. [405] If the company's due diligence process is relatively consistent throughout the supply chain, the description of the due diligence can be general, but if there are significantly different processes for various aspects of the supply chain (*e.g.*, for different minerals or products), those differences should be described. [406]

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The conflict minerals rule as originally adopted required certain descriptors to be used in a company's Conflict Minerals Report. [407] As noted above, the D.C. Circuit Court of Appeals decided in 2014 that the conflict minerals rule, and the underlying provision of the Dodd-Frank Act, violate the First Amendment to the extent that they require an issuer to report to the SEC and state on its website that any of its products have "not been found to be ‘DRC conflict free.’" [408] Following the decision, the director of the SEC's Division of Corporation Finance released a statement addressing the effect on the rule of the appeals court's decision. [409] Since the remainder of the rule was upheld and the appeals court had no First Amendment objection to any other aspects of the rule, the statement indicated that the Division expected that issuers required to file a Form SD under the rule would still do so on or before the due date of June 2, 2014, subject to the following guidance:

1. An issuer is not required to identify any of its products with the descriptors "DRC conflict free," "DRC conflict undeterminable" or "not found to be ‘DRC conflict free,’" but may voluntarily elect to do so.
2. An issuer should make all other disclosures called for in the rule, including a description of its reasonable country of origin inquiry and, if required to attach a Conflict Minerals Report, a description of the due diligence it undertook.
3. For any products that an issuer finds to be "DRC conflict undeterminable" or "not found to be ‘DRC conflict free’" in accordance with the rule and Form SD, while disclosures using these terms are not required, the issuer must still disclose the facilities used to produce the

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   conflict minerals, the country of origin of the minerals and the efforts to determine the mine or location of origin.
4. An IPSA is no longer required unless an issuer voluntarily elects to describe any of its products as "DRC conflict free" in its Conflict Minerals Report.

On May 2, 2014, the SEC issued a partial stay of the rule consistent with this guidance. [410] It has not taken any further action to modify the rule in response to the Court of Appeals decision.

A product is "DRC conflict free" if it does not contain conflict minerals that directly or indirectly finance or benefit armed groups in the covered countries. [411] Under the rule as originally written, after the transition period (now applicable only to smaller reporting companies), [412] if, after conducting due diligence, a company was unable to determine that (i) its conflict minerals did not originate in the covered countries, (ii) its conflict minerals that originated in the covered countries did not directly or indirectly finance or benefit armed groups, or (iii) its conflict minerals came from recycled or scrap sources, those products making use of any such minerals were required to be described as "not having been found to be ‘DRC conflict free,’" and the company had to provide the IPSA with respect to the related minerals in the Conflict Minerals Report. [413] The Conflict Minerals FAQs clarified that products that contain multiple conflict minerals from different sources must be described as "not having been found to be ‘DRC conflict free’" if even one of those minerals did finance or benefit armed

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groups in the covered countries. Similarly, if the company was unable to determine the source of even one of those minerals, it could not describe the product as "DRC conflict free." [414] However, neither the descriptor nor an IPSA are currently required pursuant to the 2014 SEC guidance.

[c] Key Definitions and Guidance

[i] *Definition of "Manufacture" and "Contract to Manufacture"*

The final rule does not define either "manufacture" or "contract to manufacture," but the SEC provided guidance for both terms in the Conflict Minerals Adopting Release.

A company that only services, maintains or repairs a product is not "manufacturing" the product. A company that assembles a product is "manufacturing" the product, however, even if it does not manufacture any of the components. Under the final rule, a mining company is not deemed to manufacture unless it also conducts manufacturing activities. [415] The Conflict Minerals FAQs clarified that "[a]n issuer that only engages in those activities customarily associated with mining, including gold mining of lower grade ore, is not considered to be manufacturing those minerals." [416]

If a company does not actually manufacture the product, it still may be considered to "contract to manufacture" it, and be subject to the rule. Whether a company "contracts to manufacture" depends on the degree of influence the company exercises over the materials, parts, ingredients or components included in the product, based on the individual facts and circumstances surrounding the company's business and industry. The term includes contracting to manufacture components of a product, and it could apply even if an issuer does not have "substantial" influence or control over the manufacturing of a product. A company is not "contracting to manufacture" if it only (1) specifies or negotiates contractual terms with a manufacturer that does not directly relate to the manufacturing of the product, such as training, technical support, price, insurance, indemnity, intellectual property rights or dispute resolution (unless it exercises a degree of influence over the manufacturing of the product that is practically equivalent to doing so); (2) affixes its brand, marks, logo or label to a generic product manufactured by a third party; [417] or (3) services, maintains or repairs a product manufactured

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by a third party. [418] In practice, the determination of whether a company is "contracting to manufacture" for purposes of the rule is a matter of significant judgment regarding the specific facts and circumstances.

[ii] *Definition of "Necessary"*

The SEC did not define "necessary to the functionality" or "necessary to the production" of a product, indicating that both depend on the company's particular facts and circumstances, but again provided guidance. For a conflict mineral to be considered "necessary," it must be contained in the product and have been intentionally added to the product or a product component rather than being a naturally occurring byproduct. [419] There is no *de minimis* exception; even minute or trace amounts of a conflict mineral in a product or product component could trigger disclosure obligations. [420]

In order to determine whether a conflict mineral is "necessary to the functionality" of a product, a company should consider whether the conflict mineral is necessary to the product's generally expected function, use or purpose. Where a product has multiple functions, a conflict mineral need only be necessary for one function to be considered necessary to the product as a whole. If the conflict mineral is incorporated for purposes of ornamentation, decoration or embellishment, the company should consider whether the primary purpose of the product is ornamentation or decoration. [421] The Conflict Minerals FAQs specifically clarified that the packaging and container for a product are not considered to be part of the product, even if the packaging or container is necessary to preserve the usability of the product up to and following the product's purchase; packaging and containers sold independently of the product are considered products in their own right. [422]

The following are not considered "necessary to the production" of a product: (1) a conflict mineral used as a catalyst or in a similar manner but that is not contained in the product, even in trace amounts; (2) a conflict mineral in a physical tool, machine or other equipment used to manufacture the product; [423] and (3) a conflict mineral included in materials, prototypes and other demonstration

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devices. [424] The SEC also provided guidance in its Conflict Minerals FAQs that services are not products, and equipment that a company may manufacture or contract to manufacture to allow it to provide a service is not itself a product for purposes of the rule. [425]

[d] Reasonable Country of Origin Inquiry

A company that reaches Step Two in the disclosure process must conduct a reasonable country of origin inquiry, which must be reasonably designed to determine whether the company's conflict minerals originated in a covered country or came from recycled or scrap sources, and which must be performed in good faith. The SEC did not specify what steps are necessary to meet that standard, stating in the Conflict Minerals Adopting Release that it is a facts-and-circumstances determination based on a company's size, products, relationships with suppliers and other factors, as well as the available resources, which will evolve over time. The SEC noted that a "reasonableness standard" is not absolute—certainty is not required, and there is no need for disclosure indicating that the determination is uncertain (although companies may wish to provide it). [426] Many companies preparing their first Form SD in 2014 used the more detailed due diligence procedures described below at § 4.08[1][e] as their Reasonable Country of Origin Inquiry, rather than having two separate sets of procedures, but the SEC Division of Corporation Finance staff later noted that companies should take care to distinguish between the two processes in their Conflict Minerals Reports. [427]

The Conflict Minerals Adopting Release states that a company may rely on supplier and smelter representations regarding the origination of the conflict minerals if the company has reason to believe the representations are true given the facts and circumstances, taking into account any applicable warning signs or other circumstances indicating that the conflict minerals may have originated in the covered countries or did not come from recycled or scrap sources. For example, a company would have reason to believe a smelter representation was true if the processing facility received a "conflict-free" designation by a recognized industry group that requires an IPSA of the smelter, or if the facility itself obtained an IPSA that is made publicly available. A company need not receive representations from all of its suppliers, however, so long as it designs the inquiry reasonably, performs the inquiry in good faith and does not ignore

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warning signs that some of its conflict minerals may have originated in the covered countries. [428]

[e] Nationally or Internationally Recognized Due Diligence Framework

A company that reaches Step Three in the disclosure process must conduct due diligence on the source and chain of custody of its necessary conflict minerals. The due diligence must conform to a nationally or internationally recognized due diligence framework, if one is available. [429] Currently, the only such framework in place is the OECD's "Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas." [430]

The OECD guidance contains supplements with specific guidance on implementation of the OECD due diligence framework for the supply chains of tin, tantalum, tungsten and gold. [431] It should be noted that the OECD framework generally aims "to help companies respect human rights and avoid contributing to conflict through their sourcing decisions," [432] and includes steps to prevent or mitigate the risk that they may be contributing to conflict; § 1502 of the Dodd-Frank Act and the final rule have the same overall goal, but take a disclosure-based approach and do not explicitly require a company to avoid using conflict minerals.

The OECD's Due Diligence Guidance consists of the following five steps:

1. *Establish strong company management systems*
   - Adopt and commit to a supply chain policy for minerals originating from conflict-affected and high-risk areas.
   - Structure internal management systems to support supply chain due diligence.

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   - Establish a system of controls and transparency over the mineral supply chain.
   - Strengthen company engagement with suppliers.
   - Establish a company level grievance mechanism.
2. *Identify and assess risks* [433] *in the supply chain*

   For upstream companies:
   - Identify the scope of the risk assessment of the mineral supply chain.
   - Map the factual circumstances of the company's supply chain(s), underway and planned.
   - Assess risks in the supply chain.

   For downstream companies:
   - Identify, to the best of their efforts, the smelters/refiners in their supply chain.
   - Identify the scope of the risk assessment of the mineral supply chain.
   - Assess whether the smelters/refiners have carried out all elements of due diligence for responsible supply chains of minerals from conflict-affected and high-risk areas.
   - Where necessary, carry out, including through participation in industry-driven programs, joint spot checks at the mineral smelter/refiner's own facilities.
3. *Design and implement a strategy to respond to identified risks*
   - Report findings to designated senior management.
   - Devise and adopt a risk management plan.
   - Implement the risk management plan, monitor and track performance of risk mitigation, report back to designated senior

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     management and consider suspending or discontinuing engagement with a supplier after failed attempts at mitigation.
   - Undertake additional fact and risk assessments for risks requiring mitigation or after a change of circumstances.
4. *Carry out an independent third-party audit of smelter/refiner’s due diligence practices*
   - Plan an independent third-party audit of the smelter/refiner's due diligence for responsible supply chains of minerals from conflict-affected and high-risk areas.
   - Implement the audit in accordance with set out audit scope, criteria, principles and activities.
5. *Report annually on the supply chain due diligence*
   - Annually report or integrate, where practicable, into annual sustainability or corporate

responsibility reports additional information on due diligence for responsible supply chains of minerals from conflict-affected and high-risk areas.

[f] Determination Whether Conflict Minerals "Directly or Indirectly Finance or Benefit Armed Groups"

The SEC has provided only limited guidance regarding how a company should determine whether its conflict minerals directly or indirectly finance or benefit armed groups in the covered countries. The SEC did not clarify what would constitute, for example, an "indirect benefit" to an armed group. Form SD defines the term "armed group" as "an armed group that is identified as a perpetrator of serious human rights abuses in annual Country Reports on Human Rights Practices under §§ 116(d) and 502B(b) of the Foreign Assistance Act of 1961" [434] relating to the covered countries. The SEC noted in the Conflict Minerals Adopting Release that authority to identify those perpetrators is assigned to the U.S. Department of State, and that the SEC lacks "the authority and expertise to provide further guidance or qualify the State Department's conclusions in this area." [435]

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The SEC suggests in the Conflict Minerals Adopting Release that the due diligence framework used would provide guidance to a company in determining whether its conflict minerals directly or indirectly finance or benefit armed groups in the covered countries. [436] The State Department guidance for commercial entities seeking to exercise due diligence on conflict minerals used in their products and on their suppliers [437] also provides guidance to companies in this determination, although the Conflict Minerals Adopting Release notes that it does not have a direct impact on the rule and a company need not rely solely on it in making the determination. [438]

One specific clarification the Conflict Minerals Adopting Release provides is that products are considered "DRC conflict free" if the conflict minerals contained in those products did not directly or indirectly finance or benefit armed groups in the covered countries at the time they were purchased and transported through the supply chain from the mine to the company even if at some later time an element of that supply chain becomes controlled by an armed group (and even if the money the company paid to purchase the conflict minerals is seized by the armed group and thus in fact benefits the armed group). [439]

[g] Independent Private Sector Audit

The IPSA, if required, must comply with standards established by the Comptroller General of the Government Accountability Office ("GAO"). The SEC indicated that the GAO does not intend to establish new auditing standards for the audit; auditors may use the provisions for either Attestation Engagements or Performance Audits in the generally accepted government auditing standards established by the GAO ("GAGAS," referred to as the Yellow Book). [440]

[i] *Audit Objective*

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The objective of the audit is to express an opinion or conclusion as to (i) whether the design of the company's due diligence measures as set forth in, and with respect to the period covered by, the Conflict Minerals Report is in conformity with, in all material respects, the criteria set forth in the nationally or internationally recognized due diligence framework used by the company, and (ii) whether the company's description of the due diligence measures in the Conflict Minerals Report is consistent with the due diligence process the company undertook. [441] The SEC has confirmed that the IPSA need not cover any matter beyond that objective, such as the company's reasonable country of origin inquiry. [442]

[ii] *Effect on Auditor Independence*

The Conflict Minerals Adopting Release states that it would not be inconsistent with the auditor independence requirements in Rule 2-01 under Regulation S-K if the independent public accountant also performs the IPSA of the Conflict Minerals Report, but that the engagement to perform the Conflict Minerals Report audit would be considered a "non-audit service" subject to the pre-approval requirements of Rule 2-01(c)(7) under Regulation S-K. [443]

[iii] *Audit Certification*

The statutory provision required the company to provide an "audit certification." The SEC's rule provided that this need not be signed by an officer of the company. Instead, the certification takes the form of a statement in the Conflict Minerals Report that the company obtained an IPSA. [444]

[h] Conflict Minerals from Recycled or Scrap Sources

Conflict minerals from recycled or scrap sources are considered DRC conflict free and do not require the company to prepare a Conflict Minerals Report. [445] However, if as a result of its reasonable country of origin inquiry the

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company has reason to believe its conflict minerals may not have been from recycled or scrap sources, it must exercise due diligence on the source and chain of custody of the minerals using a nationally or internationally recognized due diligence framework specifically for conflict minerals from recycled or scrap sources, where available. [446] Currently, the only such standard is the OECD standard for recycled gold. [447] There is no such due diligence framework for the 3Ts at this time. Where there is no such framework, the company must describe its due diligence measures in the Conflict Minerals Report, but need not obtain an IPSA regarding those recycled conflict minerals. [448]

The final rule tracks the OECD definition of "recycled metals"—minerals from recycled metals, including reclaimed end-user or post-consumer products and scrap process metals created during product manufacturing, but not minerals that are partially processed or unprocessed, or a byproduct from another ore. [449]

[i] Other Supply Chain Tracking and Reporting Initiatives

A number of other initiatives are focused on facilitating supply chain tracking and reporting. For example:

- In 2010, the Electronic Industry Citizenship Coalition ("EICC") and the Global e-Sustainability Initiative ("GeSI") launched the Conflict-Free Smelter ("CFS") Program, which identifies and validates conflict-free smelters and refiners. [450]
- The Public-Private Alliance for Responsible Minerals Trade ("PPA") established by the U.S. State Department and the U.S. Agency for International Development is working to establish a verifiable traceability scheme for the covered countries for conflict-free minerals. [451]

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- The International Conference on the Great Lakes Region of central Africa ("ICGLR"), comprised of 12 countries in that region, has established standards for traceability and certification of conflict minerals compliant with the OECD due diligence guidelines. Beginning in December 2012, the government and companies in each member country have had to comply with the standards upon export of the minerals, which is evidenced by a certificate that minerals are "conflict free." Any imports of the minerals from another member country must also be accompanied by such a certificate. [452] The DRC passed legislation in February 2012 requiring adherence to the ICGLR standards.

[j] International Context of Rule

Other jurisdictions and states have passed or are considering legislation or regulation relating to conflict minerals. In 2014, the European Commission proposed an integrated EU approach to stop profits from conflict minerals being used to fund armed conflicts. [453] The proposals included a regulation to increase transparency of the supply practices of importers, smelters and refiners in order to facilitate the responsible sourcing of tin, tantalum, tungsten and gold and encourage legitimate trade (the "Regulation"). The Regulation included a voluntary self-certification system for EU companies that chose to be "responsible importers." Under the proposed regulation, EU importers would need to exercise due diligence and provide audit assurances and disclosure information. The EU would also publish an annual list of EU and global "responsible smelters and refiners." In June 2016, the Council, European Parliament and European Commission reached an informal agreement on the text of the proposed Regulation. [454] However, the text goes beyond the Commission's "self-certification" approach, calling for mandatory due diligence checks, conducted according to OECD due diligence guidelines, for importers of tin, tungsten, tantalum and gold

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and their ores from certain areas, as well as smelters and refiners. Large EU firms that make or sell goods containing these minerals in their supply chain will also be encouraged to report on their sourcing practices based on a new set of performance indicators developed by the Commission. Final approval of the text of the Regulation is expected to occur in the first quarter of 2017.

[2] Resource Extraction Payments

On June 27, 2016, the SEC adopted a revised final rule, which, as discussed below, has now been disapproved by Congress, on specialized disclosure relating to payments to governments by companies engaged in resource extraction pursuant to § 1504 of the Dodd-Frank Act. [455] The SEC had initially approved a rule on disclosure of resource extraction payments in August 2012 (the "2012 Rule"), but that version of the rule was vacated by the U.S. District Court for the District of Columbia in July 2013. [456] The revised final rule under the Exchange Act (Rule 13q-1) and revised Form SD would have required disclosures by any company that was a "resource extraction issuer," defined as an issuer that is required to file an annual report with the SEC pursuant to § 13 or § 15(d) of the Exchange Act and that engages in the commercial development of oil, natural gas or minerals. [457] Reporting foreign issuers (including government-owned entities) [458] and smaller reporting companies would have been subject to the rule, while registered investment companies would not have been. [459]

As a result of action recently taken by the new U.S. Congress under the Congressional Review Act (the "CRA"), the revised rule adopted by the SEC on

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June 27, 2016 ceased to have effect as of February 3, 2017. [460] The mandate to the SEC under Dodd-Frank Act § 1504 to adopt a rule on the disclosure of resource extraction payments is still law, however, with a new deadline for the SEC to adopt a final rule by February 2018. [461] Any new rule would have to meet both the detailed prescriptions of § 1504 of the Dodd-Frank Act [462] and the prohibition under the CRA on reissuing a rule after disapproval. This could be difficult, and, separately, the Financial Services Chair of the U.S. House of Representatives has already proposed to repeal § 1504 itself. [463]

In the remainder of this section we discuss (a) how Dodd-Frank Act § 1504 relates to measures taken elsewhere in the world to enhance disclosure relating to resource extraction payments and (b) the legal challenges the SEC faced in adopting its rule. However, because the rule has ceased to have effect, and may not be reissued in the same form, we do not discuss it in any detail.

[a] International Context

The SEC summarized the congressional intention of Dodd-Frank Act § 1504 as being to support global efforts to improve transparency in extractive industries, to help combat corruption and to empower citizens of resource-rich countries to hold their governments accountable. [464]

Section 1504 of the Dodd-Frank Act is broadly derived from the Extractive Industries Transparency Initiative ("EITI"), a global initiative of a voluntary coalition of companies, governments, investor groups and non-governmental organizations that seeks to promote accountability for payments made by resource extraction companies to foreign governments by increasing transparency around these payments. "EITI compliant" countries undergo a reconciliation process in which company payments are matched with government revenues

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by an independent administrator. [465] The United States completed the process of becoming an EITI candidate country on March 19, 2014 and published its first report, covering calendar year 2013, on December 15, 2015. [466] In order to become fully EITI compliant, the United States must undergo a formal evaluation process conducted by an external, independent validator procured by the EITI International Secretariat. The validation process is scheduled to begin on April 1, 2018 and will assess the United States' progress in complying with the EITI requirements. [467]

The rule as adopted explicitly linked the disclosures it would have required to broader international efforts to better track and disclose resource extraction payments, including but not limited to the work of the EITI, directing that "[t]o the extent practicable, the rules … shall support the commitment of the Federal Government to international transparency promotion efforts relating to the commercial development of oil, natural gas, or minerals." [468]

The European Union has adopted two directives providing for disclosures similar to those under the now vacated Rule 13q-1. [469] Those rules apply to companies in the European Economic Area that are "large undertakings" or "public-interest entities" active in the extractive or logging industries, as well as companies in those industries that are admitted to trading on a European Union regulated market.

Canada has also adopted a federal resource extraction disclosure law, the Extractive Sector Transparency Measures Act ("ESTMA"), which came into force in 2015. [470] These rules apply to entities that engage in commercial development of oil, gas or minerals and are listed on a stock exchange in Canada, as well as entities that have a place of business in Canada, do business in Canada or have assets in Canada and meet certain other criteria. [471]

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Stock exchanges, such as the London Stock Exchange's Alternative Investment Market [472] and the Hong Kong Stock Exchange, [473] also have rules related to resource extraction payment disclosures for companies listed on those exchanges.

[b] Legal Challenge

As noted above, the mandate for the SEC to adopt a new resource extraction payments disclosure rule under § 1504 of the Dodd-Frank Act is still in effect, and the SEC is now required to issue a new rule by February 2018. [474] Even if § 1504 is not repealed, it is unlikely the SEC under the administration of President Trump will move quickly to propose a new rule unless compelled by a court to do so, as it was in 2015 after the 2012 Rule was vacated and the SEC was sued to implement the statutory mandate. The future of the rule remains unclear, but we provide a summary of the historical legal challenges to it below.

The U.S. Chamber of Commerce and three industry groups (the American Petroleum Institute ("API"), the Independent Petroleum Association of America and the National Foreign Trade Council) [475] challenged the 2012 Rule on October 10, 2012 [476] primarily based on the claims, among others, that (i) the required disclosures of sensitive, confidential information violated rights under the First Amendment to the U.S. Constitution protecting a person's rights against compelled speech and (ii) the SEC failed to adequately perform the cost-benefit analysis required by the Administrative Procedure Act. [477] In connection with the lawsuit, the plaintiffs also filed with the SEC a motion for a stay of the effectiveness of the 2012 Rule and the related amendments to

Form SD pending final

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resolution of their legal challenges. [478] The SEC denied the stay on November 8, 2012, and the rule and amendments to Form SD became effective on November 13, 2012. [479]

In a decision issued on July 2, 2013, the U.S. District Court for the District of Columbia granted the plaintiffs' motion for summary judgment; the court also issued a separate order vacating the 2012 Rule and remanding the matter to the SEC for further proceedings consistent with the court's Memorandum Opinion. [480] This delayed the implementation of the rule, which would otherwise have required disclosures beginning in 2014. The court found that (1) the SEC wrongly concluded that the statute requires reports of resource extraction payments to be publicly available (citing the statutory language requiring the SEC to make public only "a compilation of the information required to be submitted" to the SEC "to the extent practicable") [481] and (2) the SEC's failure to provide an exemption for payments in countries that prohibit disclosure was arbitrary and capricious. [482]

In September 2014, when the SEC had still not made a new rule proposal following the 2013 court decision vacating the initial version of the rule, Oxfam brought an action in federal court to compel the agency to adopt a rule as required by the Dodd-Frank Act. In September 2015, the court held that the SEC had unlawfully withheld action by not promulgating a final rule. [483]

The SEC adopted a revised final rule on June 27, 2016. The revised final rule was consistent with the 2012 Rule on the two issues that the District Court found problematic with the 2012 Rule: it required the disclosure to be publicly filed and provided no exemption for payments in countries that prohibit disclosure. In 2013, the District Court expressly reserved the constitutional argument that the disclosure of resource extraction payments is a prohibited instance of compelled speech.

Footnotes

383 The "covered countries" are the DRC and the "adjoining countries," which currently consist of Angola, Burundi, Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia. On January 31, 2017, acting SEC Chairman Piwowar directed the SEC staff to reconsider its guidance (discussed below) under the conflict minerals rule and whether any additional relief might be appropriate, stating that the disclosure requirements have resulted in a de facto boycott of minerals from parts of Africa and that it is unclear whether the costs associated with the rule have resulted in any of the desired benefits. The SEC is soliciting comments from interested parties on all aspects of the rule and guidance. *See* Michael S. Piwowar, Acting Chairman SEC, Reconsideration of Conflict Minerals Rule Implementation (Jan. 31, 2017).

384 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,352–53 (Sept. 12, 2012).

385 A foreign issuer that has a class of securities exempt from Exchange Act registration pursuant to Rule 12g3-2(b) under the Exchange Act is not required to provide conflict minerals disclosure under the rules as it does not file reports with the SEC under § 13(a) or § 15(d) of the Exchange Act. Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,286 (Sept. 12, 2012).

386 The SEC Division of Corporation Finance has published two sets of guidance setting forth the SEC staff's interpretation of certain provisions of § 13(p) of the Exchange Act, Rule 13p-1 under the Exchange Act and Form SD. SEC, Division of Corporation Finance, Dodd-Frank Wall Street Reform and Consumer Protection Act, Frequently Asked Questions, Conflict Minerals (Apr. 7, 2014 and May 30, 2013) ("SEC CM FAQs"), which we refer to together as the "Conflict Minerals FAQs." *See* SEC CM FAQs 1 and 3.

387 The Conflict Minerals Adopting Release estimated the total number of affected suppliers at approximately 278,000. *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,352–53 (Sept. 12, 2012). A 2015 report by the U.S. Government Accountability Office noted that many company representatives cited difficulties in obtaining information from suppliers as a reason they were unable to determine the country of origin of conflict minerals. *See* UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE, SEC CONFLICT

MINERALS RULE: INITIAL DISCLOSURES INDICATE MOST COMPANIES WERE UNABLE TO DETERMINE THE SOURCE OF THEIR CONFLICT MINERALS, 14 (Aug. 2015), http://www.gao.gov/assets/680/672051.pdf.

388 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,275 (Sept. 12, 2012).

389 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,285 (Sept. 12, 2012).

390 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,280 (Sept. 12, 2012). *See* § 11.05[1][c] for a discussion of § 18 of the Exchange Act and liability thereunder.

391 *See* § 11.04[2] for a discussion of § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

392 General Instruction B of Form SD.

393 SEC CM FAQ 12. *See* § 3.02[1][b] for a discussion of the eligibility criteria for an issuer to use Form F-3.

394 The Conflict Minerals FAQs also confirmed that a similar delay in reporting would be available to an issuer conducting an IPO, where such issuer need only start reporting for the first calendar year that begins no sooner than eight months after the effective date of the IPO registration statement. *See* SEC CM FAQ 11.

395 *See* § 4.08[1][b] for more information on the legal challenge to the conflict minerals rule.

396 *National Association of Manufacturers v. SEC*, 748 F.3d 359, 373 (D.C. Cir. 2014).

397 *See National Association of Manufacturers*, No. 13-5252 (D.C. Cir. 2015), rehearing *National Asssociation of Manufacturers v. SEC*, 748 F.3d 359 (D.C. Cir. 2014).

398 *In the Matter of Exchange Act Rule 13p-1 and Form SD: Order Issuing Stay*, SEC Release No. 34-72079 (May 2, 2014); Keith F. Higgins, Director, SEC, Division of Corporation Finance, Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule (Apr. 29, 2014).

399 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,279–80 (Sept. 12, 2012) for a more detailed discussion of each of the three steps.

400 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,280 (Sept. 12, 2012).

401 Following the 2014 D.C. Court of Appeals decision and subsequent SEC guidance, an issuer is not required to use the descriptor "DRC conflict free" in its Form SD. *See* § 4.08[1][b] for further discussion of the D.C. Court of Appeals decision and the related SEC guidance.

402 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,281–82, 56,299 (Sept. 12, 2012).

403 The SEC noted in the Conflict Minerals Adopting Release that an issuer may describe its products based on its own facts and circumstances because the issuer is in the best position to know its products and to describe them in terms commonly understood within its industry. Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,323 (Sept. 12, 2012). The Conflict Minerals FAQs clarify that an issuer is not required to describe its products using model numbers. *See* SEC CM FAQ 9.

404 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,320–21 (Sept. 12, 2012).

405 *See* SEC CM FAQ 20.

406 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,326 (Sept. 12, 2012). The Conflict Minerals Report need not include a full description of the design of the issuer's due diligence; however, the due diligence measures actually undertaken must be described in sufficient detail to allow the auditor preparing an IPSA to form an opinion about whether the description is consistent with the issuer's actual process. *See* SEC CM FAQ 21.

407 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,276 (Sept. 12, 2012).

408 On August 18, 2015, the same panel of the D.C. Circuit Court of Appeals reaffirmed its original 2014 judgment despite an intervening *en banc* decision of the full D.C. Circuit Court of Appeals in another case that upheld certain Department of Agriculture requirements for labeling meat products and took a different view of the applicable standard of review for government-compelled commercial speech. *See National Association of Manufacturers. v. SEC*, No. 13-5252 (D.C. Cir. 2015), rehearing *National Association of Manufacturers v. SEC*, 748 F.3d 359 (D.C. Cir. 2014); *American Meat Institute. v. U.S. Dep't of Agriculture*, 760 F.3d 18 (D.C. Cir. 2014), rehearing *en banc American Meat Institute. v. U.S. Dep't of Agriculture*, 746

F.3d 1065 (D.C. Cir. 2014). On March 4, 2016, the Department of Justice notified the Speaker of the House that it would not appeal the decision. *See* Letter from Loretta Lynch, Attorney General to Hon. Paul Ryan, Speaker, U.S. House of Representatives (Mar. 4, 2016), https://www.justice.gov/oip/foia-library/osg-530d-letters/3-4-2016.pdf/download. The district court is now expected to take action in accordance with the appeals court's ruling, and whether and when the SEC may come out with updated guidance is uncertain.

409 Keith F. Higgins, Director, SEC, Division of Corporation Finance, Statement on the Effect of the Recent Court of Appeals Decision on the Conflict Minerals Rule (Apr. 29, 2014).

410 *In the Matter of Exchange Act Rule 13p-1 and Form SD: Order Issuing Stay*, SEC Release No. 34-72079 (May 2, 2014).

411 § 13(p)(1)(D) of the Exchange Act.

412 While the initial two-year transition period has now passed for other filers, under the rule as originally written, smaller reporting companies (for which the transition period is four years) may still designate products "DRC conflict undeterminable" if, after conducting due diligence, the company is unable to determine that (i) its conflict minerals did not originate in the covered countries, (ii) its conflict minerals that originated in the covered countries did not directly or indirectly finance or benefit armed groups, or (iii) its conflict minerals came from recycled or scrap sources. Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,322–23, 56,344–45 (Sept. 12, 2012). If a company designates some of its products as "DRC conflict undeterminable," it is also not required to obtain an IPSA regarding the related minerals, but it must include in the Conflict Minerals Report a description of the steps it has taken or will take, if any, since the end of the period covered in its most recent prior Conflict Minerals Report to mitigate the risk that those minerals benefit armed groups, including any steps to improve its due diligence. However, neither the descriptor nor an IPSA are currently required pursuant to the 2014 SEC guidance.

For the definition of a "smaller reporting company" (generally, a company with a public float of at least $75 million), *see* Rule 12b-2 under the Exchange Act.

413 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,345 (Sept. 12, 2012).

414 *See* SEC CM FAQ 16.

415 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,290 (Sept. 12, 2012).

416 SEC CM FAQ 2. The specific mining company activities cited to exemplify those customarily associated with mining, and therefore not "manufacturing" for purposes of the rule, include transporting, processing, smelting and refining ores.

417 This point was emphasized in the Conflict Minerals FAQs. *See* SEC CM FAQ 4.

418 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,290–92 (Sept. 12, 2012).

419 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,296–97 (Sept. 12, 2012).

420 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,298 (Sept. 12, 2012).

421 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,297 (Sept. 12, 2012).

422 *See* SEC CM FAQ 6.

423 Even if tools, machines or other equipment were manufactured by an issuer to manufacture its products and subsequently sold by the issuer, the Conflict Minerals FAQs clarified that "the staff will not view their later entry into the stream of commerce as transforming them into products of that issuer." *See* SEC CM FAQ 8.

424 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,297–98 (Sept. 12, 2012).

425 *See* SEC CM FAQ 7.

426 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,314 (Sept. 12, 2012).

427 *See*, *e.g.*, Yin Wilczek, SEC Official Offers Three Pointers on Issuers' Conflict Mineral Disclosures, Bloomberg BNA, Sept. 19, 2014, *available at* http://www.bna.com/sec-official-offers-n17179895108.

428 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,312 (Sept. 12, 2012). The due diligence

guidance developed by the Organisation for Economic Co-operation and Development ("OECD") provides examples of red flags that should trigger increased diligence. *See* OECD DUE DILIGENCE GUIDANCE FOR RESPONSIBLE SUPPLY CHAINS OF MINERALS FROM CONFLICT-AFFECTED AND HIGH-RISK AREAS at 33–34, 79–80, 87–88 (3d ed. 2016) (the "OECD Due Diligence Guidance").

429 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,281, 56,326 (Sept. 12, 2012). Form SD and the Conflict Minerals Adopting Release provide guidance on how a company should conduct due diligence if there is no framework in place for a conflict mineral. *See* Item 1.01(c)(1)(v) of Form SD; Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,282 (Sept. 12, 2012).

430 *See* OECD Due Diligence Guidance.

431 OECD Due Diligence Guidance at 31, 61.

432 OECD Due Diligence Guidance at 3.

433 Although the OECD due diligence guidance defines "risks" generally to include any potential adverse impacts to the company or others in connection with its operations (including the supply chain), the guidance is focused on the risks that a company may be contributing to conflict, and a "high-risk area" (as opposed to a "conflict-affected area") may include areas of political instability or repression, institutional weakness, insecurity, collapse of civil infrastructure and widespread violence. *See*, *e.g.*, OECD Due Diligence Guidance at 13.

434 *See* Item 1.01(d)(2) of Form SD. *See also* § 1502(e)(3) of the Dodd-Frank Act, which has a similar, but not identical definition; Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,324 (Sept. 12, 2012).

435 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,324 (Sept. 12, 2012). *See also* Department of Commerce Reporting Requirements Under Section 1502(d)(3)(C) of the Dodd-Frank Act, World-Wide Conflict Mineral Processing Facilities (stating that Department of Commerce is unable to distinguish which facilities finance conflict in the covered countries).

436 For example, the OECD due diligence guidance notes that it is intended "to help companies respect human rights and avoid contributing to conflict through their sourcing decisions." OECD Due Diligence Guidance at 12. Accordingly, the due diligence framework is designed to allow companies to identify and prevent or mitigate "adverse impacts" associated with those decisions, which include financing or otherwise contributing to conflict.

437 U.S. Department of State, Bureau of Economic, Energy, and Business Affairs, Statement Concerning Implementation of Section 1502 of the Dodd-Frank Legislation Concerning Conflict Minerals Due Diligence (July 15, 2011).

438 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,323–24 (Sept. 12, 2012).

439 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,324 (Sept. 12, 2012).

440 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,328 (Sept. 12, 2012). An auditor that is not a certified public accountant may perform an IPSA if the audit meets the applicable requirements under the Performance Audit provisions in the Yellow Book. SEC CM FAQ 13.

441 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,329 (Sept. 12, 2012).

442 *See* SEC CM FAQs 17 and 18.

443 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,328–29 (Sept. 12, 2012). *See* § 5.03[1][b] for a discussion of Rule 2-01(c)(7) under Regulation S-K.

444 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,320 (Sept. 12, 2012).

445 If the company determines that the conflict minerals in some of its products come from recycled or scrap sources, but is also required to prepare a Conflict Minerals Report as to the conflict minerals in some of its other products, the report (and any required IPSA) need not include disclosures about the recycled or scrap sources. *See* SEC CM FAQ 19.

446 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,332 (Sept. 12, 2012).

447 *See* Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,332–33 (Sept. 12, 2012).

448 Conflict Minerals Adopting Release, 77 Fed. Reg. 56,274, 56,322 n.561 (Sept. 12, 2012).

449 *See* OECD Due Diligence Guidance at 12 n.1.

450 The CFS Program requires smelters and refiners to undergo a third-party audit to ensure that they have procured only from global conflict-free sources. To date, the CFS Program has identified 46 compliant tantalum smelters, 90 compliant gold smelters, 66 compliant tin smelters, and 39 compliant tungsten smelters. *See* CONFLICT-FREE SMELTER (CFS) PROGRAM: CONFLICT-FREE SMELTERS AND REFINERS, http://www.conflictfreesourcing.org/conflict-free-smelter-refiner-lists/ (last visited Dec. 28, 2016). The EICC operates a validated audit process ("VAP") program. A typical VAP audit includes a thorough document review, interviews with management and employees and a visual site survey. *See* EICC: VALIDATED AUDIT PROCESS, http://www.eiccoalition.org/standards/validated-audit-process (last visited Dec. 28, 2016).

451 *See*, *e.g.*, Fact Sheet, U.S. Department of State, Public-Private Alliance for Responsible Minerals Trade (Nov. 15, 2011); PUBLIC-PRIVATE ALLIANCE FOR RESPONSIBLE MINERALS TRADE (PPA), OVERVIEW (2015), and PUBLIC-PRIVATE ALLIANCE FOR RESPONSIBLE MINERALS TRADE, PARTICIPATION AND GOVERNANCE PROTOCOLS (Jan. 30, 2013).

452 *See*, *e.g.*, *ICGLR Regional Initiative against the Illegal Exploitation of Natural Resources (RINR)*, and ICGLR Regional Certification Mechanism (RCM)—Certification Manual. The ICGLR countries are Angola, Burundi, Central African Republic, Republic of Congo, the DRC, Kenya, Rwanda, South Sudan, Sudan, Tanzania, Uganda, and Zambia (which includes all covered countries).

453 European Commission, Proposal for a Regulation of the European Parliament and of the Council setting up a Union system for supply chain due diligence self-certification of responsible importers of tin, tantalum and tungsten, their ores, and gold originating in conflict-affected and high-risk areas (Mar. 5, 2014), http://trade.ec.europa.eu/doclib/docs/2014/march/tradoc_152227.pdf.

454 Press Release, European Parliament, Conflict minerals: MEPs secure mandatory due diligence for importers (June 16, 2016), http://www.europarl.europa.eu/pdfs/news/expert/infopress/20160615IPR32320/20160615IPR32320_en.pdf.

455 *See* Resource Extraction Payments Adopting Release, 81 Fed. Reg. 49,359 (July 27, 2016).

456 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5 (D.D.C. 2013). The U.S. Chamber of Commerce and three industry groups (the American Petroleum Institute ("API"), the Independent Petroleum Association of America and the National Foreign Trade Council) challenged the 2012 Rule. *See* § 4.08[2][b].

457 Resource Extraction Payments Adopting Release, 81 Fed. Reg. 49,359 (July 27, 2016); § 13(q)(1)(D) of the Exchange Act. Although the SEC has not explicitly defined the phrase "oil, natural gas or minerals," it is generally understood that the phrase as used in the U.S. securities laws includes coal, as well as gold and other metals. *See*, *e.g.*, *Penturelli v. Spector, Cohen, Gadon & Rosen*, 779 F.2d 160, 166 (3d Cir. 1985) (holding that fractional undivided interests in coal are encompassed by "fractional undivided interest in oil, gas, or other mineral rights" in the definition of "security" in § 2(a)(1) of the Securities Act); and SEC Industry Guide 7, which contemplates the inclusion of coal, among other things, in the term "mineral deposit."

458 Resource Extraction Payments Adopting Release, 81 Fed. Reg. 49,359, 49,400 (July 27, 2016).

459 Resource Extraction Payments Adopting Release, 77 Fed. Reg. 56,365, 56,390 n.390 (Sept. 12, 2012).

460 The recent adoption of the final rule made it available for disapproval by the new Congress under the CRA, and, now that Congress has disapproved it, the rule is treated as if it had never taken effect. *See* H.R.J. Res. 41, 115 th Cong. (2017), Pub. L. No. 115-4 (2017).

461 5 U.S.C. § 803.

462 § 1504 of the Dodd-Frank Act added § 13(q) to the Exchange Act, which directs the SEC to issue rules requiring resource extraction companies to include in an annual report information relating to any payment made by the company, a subsidiary of the company, or an entity under the control of the company, to a foreign government or the federal government for the purpose of the commercial development of oil, natural

gas, or minerals. Section 13(q) requires a resource extraction company to provide information about the type and total amount of such payments made for each project related to the commercial development of oil, natural gas, or minerals, and the type and total amount of payments made to each government.

463 *See* H.R. 5983, 114 th Cong. (2016).

464 Resource Extraction Adopting Release, 81 Fed. Reg. 49,359, 49,361 (July 27, 2016).

465 *See* The EITI Standard (Feb. 23, 2016). *See also* The International Bank for Reconstruction and Development/The World Bank, IMPLEMENTING THE EXTRACTIVE INDUSTRIES TRANSPARENCY INITIATIVE: APPLYING EARLY LESSONS FROM THE FIELD (2008).

466 *See* the United States Extractive Industries Transparency Initiative, 2015 Executive Summary, *available at* https://useiti.doi.gov/downloads/USEITI_executive-summary_2015-12-22.pdf.

467 *See* EITI Standard, Part I, Chapter 3 (Feb. 23, 2016) for full EITI Requirements and *United States of America*, EITI.ORG, https://eiti.org/united-states-america (last visited Dec. 28, 2016).

468 Resource Extraction Adoption Release, 81 Fed. Reg. 49,359, 49,361 (July 27, 2016).

469 Council Directive 2013/34, 2013 O.J. (L 182) 19–76 (EU) (the "EU Accounting Directive"); Council Directive 2013/50, 2013 O.J. (L 294) 13–27 (EU) (the "EU Transparency Directive" and, together with the EU Accounting Directive, the "EU Directives").

470 S.C. 2014, c. 39, s. 376 (Can.).

471 The rules apply if, during at least one of the previous two financial years, relevant companies have met at least two of the following criteria: (i) have at least C$20 million in assets, (ii) have generated at least C$40 million in revenue, or (iii) employ an average of at least 250 employees.

472 *See* Note for Mining and Oil and Gas Companies – June 2009, *available at* http://www.londonstockexchange.com/companies-and-advisors/aim/advisers/rules/guidance-note.pdf.

473 *See* the Main Board Listing Rules (Chapter 10.05(6)(c)) and the Growth Enterprise Market (GEM) Board Listing Rules (Chapter 18A.05(6)(c)) of the HKSE, *available at* https://www.hkex.com.hk/eng/rulesreg/listrules/mbrules/documents/chapter_18.pdf and https://www.hkex.com.hk/eng/rulesreg/listrules/gemrules/documents/chapter_18a.pdf, respectively.

474 H.R.J. Res. 41, 115 th Cong. (2017), Pub. L. No. 115-4 (2017).

475 The API represents over 500 companies involved in all aspects of the U.S. and international oil and gas industry, including exploration, production, refining, marketing, distribution and marine activities. The Independent Petroleum Association of America and the National Foreign Trade Council are trade associations that represent thousands of oil, natural gas, mining and service companies.

476 Complaint, *American Petroleum Institute v. SEC*, No. 12-1668 (D.D.C. filed Oct. 10, 2012). On the same day that they filed their complaint in the U.S. District Court for the District of Columbia, these groups also filed a Petition for Review in the U.S. Court of Appeals for the District of Columbia Circuit; the appeals court dismissed the petition for lack of jurisdiction. *American Petroleum Institute v. SEC*, 714 F.3d 1329 (D.C. Cir. 2013).

477 5 U.S.C. §§ 551-559.

478 Motion for Stay of Rule 13q-1 and Related Amendments to New Form SD by Am. Petroleum Inst., Chamber of Commerce of the U.S., Indep. Petroleum Ass'n of Am., and Nat'l Foreign Trade Council (Oct. 25, 2012).

479 SEC Release No. 34-68197 (Nov. 8, 2012) (Order denying stay).

480 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5 (D.D.C. 2013).

481 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5, 17–20 (D.D.C. 2013).

482 *American Petroleum Institute v. SEC*, 953 F. Supp. 2d 5, 20–23 (D.D.C. 2013).

483 *See Oxfam America, Inc., v. SEC*, 126 F. Supp. 3d 168 (D. Mass. 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.09, DISCLOSURE OF NON-GAAP FINANCIAL MEASURES

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 § 4.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Rules adopted by the SEC to implement § 401(b) of the Sarbanes-Oxley Act amended Form 20-F to impose more stringent conditions on SEC filings containing non-GAAP financial measures (a term used by the SEC to identify the

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"*pro forma*" information targeted by § 401(b) of the Sarbanes-Oxley Act). These rules are contained in Item 10(e) of Regulation S-K [484] and Regulation G. [485]

[1] Definitions

"Non-GAAP financial measures" are defined as numerical measures of an issuer's historical or future financial performance, financial position or cash flows that (i) exclude amounts, or are subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer or (ii) include amounts, or are subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented. [486] Financial measures that an issuer is required to disclose under GAAP, SEC rules or a system of regulation of a government or governmental agency or self-regulatory organization that is applicable to the issuer are, however, exempt. [487] The SEC has indicated that measures of capital or reserves calculated for regulatory purposes would fall within this exclusion. [488]

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For purposes of the rules, "GAAP" refers to generally accepted accounting principles in the United States, except that (i) in the case of foreign issuers whose primary financial statements are prepared in accordance with non-U.S. GAAP, the term GAAP refers to the principles under which those primary financial statements are prepared and (ii) in the case of foreign issuers that include a non-GAAP financial measure derived from or based on a measure calculated in accordance with U.S. GAAP, GAAP refers to U.S. GAAP for purposes of the application of these rules to the disclosure of that measure. [489]

The SEC has stated that the term "non-GAAP financial measure" is intended to include all measures that have the effect of depicting either a measure of performance that is different from that presented in the financial statements (such as income or loss before taxes or net income or loss as calculated in accordance with GAAP) or a measure of liquidity that is different from cash flow or cash flow from operations calculated in accordance with GAAP. [490] The SEC has provided further guidance as to what items are intended to be excluded from the definition of "non-GAAP financial measure." For example, "non-GAAP financial measure" would not include:

- ratios or measures calculated using only (i) financial measures calculated in accordance with GAAP and (ii) operating measures or other measures that are not non-GAAP financial measures; or
- operating and other statistical measures (such as unit sales, "same store sales," numbers of employees, numbers of subscribers or numbers of advertisers). [491]

In addition, measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP are not non-GAAP financial measures. [492]

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The SEC has confirmed that, notwithstanding the use of the term "*pro forma*" financial information in § 401(b) of the Sarbanes-Oxley Act, *pro forma* financial information presented pursuant to Article 11 of Regulation S-K (*e.g.*, required disclosures relating to certain acquisitions or divestitures) is not subject to these rules.

[2] Requirements under Item 10(e) of Regulation S-K

Under the rule, all subject filings that include a non-GAAP financial measure must also include:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP; [493]
- a reconciliation (by schedule or other clearly understandable method), which must quantify the differences between the non-GAAP financial measure disclosed and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP; [494]
- a statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful

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information to investors regarding the registrant's financial condition and results of operations; [495] and
- to the extent material, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure that are not disclosed under the preceding bullet point. [496]

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In addition, subject to a limited exception for foreign issuers discussed below, filings may not:

- exclude charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP *liquidity* measures, other than EBIT (earnings before interest and taxes) and EBITDA (earnings before interest, taxes, depreciation and amortization); [497]
- present non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
- present non-GAAP financial measures on the face of any *pro forma* financial information required to be disclosed by Article 11 of Regulation S-K ;
- use titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures; [498] or

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- adjust a non-GAAP *performance* measure to eliminate or smooth items identified as nonrecurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or where there was a similar charge or gain within the prior two years. [499]

With respect to the last prohibition, C&DIs state that it is based on the *description* of the item being adjusted, rather than its nature. In other words, the rule does not prohibit adjustment for recurring items. It prohibits characterizing an item as nonrecurring, infrequent or unusual unless it, in fact, meets the specified criteria. This guidance marked a significant change as compared to the SEC's previous guidance in this area, which has been eliminated, under which the SEC had articulated burdens and conditions that, together with staff practices under the guidance, led companies to avoid using non-GAAP performance measures in SEC filings, unless the adjustments were for nonrecurring items only. Instead, the Non-GAAP Measures C&DIs emphasize clear disclosure and explanation surrounding the use of non-GAAP financial measures in accordance with Item 10(e). [500]

These prohibitions will not, however, apply to a non-GAAP financial measure included in a filing of a foreign issuer, provided that the non-GAAP financial measure:

- relates to the GAAP used in the issuer's primary financial statements included in its filings with the SEC;

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- is required or expressly permitted by the standard-setter that is responsible for establishing the GAAP used in such financial statements; and
- is included in the annual report prepared by the issuer for use in its home jurisdiction or for distribution to its securityholders. [501]

The prohibitions in Item 10(e) of Regulation S-K do not apply to non-GAAP financial measures contained in disclosures subject to the SEC's rules regarding communications in connection with business combinations. [502]

[3] Requirements under Regulation G

Unlike Item 10(e) of Regulation S-K, Regulation G extends beyond SEC filings to all public disclosures of non-GAAP financial measures by issuers. Regulation G thus joins the general antifraud provisions of the federal securities laws and Regulation FD in covering an issuer's public statements generally and not only statements in SEC filings. [503]

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Under Regulation G, whenever an issuer required to file reports under the Exchange Act publicly discloses (other than disclosure subject to Regulation M-A) material information that includes a non-GAAP financial measure, it must accompany that disclosure with:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with generally accepted accounting principles, [504] and
- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable financial measure or measures calculated and presented in accordance with generally accepted accounting principles. [505]

Regulation G permits the public presentation of non-GAAP financial measures orally, telephonically, by webcast or broadcast or by similar means without requiring the additional disclosure, provided that the most directly comparable financial measure using generally accepted accounting principles and the required reconciliation are provided on the issuer's website at the same time, and the location of the website is also included in the public presentation. [506]

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Regulation G contains an antifraud provision prohibiting the publication of any non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. [507] However, noncompliance with Regulation G does not in itself affect any person's liability in a private cause of action under the antifraud provisions of § 10(b) of the Exchange Act or Rule 10b-5 thereunder. An issuer that fails to comply with Regulation G could be subject to an SEC enforcement action under Regulation G and, if warranted by the facts and circumstances, an enforcement action pursuant to § 10(b) and Rule 10b-5. [508]

Regulation G does not apply to non-GAAP financial measures contained in disclosures specifically subject to the SEC's rules regarding communications in connection with business combinations, [509] although related communications not specifically captured by the business combination communications rules, and related Securities Act registration and proxy or tender offer statements, are subject to Regulation G. Regulation G does not apply to the disclosure of non-GAAP financial measures by foreign issuers if the following conditions are satisfied:

- the securities of the issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. generally accepted accounting principles; [510] and
- the disclosure is made by or on behalf of the issuer outside the United States, or is included in a written communication that is released by or on behalf of the issuer outside the United States. [511]

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Provided that these conditions are satisfied, the exemption is available notwithstanding the existence of one or more of the following circumstances:

- a written communication is released in the United States as well as outside the United States, so long as the communication is released in the United States contemporaneously with or after the release outside the United States and is not otherwise targeted at persons located in the United States;
- U.S. journalists have access to the information;
- the information appears on one or more websites maintained by the issuer, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or
- following the disclosure or release of the information outside the United States, the information is included in a submission by the issuer to the SEC made under cover of a Form 6-K. [512]

Footnotes

484 Item 10(e) of Regulation S-K applies to all filings with the SEC. Additionally, Item 10(e)(1)(i) of Regulation S-K applies to financial information furnished under Item 2.02 of Form 8-K. However, Item 10(e) of Regulation S-K does not apply to filings made by investment companies registered under § 8 of the Investment Company Act, which are exempt from § 401 of the Sarbanes-Oxley Act, and eligible Canadian companies under the U.S.-Canadian multijurisdictional disclosure system discussed in Chapter 13.

485 Simultaneously with its adoption of Item 10(e) of Regulation S-K, which governs non-GAAP financial measures in SEC filings, the SEC adopted Regulation G, which governs the public disclosure of non-GAAP financial measures. *See* § 4.09[3]. Under Regulation G, companies are prohibited from disseminating false or misleading non-GAAP financial measures or presenting non-GAAP financial measures in a manner that is misleading or obscures the company's GAAP results.

486 Item 10(e)(2) of Regulation S-K under the Securities Act and Form 20-F, General Instruction C(e).

487 Item 10(e)(5) of Regulation S-K under the Securities Act and Form 20-F, General Instruction C(e).

488 SEC Release No. 33-8176 (Jan. 22, 2003), 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003) (the "Non-GAAP Measures Release"). The SEC has been quite strict in applying this exception. For example, even though U.S. federal banking regulations have increasingly treated common equity and tangible common equity ("TCE") measures as significant, financial institutions have been forced to treat TCE measures as non-GAAP measures. In any event, these financial measures remain subject to § 10(b) of the Exchange Act, Rule 10b-5 thereunder and the SEC's existing guidance on non-GAAP financial measures. *See*, *e.g.*, *In the Matter of Trump Hotels & Casino Resorts, Inc.*, SEC Release No. 34-45287 (Jan. 16, 2002); Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, SEC Release No.

33-8039 (Dec. 4, 2001); SEC Accounting Series Release No. 142, SEC Release No. 33-5377 (Mar. 15, 1973). The SEC also has brought enforcement actions under Regulation G. *See SEC v. SafeNet, Inc.*, SEC Litigation Release No. 21290 (Nov. 12, 2009) (The SEC alleged that the defendant violated Regulation G reporting obligations by improperly excluding certain ordinary expenses as non-recurring charges. SafeNet later settled these charges.).

489 Item 10(e)(3) of Regulation S-K under the Securities Act and Form 20-F, General Instruction C(e).

490 Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003).

491 Item 10(e)(4) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e); Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003).

492 Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4822 (Jan. 30, 2003). To not be a non-GAAP financial measure, the segment information must be presented in conformity with ASC 280. *See* SEC, Division of Corporation Finance, Compliance & Disclosure Interpretations, Non-GAAP Financial Measures ("Non-GAAP Measures C&DIs"), Question 104.01. A segment measure that is adjusted to include amounts excluded from, or exclude amounts included in, the segment measure calculated and presented in accordance with ASC 280 would be a non-GAAP measure. *See* Non-GAAP Measures C&DIs, Question 104.03. If a company includes in its MD&A a discussion of segment profitability that is consistent with ASC 280, which requires that a footnote to the company's consolidated financial statements provide a reconciliation, the company also should include in the segment discussion in the MD&A a complete discussion of the reconciling items that apply to the particular segment being discussed. *See* Non-GAAP Measures C&DIs, Question 104.02. Similar principles would apply to the use of measures in respect of segment disclosure for foreign issuers that prepare their financial statements in accordance with IFRS as issued by the IASB, except that for such issuers, such segment measures would be required to be calculated and presented in accordance with IFRS 8, *Operating Segments*, to be non-GAAP measures.

493 In May 2016, the SEC's Division of Corporation Finance released new and updated Compliance & Disclosure Interpretations ("C&DIs") on the use of non-GAAP financial measures that signaled the SEC's tightening policy. One new C&DI provides an illustrative list of disclosure practices the SEC staff believes improperly make non-GAAP financial measures more prominent than the most directly comparable GAAP measures. For example, the staff would consider a non-GAAP financial measure to be more prominent if it is disclosed or discussed before the most directly comparable GAAP measure. *See* Non-GAAP Measure C&DIs, Question 102.10.

494 The rules provide an exception from the quantitative reconciliation requirement with respect to forward-looking non-GAAP financial measures in situations where a quantitative reconciliation is not available without unreasonable effort. *See* Item 10(e)(1)(i)(B) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). Where this exception applies, the SEC expects the issuer to (i) disclose the fact that the most directly comparable GAAP measure is unavailable, (ii) provide reconciling information that is available without unreasonable effort and (iii) identify information that is unavailable and disclose its probable significance, in a location of equal or greater prominence compared to the forward-looking non-GAAP financial measures in question. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 (Jan. 30, 2003); Non-GAAP Measure C&DIs, Question 102.10.

495 The SEC has indicated that use by, or usefulness to, analysts cannot be the sole support for presenting a non-GAAP financial measure. Rather, the justification for use of the measure must be substantive, although it can be a justification that causes a measure to be used by or useful to analysts. Significantly, the SEC made clear in the adopting release for the rules that the required statement of the utility of the information to investors (i) should not be boilerplate, (ii) must in certain instances discuss why investors would find the non-GAAP financial measure valuable in the context in which it is presented, given the excluded items, and (iii) is intended to "be clear and understandable [and]… specific to the non-GAAP financial measure used, the registrant, the nature of the registrant's business and industry and the manner in which management assesses the non-GAAP financial measure and applies it to management decisions." Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4825 (Jan. 30, 2003). The Non-GAAP Measures C&DIs made clear that a

company is not required to use a non-GAAP financial measure in managing its business or for other purposes as a condition to being able to disclose it. *See* Non-GAAP Measures C&DIs, Question 102.04.

The SEC routinely asks questions on registration statements and periodic reports regarding the explanation given as to why a proposed non-GAAP metric provides useful information to investors, particularly with respect to more unusual or unconventional measures, and at times has pressured issuers to remove references to certain non-GAAP measures. In particular, the new C&DIs introduced in May 2016 emphasize that the SEC staff may view certain types of non-GAAP financial measures as inherently misleading and therefore prohibited from use regardless of their purported usefulness. *See* Non-GAAP Measures C&DIs, Questions 100.01 through 100.04. Under this guidance, non-GAAP performance measures that exclude "normal, recurring, cash operating expenses necessary to conduct the company's business" could be considered inherently misleading. Non-GAAP Measures C&DI, Question 100.01. Although it predates the new C&DIs, Groupon Inc.'s use of a non-GAAP financial measure called adjusted consolidated segment operating income, or adjusted CSOI, in its initial Form S-1 filing for its IPO, is often cited as an example of a non-GAAP performance measure that would be considered misleading under this guidance. The metric presented consolidated segment operating income before subtracting subscriber acquisition costs and certain other non-cash charges. Groupon described the measure as its "operating profitability before marketing costs incurred for long-term growth." Groupon, Inc., Form S-1 (June 2, 2011). According to published reports, after questions and pressure from the SEC staff during the comment process, Groupon removed adjusted COSI from its offering documents. Shayndi Rice and Lynn Cowan, *Groupon Bows to Pressure*, WALL ST. J., Aug. 11, 2011. Furthermore, a new C&DI indicates that a non-GAAP revenue measure that backs out the effect of GAAP revenue recognition and measurement principles applicable to a company's business could be inherently misleading. Specifically, a non-GAAP financial measure that adds back revenue that would have been deferred and recognized ratably under GAAP is considered misleading under this guidance. Similar non-GAAP adjustments to other line items may also be misleading. Non-GAAP Measures C&DIs, Question 100.04.

496 In the case of filings other than annual reports on Form 20-F, the rules do not require a registrant to include information regarding the purpose for which the non-GAAP financial measure is used and the reasons why that financial measure is believed to be useful to investors, so long as (i) that information was included in the registrant's most recent annual report on Form 20-F or a more recent filing and (ii) that information is updated to the extent necessary to meet the applicable requirements at the time of the current filing. The SEC has confirmed that the reference to filings does not include reports on Form 6-K, which are "furnished" to the SEC, except insofar as they are incorporated by reference into a Securities Act registration statement or prospectus or an Exchange Act report filed with the SEC. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4824 n.39 (Jan. 30, 2003). The SEC has also confirmed that the reference to filings does not include free writing prospectuses, unless the free writing prospectus is included in or incorporated by reference into a registration statement or Exchange Act filing. *See* Non-GAAP Measures C&DIs, Question 102.08.

497 The SEC has stated that, with respect to EBIT and EBITDA, (i) the term "earnings" is intended to mean net income as presented in the statement of operations under GAAP and that, if an issuer is able to justify its use as a performance measure, EBIT or EBITDA should be reconciled to net income and not operating income and (ii) measures that are calculated differently may not be characterized as EBIT or EBITDA and their titles should be distinguished, for example, as "Adjusted EBITDA." *See* Non-GAAP Measures C&DIs, Questions 103.01 and 103.02.

Presentation of "adjusted EBITDA" may nevertheless violate Item 10(e) and therefore continue to be prohibited in filings made with the SEC if adjustments that effect prohibited exclusions are made. The SEC does, however, recognize that credit agreements often require issuers to include an "adjusted EBITDA" measure in periodic reports and, accordingly, has indicated that disclosure of such a measure would be permissible to the extent (i) the credit agreement is a material agreement, (ii) the covenant requiring presentation of the measure is a material term of the credit agreement and (iii) information elicited by the covenant is material to an investor's understanding of the issuer's financial condition and/or liquidity. If this is the case, the SEC has further stated that disclosure regarding the covenant may be misleading absent a discussion of the (i) materiality of the credit agreement and covenant, (ii) amount or limit required for compliance with the covenant and (iii) actual or reasonably likely effects of compliance or non-compliance with the covenant on the issuer's financial condition and liquidity. *See* Non-GAAP Measures C&DIs, Question 102.09.

498 Item 10(e)(1)(ii) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). Notably, although the presentation of per share non-GAAP financial measures in SEC filings is not explicitly prohibited by the rules, the SEC has stated that per share measures that are prohibited specifically under GAAP or SEC rules continue to be prohibited in materials filed with or furnished to the SEC. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4820 n.11 (Jan. 30, 2003). As an example, the SEC has cited SFAS No. 95, Statement of Cash Flows, paragraph 33 of which provides that "[f]inancial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise's performance, as reporting per share amounts might imply." While not expressly cited in the Non-GAAP Measures Release, the SEC's Accounting Series Release No. 142 states that the presentation of cash flow per share "run[s] a high risk of materially misleading investors." SEC Release No. 33-5377 (Mar. 15, 1973), 38 Fed. Reg. 9158, 9159 (Apr. 11, 1973). The SEC does recognize, however, that certain non-GAAP per share measures may be meaningful to investors from an "operating viewpoint," in which case the SEC views accompanying disclosure explaining how such measures are used by management and in what way they provide meaningful information as being critical, together with a reconciliation of the per share measure to the GAAP financial measure of earnings per share. However, non-GAAP liquidity measures, such as cash flow or free cash flow, should not be presented on a per share basis and the SEC staff will focus on the substance of the non-GAAP financial measure in determining whether the measure is a performance or liquidity measure regardless of management's characterization. *See* Non-GAAP Measures C&DIs, Question 102.05. The SEC staff also makes it clear that EBIT or EBITDA cannot be presented on a per share basis, because these measures can be used as a liquidity measure. Non-GAAP Measures C&DIs, Question 103.02.

499 Item 10(e)(1)(ii) of Regulation S-K under the Securities Act.

500 *See* Non-GAAP Measures C&DIs, Question 102.03.

501 Note to paragraph (e) of Item 10 of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). The Non-GAAP Measures C&DIs provide more detail on the "expressly permitted" standard. *See* Non-GAAP Measures C&DIs, Question 106.01. In particular, express permission can be demonstrated by the explicit acceptance of the presentation of the non-GAAP financial measure by the securities regulator in the company's home country jurisdiction or market. "Explicit acceptance" includes: (i) the published views of the regulator or members of its staff, or (ii) a letter from the regulator or its staff to the issuer indicating the acceptance of the presentation, which would be provided to the SEC staff on request. This guidance on the definition of "expressly permitted" should make it easier for a foreign issuer to establish that it may use in SEC filings the same measures it presents in home-country filings. However, as the effort to harmonize the rules governing non-GAAP financial measures across different jurisdictions gains support, it would be rare for a non-GAAP financial measure to be prohibited under Item 10(e) of Regulation S-K under the Securities Act but expressly permitted in another local jurisdiction. For example, a Statement on Non-GAAP Financial Measures published by the Board of the International Organization of Securities Commissions (IOSCO) in 2016 and Guidelines on Alternative Performance Measures published by the European Securities and Markets Authority (ESMA) in June 2015 (effective in July 2016) both present guidelines that are largely consistent with Regulation G, Item 10(e) of Regulation S-K and the Non-GAAP Measures C&DIs.

502 Item 10(e)(6) of Regulation S-K under the Securities Act; Form 20-F, General Instruction C(e). This exemption does not extend beyond disclosures contained in communications subject to Rule 425 under the Securities Act or Rules 14a-12, 14d-2(b)(2) and 14d-9(a)(2) under the Exchange Act. If the same non-GAAP financial measure included in a communication under one of those rules is also disclosed in a Securities Act registration statement, proxy statement or tender offer statement, it would not be exempt from Regulation G or Item 10(e) of Regulation S-K in the Securities Act filing. *See* Non-GAAP Measures C&DIs, Question 101.01.

503 The general antifraud provisions, embodied in § 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as § 17 of the Securities Act, apply to all entities and not just those registered with the SEC, and can also apply to private fraudulent statements as discussed in § 11.04. Regulation FD is discussed in § 4.10[6]. Although Regulation FD by its terms does not apply to foreign issuers, many foreign issuers comply with it or follow its precepts.

504 As general guidance with respect to this requirement, the SEC has stated that "(1) non-GAAP financial measures that measure cash or 'funds' generated from operations (liquidity) should be balanced with disclosure of amounts from the statement of cash flows … and (2) non-GAAP financial measures that depict performance should be balanced with net income, or income from continuing operations, taken from the statement of operations." Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 n.26 (Jan. 30, 2003). The SEC has clarified that, (i) with respect to the use of EBITDA as a performance measure, it would require a reconciliation to net income (as opposed to operating income) and (ii) only non-GAAP measures derived from GAAP net income may properly be characterized as EBITDA or EBIT. *See* Non-GAAP Financial Measure C&DIs, Questions 103.01 and 103.02.

505 Rule 100(a) of Regulation G. The required reconciliation must be quantitative for historical non-GAAP financial measures and quantitative, to the extent available without unreasonable efforts, for forward-looking information. Rule 100(a)(2) of Regulation G. With respect to forward-looking non-GAAP financial measures that are not available without unreasonable effort, the SEC expects issuers to (i) disclose the fact that the most directly comparable measure using generally accepted accounting principles is unavailable, (ii) provide reconciling information that is available without unreasonable effort and (iii) identify information that is unavailable and disclose its probable significance. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 (Jan. 30, 2003).

506 Note 1 to Rule 100 of Regulation G. The SEC encourages issuers to provide website access to this information for at least a 12-month period and has suggested that this information may appear on the website or page that the issuer normally uses for its investor relations function. Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 n.28 (Jan. 30, 2003).

507 Rule 100(b) of Regulation G. Significantly, the SEC has indicated that a change in the methodology for calculating or presenting a non-GAAP financial measure from one period to another, without a complete description of the change in methodology, can violate this antifraud provision. Non-GAAP Measures C&DIs, Question 100.02; *see also* Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 n.23 (Jan. 30, 2003).

508 Non-GAAP Measures Release, 68 Fed. Reg. 4820, 4823 (Jan. 30, 2003).

509 *See* Rule 425 under the Securities Act (regulating communications in connection with a business combination in which stock consideration is being registered under the Securities Act) and Rule 14a-12 under the Exchange Act (regulating solicitations before the furnishing of a proxy statement).

510 By its terms, therefore, this exemption is not available to a foreign issuer that reports under U.S. generally accepted accounting principles and discloses non-GAAP financial measures derived from U.S. generally accepted accounting principles.

511 Rule 100(c) of Regulation G. However, to the extent such disclosure is subsequently incorporated by reference into a Securities Act registration statement, it would need to comply with Item 10(e) of Regulation S-K under the Securities Act. *See* Non-GAAP Financial Measure C&DIs, Question 106.03. Conversely, where a foreign issuer wishes to incorporate by reference into a Securities Act registration statement a portion of an earnings release that does not contain non-GAAP measures, it may do so either by (i) furnishing the entire earnings release on Form 6-K and indicating in the Form 6-K which portion of the release is incorporated by reference or (ii) furnishing two Form 6-K reports, with one containing the full earnings release and another the portions that will be incorporated by reference (which the SEC has indicated may provide more clarity to investors). *See* Non-GAAP Financial Measure C&DIs, Question 106.02. Even when the conditions for exemption from Regulation G are satisfied, foreign issuers often voluntarily comply with the requirements of Regulation G as a matter of good corporate governance practice.

512 Note 2 to Rule 100 of Regulation G.

U.S. Regulation of the International Securities and Derivatives Markets, § 4.10, COMMUNICATIONS WITH INVESTORS AND FINANCIAL ANALYSTS

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 § 4.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Securities analysts play a key role in securities markets, and publicly held companies as a matter of market practice regularly brief them to help them understand company results and business trends. Foreign issuers, like U.S. issuers, are expected to meet regularly, through telephone conference or otherwise, with securities analysts once they are SEC reporting companies. There have been some unfortunate instances, however, in which analysts have received nonpublic information and passed the information on to their clients, who have acted on it before the information was disclosed to the general public. In the wake of these cases, as well as Enron and the unanticipated and significant decline in the financial position of other public companies, the role of the securities analyst was scrutinized by Congress, the SEC, state regulators and various self-regulatory

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organizations. [513] The result was a heightened campaign against selective disclosure, facilitated by the SEC's adoption of Regulation FD (Fair Disclosure) in 2000, discussed in detail below. [514] For several years prior to 2009, the SEC brought few cases for violations of Regulation FD, but since September 2009 there has been a marked increase in the number of Regulation FD enforcement actions by the SEC. This increase in enforcement action serves as a reminder that ongoing vigilance in this area is certainly warranted.

The U.S. rules governing disclosure to analysts by issuers originally emerged from case law construing a basic antifraud rule, Rule 10b-5 under the Exchange Act. The rules provided by this case law were not straightforward, at times ambiguous and, in any event, have not been applied, with one known exception, [515] to communications between issuers and analysts. This situation led the SEC to adopt a new disclosure regime, Regulation FD, to prevent material nonpublic information from being given selectively to market professionals (broker-dealers, investment advisers and managers, and investment companies), who could use such information to their own or their clients' advantage. Regulation FD applies to communications on behalf of the issuer with market professionals and with securityholders who may foreseeably trade on the basis of the disclosed information.

Although Regulation FD does not apply to foreign issuers, [516] they too should avoid selective disclosure of material nonpublic information both as a matter of best practice and to avoid potential liability. Ill-considered disclosure

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can lead to liability both for the company and for its management personally under Rule 10b-5, raise potential issues regarding correcting or updating information and have adverse market consequences. For all of these reasons, rigorous monitoring of company communications with analysts is highly advisable.

[1] General Disclosure Requirements and Rule 10b-5 Liability

The U.S. Supreme Court has established that tipping or trading on the basis of material nonpublic information will not result in a violation of Rule 10b-5 unless there is a breach of a fiduciary duty or other relationship of trust and confidence, or a misappropriation of information received in violation of such a relationship. [517] This has led to three general principles with respect to the disclosure of corporate information to securities analysts and the public. First, Rule 10b-5 by itself does not normally require management to disclose material nonpublic information regarding the company to the investment community, unless there is otherwise a duty to disclose (for example, filing an annual report on Form 20-F, or disclosure in connection with an offering of securities). [518] Subject to certain

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exceptions discussed below, the timing of such disclosure is ordinarily left to the business judgment of management. Second, if a company does disclose corporate information (whether voluntarily or otherwise), Rule 10b-5 requires that those disclosures neither contain misleading statements of material information nor omit material facts necessary to make the statements made not misleading. [519] Third, when divulging material nonpublic information, company officials may not disclose it selectively— *e.g.*, exclusively to securities analysts—but rather must make the information available to the general public, [520] if those officials could be found to have gained a personal benefit from the selective disclosure. Selective disclosure can lead to liability for the company and for company officials themselves for insider trading by persons receiving the disclosure.

Although Rule 10b-5 might not require dissemination of material information, the NYSE and the Nasdaq require listed companies to disclose material

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information promptly to the public through any Regulation FD-compliant method of disclosure, [521] except under certain limited circumstances. [522] In addition, listed companies are required to notify the NYSE or Nasdaq of the release of any such information prior to its release to the public. [523] NYSE and Nasdaq rules, however, do not have the force of law and cannot be the basis for an implied private right of action. The Second Circuit held in *State Teachers Retirement Board v. Fluor Corp.* that no private right of action exists for a violation of the NYSE LISTED COMPANY MANUAL'S disclosure rules. [524] The court reasoned

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that, given the extensive regulation in this area by Congress and the SEC, "a federal claim for violation of the [NYSE's LISTED] COMPANY MANUAL rules regarding disclosure of corporate news cannot be inferred." [525]

Finally, when preparing disclosure responsive to the SEC's Exchange Act reporting requirements, companies should be mindful of Rule 12b-20, which requires inclusion of any information beyond what is expressly required "as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading." The SEC has brought enforcement actions for violating Rule 12b-20 even in the context of Form 6-K filings, where there are no express disclosure requirements. [526]

[2] The Nature of "Material" Information

Because the U.S. securities laws, including Rule 10b-5 under the Exchange Act, generally impose liability only when the information disclosed or omitted is "material," it is important, but also exceedingly difficult in many cases, to distinguish "material" from "immaterial" facts. [527] Courts have formulated a number of tests in recent years attempting to define the types of information that would be material for purposes of Rule 10b-5. The Supreme Court held in *Basic Inc. v. Levinson* that information is material if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." [528] The Second Circuit has enunciated a more specific standard, holding before *Basic Inc. v. Levinson* that a fact is to be considered material if it is "reasonably certain to have a substantial effect on the market price of the security" [529] and holding subsequently that a fact is to be considered material "if there is a substantial likelihood that a reasonable person would consider it important in deciding whether to buy or sell shares." [530] The SEC has consistently stated that materiality is not solely a quantitative determination and that qualitative materiality judgments must be made based on "all the facts and circumstances." [531] The SEC, in Staff Accounting Bulletin No. 99, discussed the necessity and difficulty of making these determinations and provided some examples. [532]

While these judicial standards are imprecise, certain types of information would almost always be considered material. The most obvious example would be earnings reports or earnings projections (whether favorable or unfavorable) because these data usually have an immediate, and often dramatic, impact on a company's stock price. [533] The following list of potentially material information illustrates by way of example other types of facts that may be so important to investment decisions that their selective disclosure to analysts could lead to Rule 10b-5 liability:

- a decrease or increase in dividend rate or a proposed stock split;
- a significant acquisition or disposition of assets or businesses, including pursuant to a joint venture or merger;
- significant labor problems;

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- the discovery or development of a significant new product;
- the acquisition or loss of an important contract or major change in backlog or other significant development involving customers or suppliers;
- the proposed sale of a significant amount of additional securities or the incurrence of significant new indebtedness or a default under existing indebtedness;
- a change in control or significant change in management;
- a tender offer for another company's shares;
- significant litigation; and
- another event requiring the filing of a current report under the Exchange Act. [534]

Courts, however, have found certain types of statements not to be material as a matter of law. For example, they have held that statements such as "our company is poised to carry the growth and success of the past year well into the future" to be soft, puffing statements that are not material for purposes of Rule 10b-5. [535] Similarly, the Supreme Court has held that a statement of belief and opinion is not subject to Securities Act liability unless (i) the statement was subjectively disbelieved by the defendant at the time it was expressed, (ii) the statement was accompanied by "embedded statements of fact" that are untrue or (iii) the statement omitted material facts concerning the defendant's inquiry or knowledge about the statement if "those facts conflict with what a reasonable investor would take from the statement itself." [536] Courts have also held that an omission is not material where the information omitted is already in the public domain. [537] In adopting Regulation FD, the SEC made clear that an analyst's ability to piece together immaterial information into a mosaic of information

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that, taken together, is material would not result in a violation of Regulation FD (or, presumably, Rule 10b-5). [538]

Nevertheless, in light of the broad range of information that has been found to be material, [539] management should be cautious when concluding that any factual information is not material and therefore may be selectively disclosed to analysts. Management should do so only when it is confident the information in question is entirely consistent with information that already is publicly available so that the additional disclosure will have no impact on the market price of the company's securities.

[3] Liability for Misleading Statements and Omissions of Material Fact

Rule 10b-5 liability can arise if a communication made to analysts or to the general public contains a misleading material statement or omits a material fact necessary to make the statements made not misleading. [540] Two SEC administrative rulings, *In re Carnation Company* [541] and *In re E.ON AG*, [542] demonstrate the extent to which liability can attach under these circumstances.

In *In re Carnation Company*, a corporate official publicly stated that no company news or corporate developments could account for recent stock activity and that, to the best of his knowledge, the company was not engaged in any acquisition negotiations. The official, however, was unaware that negotiations were actually taking place regarding the acquisition of Carnation by Nestle. The SEC ruled that, despite the official's ignorance of company developments, such comments violated the Rule 10b-5 prohibition against material misstatements. Because an official cannot be expected to know everything that happens in a corporation, officials communicating with analysts or the public should consult with senior executives prior to making a statement about matters of which they are not certain.

In re E.ON AG involved management denials of merger discussions that were in fact occurring. The merger discussions involved two German companies, and the denials were not, according to *E.ON AG*, a violation of German law.

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While one of the parties was listed on the NYSE, only a small percentage of its shares was held by U.S. investors. Moreover, both companies were persuaded that a no-comment policy would be construed by the German press as a confirmation that talks were going on and that premature disclosure would have jeopardized the ultimate merger. Nevertheless, the SEC ruled that the statements denying the merger discussions were false and a violation of Rule 10b-5. E.ON subsequently adopted a no-comment policy, as have most other German companies publicly traded in the United States.

[4] Duty to Correct or Update Previous Communications

A duty to correct previous communications arises when the issuer of the statement discovers that the statement was inaccurate or misleading when made. [543] Even if a company's statements are accurate when made, a duty to update explicit or implicit forward-looking statements may arise if circumstances change and such statements become inaccurate or misleading. [544] Currently, the circuits are split on whether a duty to update exists. The First, Second and Third Circuits have recognized a duty to update but generally have construed it narrowly (including rejecting its applicability to routine earnings guidance in the Third Circuit and the Southern District of New York), while the Seventh Circuit has held that there is no duty to update forward-looking statements. Other circuits either appear to have approved a duty to update in dicta [545] or have not yet decided whether a duty to update exists. [546]

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Courts have considered a variety of factors in determining whether a company has a duty to update. Some courts have emphasized that "optimistic, vague projections of future success which prove to be ill-founded are not, without more, sufficiently material to incur Rule 10b-5 liability." [547] Other courts have concluded that a duty to update forward-looking disclosure requires an implicit factual representation that remained "alive" in the minds of investors as a continuing representation. [548] In *McCarthy v. C-COR Electronics, Inc.*, the court suggested certain elements that could be considered in determining whether or not a duty to update exists. [549] For example, the specificity of the predictions was one factor that could weigh in favor of a duty to update. Predictions of corporate success more distant in the future were also believed to be "necessarily less reliable." [550] Finally, the court suggested that courts should also consider the "degree to which the prediction … is inherently [more] difficult or unreliable." [551]

In *Backman v. Polaroid Corp.*, the company released a quarterly report that allegedly misrepresented the prospects for the sales and profitability of a new camera. [552] The plaintiffs argued that although the company had instructed its manufacturers to significantly reduce production, the report expressed the company's continued optimism regarding the product. The First Circuit stated that if a disclosure is misleading when made, the company is under a duty to correct the statement promptly. The court also recognized that "in special circumstances, a statement, correct at the time, may have a forward intent and connotation upon which parties may be expected to rely." [553] In such circumstances, "further disclosure" could be necessary to avoid misleading the investing public. [554]

In *In re Time Warner Inc. Securities Litigation*, corporate officials had previously disclosed that the company was seeking foreign strategic alliances, and plaintiffs alleged that management had a duty to update such disclosure when

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problems arose concerning negotiations within the proposed alliance. [555] The Second Circuit held that, pursuant to Rule 10b-5, companies have a duty to update prior statements not only if intervening events completely negate such earlier remarks, but also if such events render previously disclosed information materially misleading. [556] However, the court refused to hold the company liable under the facts of this case, emphasizing that company statements were not definitive predictions that such deals would be struck, but rather merely expressed management hopes that negotiations would be successful. For this reason, the court found that the attributed public statements lacked the sort of definitive projections that might require later correction. [557]

The Third Circuit's decision in *Weiner v. Quaker Oats Co.* indicates how courts may analyze differently the broad range of forward-looking statements companies make. [558] On the one hand, the court held that a failure to update a statement could be actionable when the statement related to a specific targeted debt-to-equity ratio guideline that ceased to apply because of a subsequent acquisition. [559] On the other hand, the court refused to find actionable a failure to update an earnings projection rendered inaccurate by that same acquisition,

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because the projection was presented more vaguely as "earnings growth of at least 7 percent over time." [560]

The Seventh Circuit is the only circuit that has affirmatively taken the position that there is no duty to update. In *Stransky v. Cummins Engine Co.*, the company issued optimistic statements in press releases about its redesigned engines. [561] The engines were later discovered to have design problems that led to higher-than-anticipated warranty costs. The court held that there was no duty to update forward-looking statements that become untrue due to subsequent events. [562]

Regulation FD's prohibition on selective disclosure resulted in the public issuance of earnings guidance becoming more prevalent, making the question whether there is a duty to update earnings guidance more important. [563] The Third Circuit is the only circuit that has both recognized the duty to update and expressly addressed whether it applies to ordinary earnings guidance. In *In re Burlington Coat Factory Securities Litigation*, the Third Circuit declined to impose a duty to update an ordinary earnings projection, noting that "disclosure of a specific earnings forecast does not contain the implication that the forecast will continue to hold good even as circumstances change." [564] This holding arguably is inconsistent with other cases in the Third Circuit, and in other circuits that recognize a duty to update, because it appears to create a per se exception for earnings guidance, whereas the other cases generally exclude only statements that are too vague or optimistic to be treated as ongoing factual representations. [565] Nevertheless, the Third Circuit reaffirmed this decision in *In re Advanta Corp. Securities Litigation*, holding that Advanta had no duty to update a statement made by one of its investor relations officers in a Dow Jones article that "[o]ver the next six months Advanta will experience a large increase in revenues as it converts more than $5 billion in accounts that are now at teaser rates of about 7% to its normal interest rate of about 17%" when Advanta later decided to reprice the accounts at 13% or 14%. [566]

A case decided in the Southern District of New York in 2003 (subsequently affirmed by the Second Circuit in an unreported decision) indicates that the Second Circuit may strike a similar balance between the duty to update and routine earnings guidance. In *In re Duane Reade Inc. Securities Litigation*, the court held that Duane Reade did not have a duty to update quarterly sales projections for its non-prescription products before releasing quarterly results of the products' sales performance that did not meet the projections. [567] The district court held that the non-prescription sales projections were immaterial and therefore not subject to a duty to update. [568] Moreover, quoting the Seventh Circuit's decision in *Stransky*, the court stated that a "‘company has no duty to update forward-looking statements merely because changing circumstances have proven them wrong.’" [569] The district court, however, did not attempt to harmonize its holding with the Second Circuit's decision in *In re Time Warner Inc. Securities Litigation*, which suggested in dicta that a duty to update "definite" projections or opinions may arise if intervening events have rendered them misleading. [570] Nor did the district court address Second Circuit precedent, albeit dated, finding earnings projections material. [571] Nevertheless, the Second Circuit has now affirmed the district court decision in *Duane Reade*, although in a nonprecedential, unpublished summary order, and we believe other courts are likely to follow the Third Circuit trend and reject a duty to update routine earnings guidance.

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In sum, the case law demonstrates that outside the Seventh Circuit, forward-looking statements may be subject to a duty to update. Generally, this duty applies unless the statements in question are vague or in the nature of puffing, or, as concluded in *Burlington*, *Advanta* and *Duane Reade*, involve routine earnings guidance or similar estimates of future results.

[5] Correcting or Confirming Market Rumors

As described above, under Rule 10b-5 companies generally do not have an obligation to disclose material nonpublic information to either analysts or the public at large. In *State Teachers Retirement Board v. Fluor Corp.*, the Second Circuit held that corporate officials have no duty to correct or verify rumors in the marketplace unless such rumors can be attributed to the company. [572] The test for attribution in the context of market rumors mirrors the test described below in the section on analysts' reports (for example, whether the company has "sufficiently entangled itself" with the disclosure of information giving rise to the rumor). In *Fluor*, the company had been awarded a major contract, and before it publicly released information regarding this contract, its share price and volatility began to increase dramatically. The court held that the company could not be held liable for its decision not to confirm these contract rumors because there had been no evidence linking corporate employees to such rumors and because company officials had refused to respond to inquiries by analysts. [573]

[6] Regulation FD

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In August 2000, the SEC adopted rules [574] that prohibit U.S. issuers from selectively disclosing material nonpublic information to market professionals and to securityholders under circumstances in which it is reasonably foreseeable that the holders will trade on the basis of the information. Regulation FD (Fair Disclosure) requires that whenever an issuer intentionally discloses material nonpublic information, it must do so through a general public disclosure, and that whenever an issuer learns that it has made a non-intentional selective disclosure, it must make public disclosure of that information promptly. All U.S. issuers filing periodic reports with the SEC under the Exchange Act are subject to the regulation. Although Regulation FD does not apply to foreign issuers, [575] foreign issuers should continue to avoid selective disclosure of material nonpublic information out of concern for potential liability under Rule 10b-5 and should look to Regulation FD for guidance as a matter of best practice. In fact, many foreign issuers have elected to comply with Regulation FD. [576]

The following are the key provisions of Regulation FD:

- The regulation applies to communications with market professionals (broker-dealers, investment advisers and managers, and investment companies), and with securityholders that will reasonably foreseeably trade on the basis of the disclosed information. [577] It focuses on what the SEC believes to be the core problem—selective disclosure to those who will foreseeably trade on that

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  information or prompt others to do so. [578] The regulation therefore does not apply to communications with, among others, media representatives, advisers in a relationship of trust or confidence with the issuer (such as legal advisers and investment bankers), employees [579] or government officials. [580]
- The regulation applies to communications by senior officials, officers, employees or agents of the issuer

who regularly communicate with market professionals or securityholders. [581]

- The regulation applies to selective disclosures of "material" nonpublic information. [582] "Materiality" is not further defined in Regulation FD and is thus left to the guidance provided by case law and the SEC. [583]

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- Whenever an issuer makes an "intentional" disclosure of material nonpublic information, simultaneous public disclosure is required. [584] Whenever an issuer learns that it has made a non-intentional selective disclosure, it must make public disclosure of that information "promptly" (in any event, generally within 24 hours).
- Violations of Regulation FD are subject to SEC enforcement actions, but cannot give rise to Rule 10b-5 liability or private causes of action. They also do not result in a loss of short-form registration eligibility or of the Rule 144 resale safe harbor for an issuer's securities.

Public disclosure for purposes of Regulation FD can be made by filing or furnishing a Form 8-K [585] or by disseminating the information through a method or combination of methods that is "reasonably designed to provide broad, non-exclusionary distribution of the information to the public." The most common method is by press release. [586] Posting information to a company website or through social media also may be a sufficient method of public disclosure,

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depending on the facts and circumstances. [587] If an issuer wishes to make public disclosure of material nonpublic information by means of a conference call, adequate notice must be given, including the date, time, subject matter and dial-in information for the call. [588] Disclosure at a shareholders' meeting, even one that is open to the public, is not sufficient if the meeting is not webcast or broadcast by electronic means, and the mere presence of the press at an otherwise nonpublic meeting does not render the meeting public. [589]

Soon after the adoption of Regulation FD, the Director of the SEC's Division of Enforcement indicated that the SEC would look for egregious violations involving the intentional or reckless disclosure of unquestionably material information, such as those involving earnings, as well as cases against people deliberately attempting to take advantage of the system either by speaking in code or by stepping over the line again and again and therefore diminishing the credibility of any claim that disclosures were non-intentional, noting in particular that "walking the Street up or down is almost certainly prohibited and can no longer be done privately." [590] In 2002, the SEC released its first three enforcement actions [591]

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and a Section 21(a) investigation report [592] under Regulation FD, and since then has engaged in further enforcement actions from time to time. [593] Since September 2009, the SEC has exhibited a renewed emphasis on enforcement actions. [594]

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Issuers should take care to monitor their disclosures in all circumstances and use particular care when disseminating information in semi-public or private forums, such as invitation-only conferences, private offering road shows, one-on-one meetings with investors or analysts and even conference calls or webcasts where inadequate or no notice of the event has been given to the public. Moreover, if an issuer believes that analysts require supplemental information about earnings releases or other releases about important business information, that information is probably material and should not be selectively disclosed. The enforcement actions also confirm that the SEC will look to market reaction as an indicator of the materiality of selective disclosure. One significant similarity among the enforcement actions is that visible and in some instances dramatic stock trading price and volume shifts occurred in the aftermath of the selective disclosures, and the SEC has stated that a very significant market reaction to selectively disclosed information requires public disclosure of that information.

These proceedings are also noteworthy because of their varying penalties. Each of Raytheon and Secure submitted an offer of settlement in anticipation of an enforcement proceeding and agreed to a cease-and-desist order barring it from future violations of Regulation FD and § 13(a) of the Exchange Act. Siebel did

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the same in the 2002 action and also agreed to pay a fine of $250,000 as part of its settlement. Both Schering-Plough and Richard Kogan, its CEO, also agreed to cease-and-desist orders and to pay fines of $1 million and $50,000, respectively. Office Depot, its CEO and former CFO similarly agreed to cease-and-desist orders; the company also agreed to pay a fine of $1 million, and each executive agreed to a fine of $50,000. Flowserve and its CEO agreed to cease-and-desist orders and fines of $350,000 and $50,000, respectively, and Flowserve's Director of Investor Relations agreed to a cease-and-desist order. Senetek agreed to a cease-and-desist order without admitting or denying the SEC's findings, and, according to the order, the SEC took no action against any individual at Senetek and imposed no monetary penalty because of remedial acts promptly taken by Senetek and the cooperation it provided to the staff. [595] The SEC elected not to bring an enforcement action against Motorola or its senior officials because those officials sought in-house counsel's advice, which, although erroneous, was given in good faith. The SEC cautioned, however, that reliance on counsel may not provide a successful defense in future cases, especially in light of the § 21(a) report issued in connection with the Motorola proceeding, and that the availability of this defense will depend on the facts and circumstances of each case. [596]

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Then-SEC Commissioner Campos dissented as to the lack of a penalty in the Raytheon and Secure proceedings, while then-SEC Commissioners Glassman and Atkins dissented as to the imposition of the $250,000 penalty against Siebel, and then-Commissioner Atkins dissented as to the imposition of the $1 million penalty against Schering-Plough. Although the SEC does not explain the different approaches, one factor that may have contributed to the penalty in the 2002 Siebel case is that the information selectively disclosed by Siebel's CEO was diametrically opposed to the company's recent public disclosure. This contrasts with the Raytheon case, where the information selectively disclosed was broadly consistent with publicly available information, including Raytheon's results from the previous year. In the Secure case, there were extenuating circumstances, such as the need for a third party's consent before the material nonpublic information could be disclosed to the public. In addition, Secure's management, at least with respect to the initial non-intentional disclosure, immediately sought permission to disclose the information in question, but was unable to do so as a result of Secure's existing confidentiality agreement with the supply agreement counterparty and that counterparty's refusal to allow publication. In *Schering-Plough*, although the information selectively disclosed by the company's CEO was consistent with the company's previous public disclosures, it was materially more definite and clearly intended to talk down Wall Street estimates, which is exactly the type of conduct Regulation FD was adopted to prevent. In *Flowserve*, however, a fine was imposed even though the information shared with the small group of analysts merely reaffirmed earnings guidance that had been publicly disclosed less than four weeks before. [597]

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Another key development in Regulation FD jurisprudence was the unwillingness of a court in the Southern District of New York to find a violation of Regulation FD in the *Siebel II* proceeding. [598] In 2004, the SEC filed a civil action against Siebel charging the company with violating Regulation FD, as well as the prior cease-and-desist order barring it from future violations of Regulation FD. [599] In its complaint, the SEC alleged that Siebel's CFO disclosed material nonpublic information by issuing positive comments in private meetings about the company's business activity that contrasted with negative public statements made during the prior three weeks. [600] The SEC claimed that these comments led to an increase in Siebel's stock price the following day. Siebel filed a motion to dismiss the suit claiming that the remarks were neither material nor nonpublic and that Regulation FD unconstitutionally restricts free-speech rights under the First Amendment of the U.S. Constitution because the scope of the regulation extends beyond "commercial speech." After examining the statements in their context, the court dismissed the charges and chided the SEC for what it clearly viewed as an overzealous approach to the enforcement of Regulation FD, stating that the SEC had placed "an unreasonable burden on a company's management and spokespersons to become linguistic experts, or otherwise live in fear of violating Regulation FD should the words they use later be interpreted by the SEC as connoting even the slightest variance from the company's public statements." [601] Significantly, the court held that private statements could vary from prior public statements so long as they were "equivalent in substance." [602] The court also held that movements in stock prices were relevant but not determinative in establishing whether the disclosed information was material or nonpublic. [603]

[7] Developments in Regulation FD and Social Media

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Over the last decade, the rising popularity of web-based platforms as a medium for companies to communicate and engage with public audiences has presented new challenges for regulators and companies alike in determining whether such communications comply with Regulation FD.

In 2008, the SEC issued guidance providing non-exclusive factors for companies to consider in evaluating whether disclosure made on a website is compliant with Regulation FD. [604] In particular, an issuer should consider whether: (1) its website is a recognized channel of distribution; (2) posting of information on its website disseminates the information in a manner making it available to the securities marketplace in general; and (3) there is a reasonable waiting period for investors and the market to react to the posted information.

[a] SEC Social Media Guidance

The 2008 guidance did not address the use of social media channels, and in the years following the 2008 guidance, the SEC and its staff stayed largely silent on the implications of Regulation FD on disclosure made through social media. In December 2012, however, Netflix and its CEO, Reed Hastings, each received a notice from the SEC staff indicating the staff's intent to recommend that the SEC institute cease-and-desist proceedings or bring a civil injunctive action against Netflix and Mr. Hastings for violations of Regulation FD. [605] The notice followed a post by Mr. Hastings on his public Facebook page announcing a milestone in Netflix's streaming content, despite the fact that Mr. Hastings' post reached more than 200,000 followers and provided information that was in line with prior guidance.

On April 2, 2013, the SEC announced its decision not to proceed further in the Netflix matter and issued a report of investigation that builds on its 2008 guidance. [606] The new guidance clarifies that a company and its employees may use social media to report material information without violating Regulation FD, so long as two conditions are met. First, a social media channel used for this purpose must be a "recognized channel of distribution" within the meaning of the

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2008 guidance. [607] Second, the company must alert the market to the channels used and the information it may disclose using them. Since the issuance of the SEC's report of investigation in April 2013, a number of companies have disclosed on their websites and in their press releases and periodic reports that they or their executives may use social media to disseminate material information for Regulation FD compliance, and listed specific social media channels they intend to use.

Companies that wish to use social media channels to communicate material information should consider taking the following steps to ensure compliance with Regulation FD:

[i] *Alert the Market with Specific Details*

Companies should alert the market well in advance of their intention to use specified social media to disseminate company news, through press releases, periodic reports or prominent postings on their company websites. This notice should include specific details of the social media channels that may be used, such as the account name, the URL or the specific webpage. Once the company has identified the specific social media channels it intends to use, it should continue to identify these channels regularly as part of periodic reports and press releases and on its investor relations page. Companies should also disclose the kind of information that will be communicated through the designated channels, including, for example, expectations that a company will tweet its earnings or that its key executives may comment on company developments using the designated channels.

[ii] *Exercise Caution if Personal Social Media Channels Are Used*

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The SEC report clarifies that personal social media channels, such as the Netflix CEO's Facebook page, are unlikely to qualify as Regulation FD-compliant means of disseminating information absent prior notice. As in the case of its own channels, the company should include a specific identification of the URL, Twitter handle or the like for any personal social media that may be used.

[iii] *Select Appropriate Social Media Channels, and Use Them*

Companies should keep in mind that the SEC's 2008 guidance also addressed the accessibility of information after posting, such as whether it will be picked up by the media. Based on its report in the Netflix matter, the SEC appears to acknowledge Facebook and Twitter as appropriate media for public disclosure under Regulation FD; companies that choose other channels should pay particular attention to whether those channels would be widely followed. In the case of personal social media channels, the company should ensure that the individual applies site settings that permit maximum accessibility to the public. The SEC's 2008 guidance also relied on whether the company has a pattern or practice of using its website for company disclosures, and it is likewise important that companies in fact use the social media channels they establish for these purposes, to create the kind of investor and media following the SEC expects.

[iv] *Consider Whether Other Concurrent Means of Dissemination May Be Appropriate*

In some cases, it may be prudent for companies to couple publication of information via social media channels with more traditional means of communication, such as a press release or current report, to ensure broad public dissemination. Whether this is desirable will depend mainly on the significance of the information, the length of time the company or individual has been using the channel in question and the breadth of exposure the company in fact achieves through that channel. For matters identified as "material information" in applicable listing standards, [608] such as changes in executive leadership and the announcement of quarterly or annual results, we expect most companies will continue to rely on concurrent press releases.

[v] *Review Communications and Social Media Policies and Training Materials*

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The SEC's new guidance presents a good opportunity to review internal policies on communications and social media. In particular, if personal social media channels may be used, the sanctioned channels should be identified in the company's communications policy. [609] A determination that no designated spokesperson may use personal social media to disclose company information should likewise be memorialized in the communications policy. Companies should also review their existing employee guidance about responsible use of personal social media. [610] Companies should develop rules for re-tweeting, sharing on Facebook or otherwise endorsing external media regarding the company, and develop a contingency plan to mitigate the risk of hacking or information leaks.

[vi] *Comply with Other Communications Rules and Safe Harbors*

Companies should ensure that disclosures made through social media channels comply with other communications rules and safe harbors under the U.S. federal securities laws. Some of those provisions require that dissemination of specific types of information be accompanied by prescribed legends; [611] others provide safe harbors whereby the disseminated information will not violate other rules if appropriately legended. [612] It may be impractical or impossible to meet these requirements using some social media channels that limit the length of

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postings. Some commenters have suggested using abbreviated legends or links to long-form legends or other required information in these cases, and this currently appears to be the majority approach. It is unclear, however, whether these links would satisfy the relevant rules, and pending further SEC guidance, companies should proceed with caution.

[vii] *Implement Appropriate Disclosure Controls and Procedures*

Finally, companies should continue to ensure that their Exchange Act reports are materially accurate and complete. Companies should have disclosure controls and procedures in place to evaluate whether certain disclosures through social media channels, such as tweets about previously unannounced preliminary quarterly or annual financial results, must also be reflected concurrently in their periodic or current reports. Companies should also be mindful that social media communications remain subject to the antifraud provisions of the federal securities laws. In particular, companies should consider how social media communications may alter the "total mix" of information that is publicly available about them, and educate authorized users of personal social media about the importance of balance and the avoidance of cherry-picking in company communications.

[8] Selective Disclosure to Analysts and Measures to Avoid Rule 10b-5 Liability

Aside from Regulation FD, liability for selective disclosure has been based on the principles of securities fraud, particularly the law of insider trading. Under some early insider trading case law, which appeared to require that traders have equal access to corporate information, selective disclosure of material information to securities analysts could generally give rise to liability.

This understanding changed with the Supreme Court's landmark decisions in *Chiarella v. United States* [613] and *Dirks v. SEC*. [614] In *Chiarella*, the Court rejected the "parity of information" approach, which deemed trading to be fraudulent whenever the trader possessed material information not generally available to the public. The Court instead held that there must be a breach of a fiduciary duty or other relationship of trust and confidence before the law imposes a duty to disclose information or abstain from trading. [615]

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In *Dirks*, the Supreme Court addressed the disclosure, or "tipping," of material nonpublic information by an insider to an analyst and disclosure by that analyst to its clients. The Court rejected the idea that a person is prohibited from trading whenever he or she knowingly receives material nonpublic information from an insider. Instead, it stated that a recipient of inside information is prohibited from trading only when the information has been made available to him or her "improperly"—that is, in breach of the insider's fiduciary duty to shareholders—and the recipient knew or should have known of that breach. Whether a breach of duty occurs depends on whether the insider receives a direct or indirect "personal benefit" from the disclosure. The Court explained that insiders derive a personal benefit when, for instance, they make a "quid pro quo exchange" for the tip or "gift the confidential information to a trading relative or friend." [616] Because the corporate insider who provided the information to Dirks received no personal benefit (and in fact sought to expose a fraud by disclosing the information), the Court concluded that there was no breach of duty.

The *Dirks* decision was widely construed as providing considerable latitude to insiders who made selective disclosure to analysts, and to the analysts (and their clients) who received selectively disclosed information and acted on it. Commentators interpreted the "personal benefit" requirement to involve primarily a pecuniary gain, and many corporate insiders took comfort in the fact that absent a financial reward, the *Dirks* personal benefit test would seem to insulate them from liability.

There has been surprisingly little testing since *Dirks* of the limits of the personal benefit test in the context of alleged selective disclosure to analysts. [617] In one controversial case, *SEC v. Stevens*, the SEC alleged that a corporate CEO, before making a general release to the public, had disclosed information regarding disappointing revenues to certain analysts and told them that earnings, therefore, might be lower than expected. [618] The SEC further maintained that the CEO had made such disclosures in an effort to enhance his reputation within the investment community. In settling with the SEC, the CEO agreed to pay $126,455, representing the amount of losses avoided by those shareholders who sold the company's stock prior to the eventual public announcement of such financial information. The danger of the SEC's broad interpretation of "reputational benefit" in *Stevens* is that virtually all selective disclosure to the investment community is likely to have been made to some extent on the basis

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of self-interest. Thus, any executive, even one who believes he or she is mainly serving the corporation's interests, may be charged with deriving a "reputational benefit" when he or she communicates with analysts.

The *Stevens* case has proven to be something of an anomaly. It is the only post- *Dirks* insider trading case ever brought by the SEC based on selective disclosure to, or trading by, securities analysts or their clients. Indeed, the SEC's recognition of the difficulties it faced in proving "personal benefit" led to its decision to adopt Regulation FD and abandon exclusive reliance on Rule 10b-5 to regulate selective disclosure to analysts. Even though Regulation FD does not apply to foreign issuers, inherent uncertainties about the scope of Rule 10b-5 and the *Stevens* case have led many advisers to conclude that whenever material nonpublic information is disclosed to analysts, it should be publicly disclosed at the same time. [619]

Companies can take a number of measures to avoid the selective disclosure of material nonpublic information to analysts. Permitting the public to listen to a call with analysts, whether by a dial-in procedure or a webcast, will make any disclosures made during the call nonselective, provided adequate notice of the call is publicly given. [620] In addition, U.S. companies can make disclosure nonselective by furnishing the relevant information on a Form 8-K pursuant to Item 7.01 of that form, titled "Regulation FD Disclosure." [621] Foreign companies are similarly able to make disclosure nonselective by furnishing the relevant information on a Form 6-K.

Any selective presentations to analysts should be scripted and reviewed prior to the meeting, both by officials personally familiar with the issues to be

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raised, as well as by counsel, to reduce the likelihood of the disclosure of material information. Furthermore, it generally would be advisable to place responsibility for such presentations upon a limited number of officials within the company, enabling them to develop the sophistication to deal effectively with this matter. Finally, if the company anticipates that a sensitive issue will most likely be raised by an analyst during a meeting, it might be advisable for the corporate official to state diplomatically near the beginning of the presentation that he or she is not at liberty to discuss the issue. Because a company generally does not have a duty to disclose material nonpublic information, a "no comment" position is permissible. The Supreme Court in *Basic Inc. v. Levinson* noted that silence is not misleading under Rule 10b-5 absent a duty to disclose and that "‘[n]o comment’ statements are generally the functional equivalent of silence." [622]

Although the consequences of selective disclosure of material information can be serious, the federal judiciary and the SEC, as well as the NYSE and Nasdaq, have recognized that inadvertent disclosures may arise. In the event of any allegation of intentional selective disclosure, procedures to avoid disclosure of material information (such as those described above) can provide useful support for the position that any such disclosure that did occur was inadvertent. If such an inadvertent disclosure were to occur, the company should immediately prepare and disseminate broadly to the investing public a press release of such information [623] and should request that the analysts to whom the disclosure was made maintain confidentiality pending such release. [624]

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The preceding discussion regarding potential liability for selective disclosure of material information under Rule 10b-5 produces a corollary principle: management should generally avoid giving favored treatment to particular analysts either in the timing of disclosures or in the frequency of granting interviews. In *SEC v. Geon Industries, Inc.*, a company official was accused of tipping a particular analyst about a planned merger involving the company. [625] The Second Circuit could find no direct evidence that the official had leaked information of the impending merger to the analyst. Nevertheless, the court concluded that such a "tipping" had occurred based on the evidence that the official spoke often with the analyst, "lunched with [him] alone, something [the official] did with no other broker, accepted two bottles of liquor [the analyst] sent him following this lunch, and honored one of the [the analyst's] telephone messages by a return call from home." [626] The court also emphasized that the analyst had made a number of trades in Geon stock following such conversations and meetings. The *Geon* case was decided before *Dirks* and, thus, does not represent a finding of liability on the more limited basis now required by the Supreme Court in *Dirks*.

Footnotes

513 Professional associations representing public companies and analysts also made an effort to shape the parameters of the relationship between these parties. In 2004, the CFA Centre for Financial Market Integrity and the National Investor Relations Institute adopted best-practice guidelines to govern the relationship between corporate issuers and the securities analysts who cover them. *See* CFA Centre for Financial Market Integrity/National Investor Relations Institute, BEST PRACTICE GUIDELINES GOVERNING THE ANALYST/CORPORATE ISSUER RELATIONS (2004). The guidelines address: (i) information flow between analysts and issuers, (ii) analysts' conduct in preparing and publishing research reports and making investment recommendations, (iii) issuers' conduct in providing analysts with access to corporate management, (iv) review of analyst reports by issuers and (v) research that is solicited, paid for or sponsored by the issuer.

514 Selective Disclosure and Insider Trading, SEC Release No. 33-7881 (Aug. 15, 2000); *see* § 4.10[6].

515 *See SEC v. Stevens*, SEC Litigation Release No. 12813 (Mar. 19, 1991), discussed below.

516 Rule 101(b) of Regulation FD provides that both foreign governments and foreign private issuers, as those terms are defined in Rule 405 of the Securities Act, are not considered issuers for the purpose of Regulation FD. Under Rule 405, a foreign private issuer is defined as any foreign issuer, other than a foreign government, except an issuer meeting the following conditions as of the last business day of its most recently completed second quarter: (i) more than 50% of the outstanding voting securities of such issuer are directly or indirectly owned of record by United States residents, and (ii) any of the following: (a) the majority of the executive officers or directors are United States citizens or residents, (b) more than 50% of the assets of the issuer are located in the United States or (c) the business of the issuer is administered principally in the United States.

517 *See United States v. O'Hagan*, 521 U.S. 642, 650–52 (1997); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980). One recent series of court decisions has created some uncertainty on the precise circumstances in which insider trading liability may be found. The District Court for the Northern District of Texas held that absent a fiduciary (or fiduciary-like) relationship, liability under the misappropriation theory requires not just an agreement not to disclose material nonpublic information, but also an agreement not to trade. *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009). On appeal, the U.S.

Court of Appeals for the Fifth Circuit agreed with the SEC's argument that even in the absence of an express agreement not to trade on material nonpublic information, a party that agrees to keep information confidential may be liable for insider trading where there is an implied understanding that trades will not be made based upon the information. *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010). On remand, the District Court denied the defendant's motion for summary judgment, holding that there was sufficient evidence to enable a reasonable jury to find that the defendant implicitly agreed not to disclose material nonpublic information or trade on that information. *SEC v. Cuban*, Civ. Action No. 3:08-CV-2050-D, 2013 WL 791405 (N.D. Tex. 2013). Although a federal jury ultimately found the defendant not liable for insider trading, we believe other courts are likely to look to the arguments made in the *Cuban* line of cases when analyzing liability under the misappropriation theory. *See* SEC Litigation Release No. 22855 (Oct. 23, 2013); *see also* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.05 (Aug. 14, 2009) (SEC staff expressing the view that a recipient of material nonpublic information subject to an express confidentiality agreement who trades or advises others to trade could face insider trading liability). In addition, in *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009), the Second Circuit held that insider trading liability could be found where a hacker traded on the basis of material nonpublic information acquired through electronic theft, even though there was no breach of fiduciary duty. *See also* § 11.10[3]; *Morrison v. National Australian Bank*, 130 S. Ct. 2869 (2010) (where a "transactional test" was introduced to establish whether a foreign claimant could bring a private right of action under § 10(b) of the Exchange Act).

518 *See Cooperman v. Individual, Inc.*, 171 F.3d 43, 49 (1st Cir. 1999); *see also Shaw v. Digital Equipment Corp.*, 82 F.3d 1194, 1202 (1st Cir. 1996) (recognizing that "the mere possession of material nonpublic information does not create a duty to disclose it"). Despite the lack of disclosure obligations generally under Rule 10b-5, the courts have found an obligation to disclose material nonpublic information (i) when the corporation or a corporate insider trades on confidential information, (ii) when a corporation has made inaccurate, incomplete or misleading disclosure or (iii) when a statute or regulation requires disclosure. *See Backman v. Polaroid Corp.*, 910 F.2d 10, 20 (1st Cir. 1990) (*en banc*).

Although a corporation under, for example, Delaware law has a fiduciary duty to holders of its common stock and, under certain circumstances, holders of its preferred stock, it generally has no fiduciary duty to its creditors, which include holders of debt securities, whether they be straight debt or convertible debt, or warrants to purchase equity securities. *See Lorenz v. CSX Corp.*, 1 F.3d 1406, 1417 (3d Cir. 1993); *Page Mill Asset Management. v. Credit Suisse First Boston Corp.*, No. 98 Civ. 6907, 2000 WL 335557, at *11 (S.D.N.Y. Mar. 30, 2000) (citing *Parkinson v. West End Street Railway*, 173 Mass. 446, 53 N.E. 891, 892 (1899) (Holmes, J.)). Thus, as the court found in *Alexandra Global*, "[b]ecause IKON owed no such fiduciary or other analogous duty to its convertible noteholders, it follows that IKON had no duty to disclose its alleged unpublicized intentions to exercise its redemption rights at a date in the future [notwithstanding that IKON's redemption rights were at a premium and IKON was purchasing its debt from a holder at a discount]." *Alexandra Global Master Fund, Ltd. v. IKON Office Solutions, Inc.*, No. 06 Civ. 5383 (JGK), 2007 WL 2077153, at *8 (S.D.N.Y. July 20, 2007).

We note that other countries may require disclosure of material information if such information would be deemed to affect the price of a company's listed securities. *See*, *e.g.*, Entertainment Rights plc, Financial Services Authority Final Notice (Jan.19, 2009) (fining U.K. company for violation of the UK Listing Authority's Disclosure and Transparency Rule 2.2.1, which generally requires disclosure of "any inside information which directly concerns the issuer").

519 Rule 10b-5(b) under the Exchange Act.

520 The SEC staff has made clear, in the context of Regulation FD, that the disclosure of material nonpublic information at a shareholders' meeting does not constitute public disclosure even if the meeting is open to the public, but is not otherwise webcast or broadcast by any electronic means. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.05 (June 4, 2010). However, disclosure through an Exchange Act filing may constitute public disclosure so long as the issuer has brought the disclosure to the attention of the readers of the filing. SEC, Division of Corporation Finance,

Compliance and Disclosure Interpretations, Regulation FD, Question 102.02 (June 4, 2010).

521 These methods include, *e.g.*, filing a Form 8-K (or, presumably for foreign issuers, a Form 6-K), distributing a press release through a widely circulated news or wire service, holding a press conference to which the public is granted access or posting the information on a company website or Regulation FD-compliant social media platform. *See* § 4.10[7] for a discussion of developments in Regulation FD and social media.

522 NYSE LISTED COMPANY MANUAL §§ 202.01, 202.05 (stating the general rule that "a listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities" but outlining circumstances, such as negotiations leading to mergers and acquisitions or arrangements preparatory to an exchange or tender offer, under which "premature public announcement may properly be avoided"); NASDAQ Marketplace Rules, 5250(b)(1), NASDAQ Manual ("Except in unusual circumstances, a Nasdaq-listed Company shall make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions."). Although the NYSE amended its immediate release policy in May 2009 to allow an issuer to use any method of disclosure allowed by Regulation FD (an approach that matches Nasdaq's), rather than to require exclusively the use of a press release, the NYSE's amended rule continues to "encourage" issuers to use press releases. SEC Release No. 34-59823 (Apr. 27, 2009); NYSE LISTED COMPANY MANUAL § 202.06. While foreign issuers are not required to comply with Regulation FD, NYSE LISTED COMPANY MANUAL § 202.06 requires foreign issuers listed on the NYSE to comply with the timely alert policy set forth in § 202.05 by any method (or combination of methods) allowed by Regulation FD for a domestic U.S. issuer. NYSE LISTED COMPANY MANUAL § 202.06.

523 The NYSE requires issuers to notify the NYSE in advance if news of a material event or a statement dealing with a rumor is released shortly before the opening of or during market hours. NYSE LISTED COMPANY MANUAL §§ 202.03, 202.05, 202.06. Similarly, Nasdaq requires issuers to notify Nasdaq prior to the public announcement of certain specified information during Nasdaq market hours. For these purposes, the NYSE currently requires at least ten minutes' advance notification of any announcement between the hours of 7:00 A.M. and 4:00 P.M., New York time, and Nasdaq currently requires advance notification of any announcement made between 7:00 A.M. and 8:00 P.M., New York time (with notification required by 6:50 A.M., New York time, on the next trading day if announcements are made after 8:00 P.M. or on days the market is closed). NASDAQ Marketplace Rules, IM-5250-1, NASDAQ MANUAL. Advance notification must be provided to Nasdaq prior to announcing news relating to: (i) company financials, such as earnings announcements, (ii) reorganizations and acquisitions, (iii) developments regarding products, customers or suppliers, (iv) management changes, (v) resignation or termination of auditors, (vi) defaults on securities or securities redemption or repurchase plans, (vii) significant legal or regulatory developments or (viii) events requiring the filing of a Form 8-K. NASDAQ Marketplace Rules 5250(b)(1), IM-5250-1, NASDAQ MANUAL.

524 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 852 (2d Cir. 1981).

525 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 852–53 (2d Cir. 1981); *accord In re Verifone Securities Litigation*, 11 F.3d 865, 870 (9th Cir. 1993) ("We decline to hold that a violation of exchange rules governing disclosure may be imported as a surrogate for straight materiality analysis under § 10(b) and Rule 10b-5.").

526 *See In re Sony Corporation*, SEC Release No. 34-40305 (Aug. 5, 1998) (SEC found that Sony failed to identify greater than anticipated losses at Sony Pictures and to discuss a "known trend" involving cumulative losses of more than $1 billion); *see also SEC v. Sony Corp.*, SEC Litigation Release No. 15832 (Aug. 5, 1998) (proceeding against the individual Sony officer responsible for disclosure matters). *See also SEC v. BP*, SEC Litigation Release No. 22531 (Nov. 15, 2012) (BP fined $525 million for misleading investors by significantly understating oil flow rates during the 2010 oil spill on three separate Forms 6-K; BP stated that the flow rate was estimated to be 5,000 barrels of oil per day despite its own internal data that indicated potential flow rates could be as high as 146,000 barrels of oil per day).

527 *See supra* Note 27.

528 *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (internal quotation omitted).

529 *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969).

530 *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 518 (2d Cir. 1994).

531 In *Ganino v. Citizens Utilities Co.*, the Second Circuit relied on *Basic Inc. v. Levinson* and SEC Staff Accounting Bulletin No. 99 in declining to hold immaterial as a matter of law misstatements regarding revenue recognition because the revenue in question amounted to only 1.7% of the defendant's total revenue for the year. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154 (2d Cir. 2000). The court rejected a bright-line test for materiality, emphasizing that materiality judgments must be made in the context of all relevant facts and circumstances. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 165 (2d Cir. 2000).

532 SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563. For example, improper revenue recognition designed to ensure earnings do not fall outside the range of analysts' expectations could be material even if the effect were only one or two cents a share.

533 In both *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 14–15 (2d Cir. 1977), and *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163–67 (2d Cir. 1980), the Second Circuit found earnings projections to be material. The award of a significant supply contract would also most likely constitute material information. In *State Teachers Retirement Board v. Fluor Corp.*, for example, the Second Circuit held that management's selective disclosure to an analyst regarding the "imminence" of being awarded a major contract could generate liability under Rule 10b-5. *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 854 (2d Cir. 1981). The court also noted that even the mere decision to bid on this billion dollar project would represent significant information to the reasonable investor. While the court in *Fluor* noted that the award of a major contract and the decision to bid on a large project could constitute material information, the court nevertheless found that the company's actions did not violate Rule 10b-5, as discussed in more detail below. On remand, the district court further held that capital expenditure projections could be considered material. *State Teachers Retirement Board v. Fluor Corp.*, 566 F. Supp. 945, 950 (S.D.N.Y. 1982).

534 The list of additional events the SEC requires issuers to disclose on Form 8-K is also representative of presumptively material events. *See supra* Note 27.

535 *Raab v. General Physics Corp.*, 4 F.3d 286, 289 (4th Cir. 1993); *accord Lasker v. New York State Electric & Gas Corp.*, 85 F.3d 55, 59 (2d Cir. 1996) (per curiam) (observing that "broad, general statements" are "precisely the type of ‘puffery’ that this and other circuits have consistently held to be inactionable"); *San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 807, 811 (2d Cir. 1996) (holding that company statement that "[w]e expect 1993 to mark another year of strong growth in earnings per share" constituted inactionable puffery); *see also In re K-tel International, Inc. Securities Litigation*, 300 F.3d 881, 897 (8th Cir. 2002) (stating that "[i]mmaterial statements include vague, soft, puffing statements").

536 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318 (2015). *See also Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016). For further discussion of *Omnicare* and *Sanofi*, *see* § 11.03[1][C].

537 *See Longman v. Food Lion, Inc.*, 197 F.3d 675, 685–86 (4th Cir. 1999), *cert. denied*, 529 U.S. 1067 (2000).

538 SEC Release No. 34-43154 (Aug. 15, 2000).

539 The Supreme Court has rejected a bright-line rule for materiality in the securities offering context, observing that the test for materiality required an assessment as to whether there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011).

540 To prevail under Rule 10b-5 in private causes of action alleging material misrepresentation or omission, the plaintiff must also prove reliance upon such misleading disclosure. *See Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988) (holding that "reliance is an element of a Rule 10b-5 cause of action.…Reliance provides

the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury"). *See* § 11.04[2].

541 SEC Release No. 34-22214 (July 8, 1985).

542 SEC Release No. 34-43372 (Sept. 28, 2000).

543 *See*, *e.g.*, *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1331 (7th Cir. 1995) (stating that the duty to correct is often confused with the duty to update and that the "former applies when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not. The company then must correct the prior statement within a reasonable time."); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16–17 (1st Cir. 1990). While the duty to correct generally applies only to statements of historical fact, it may also apply to forward-looking statements if they are based on historical facts that a company later discovers were incorrect. *See In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1431 (3d Cir. 1997).

544 *See In re International Business Machines Corp. Securities Litigation*, 163 F.3d 102, 110 (2d Cir. 1998); *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 316 (3d Cir. 1997); *Backman v. Polaroid Corp.*, 910 F.2d 10, 16–17 (1st Cir. 1990); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 758 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985). *But see Gallagher v. Abbott Laboratories*, 269 F.3d 806, 810-11 (7th Cir. 2001) (reasoning duty to update would undermine purpose of periodic reporting regime); *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1332 (holding no duty to update forward-looking statements that become untrue because of subsequent events).

545 *See*, *e.g.*, *Hillson Partners Ltd. Partnership v. Adage, Inc.*, 42 F.3d 204, 219 n.13 (4th Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160, 170 n.41 (5th Cir. 1994).

546 *See*, *e.g.*, *Helwig v. Vencor, Inc.*, 251 F.3d 540, 561 n.6 (6th Cir. 2001) (*en banc*), *cert. denied*, 536 U.S. 935 (2002); *In re Yahoo! Inc. Securities Litigation*, No. C 11–02732 CRB, 2012 WL 3282819 (N.D. Cal. Aug. 10, 2012).

547 *In re Healthco International Inc. Securities Litigation*, 777 F. Supp. 109, 113 (D. Mass. 1991); *accord In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1432 (3d Cir. 1997); *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1276–77 (D.C. Cir. 1994); *Friedman v. Mohasco Corp.*, 929 F.2d 77, 79 (2d Cir. 1991). The law is clear, however, that statements of opinion by top corporate officials may be actionable if made without a reasonable basis, *see Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1093–94 (1991), or if they are not made in good faith, *see Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1277 (D.C. Cir. 1994).

548 *See*, *e.g.*, *Oran v. Stafford*, 226 F.3d 275, 286 (3d Cir. 2000); *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 321 (3d Cir. 1997).

549 *McCarthy v. C-COR Electronics, Inc.*, 909 F. Supp. 970 (E.D. Pa. 1995).

550 *McCarthy v. C-COR Electronics, Inc.*, 909 F. Supp. 970, 977 (E.D. Pa. 1995).

551 *McCarthy v. C-COR Electronics, Inc.*, 909 F. Supp. 970, 977 (E.D. Pa. 1995).

552 *Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990).

553 *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990).

554 *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990).

555 *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. 1993), *cert. denied*, 511 U.S. 1017 (1994).

556 *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259, 267–68 (2d Cir. 1993), *cert. denied*, 511 U.S. 1017 (1994).

557 In a 2010 nonprecedential summary order, the Second Circuit provided a specific example of an affirmative duty to update. The defendant had stated in a press release and on a conference call that it expected to amend a material agreement with a key customer in order to cure an on-going breach, but it subsequently became clear that the customer would not agree to amend. The company's officials failed to disclose that information to the market and later made misleading public statements about the status of the negotiations.

The Second Circuit determined that although the press release contained sufficient cautionary language to negate liability under the "bespeaks caution" doctrine, the conference call statements were made without adequately alerting investors to the risks involved and were therefore not eligible for protection by that doctrine. Moreover, the court found that the company could not use the defense that its misstatements of fact about the failed negotiations were forward-looking statements, even if they were accompanied by cautionary language. *Illinois State Board of Investment v. Authentidate Holding Corp.*, No. 09 Civ. 1751, 2010 WL 889294 (2d Cir. 2010). *See* § 11.03[1][c] for a discussion of forward-looking statements and the "bespeaks caution" doctrine.

558 *See Weiner v. Quaker Oats Co.*, 129 F.3d 310 (3d Cir. 1997).

559 *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 314–18 (3d Cir. 1997). Although the court in *Weiner* discusses the company's duty to update the forward-looking debt-to-equity ratio guideline when it became unreliable, at other points it suggests that the duty may be limited to not repeating a forward-looking statement that has become unreliable. *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 317, 320 n.11 (3d Cir. 1997). On remand, the district court denied the defendants' motion to dismiss, concluding that the company had a "duty to update" its debt-to-equity ratio guideline. *Weiner v. Quaker Oats Co.*, No. 98 C 3123, 2000 WL 1700136, at *11 (N.D. Ill. Nov. 13, 2000).

560 *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 313 (3d Cir. 1997).

561 *Stransky v. Cummins Engine Co.*, 51 F.3d 1329 (7th Cir. 1995).

562 *Stransky v. Cummins Engine Co*., 51 F.3d 1329, 1332 (7th Cir. 1995); *accord Higginbotham v. Baxter International Inc*., 495 F.3d 753, 760 (7th Cir. 2007); *Gallagher v. Abbott Laboratories*, 269 F.3d 806, 810–11 (7th Cir. 2001); *see also Eisenstadt v. Centel Corp*., 113 F.3d 738, 746 (7th Cir. 1997) (observing that no legal duty exists in the Seventh Circuit to revise predictions that subsequent events prove incorrect).

563 The SEC staff has stated, however, that Regulation FD did not change existing law with respect to any duty to update. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.02 (June 4, 2010).

564 *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1433 (3d Cir. 1997).

565 The court attempted to distinguish its holding from earlier decisions involving the duty to update, which the court characterized as relating to a potential fundamental change to a company's business. *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1433 (3d Cir. 1997).

566 *In re Advanta Corp. Securities Litigation*, 180 F.3d 525, 536 (3d Cir. 1999) (citing *In re Burlington Coat Factory Securities Litigation*, 114 F.3d 1410, 1433 (3d Cir. 1997)) ("[T]he voluntary disclosure of an ordinary earnings forecast does not trigger any duty to update."). *See generally In re Verity, Inc. Securities Litigation*, No. C99-5337CRB, 2000 WL 1175580, at *5 (N.D. Cal. Aug. 11, 2000) (discussing cases regarding duty to update disclosure).

567 *In re Duane Reade Inc. Securities Litigation*, No. 02 Civ. 6478(NRB), 2003 WL 22801416, at *7 (S.D.N.Y. Nov. 25, 2003), *aff'd sub nom. Nardoff v. Duane Reade, Inc.*, 107 F. App'x 250 (2d Cir. 2004).

568 *In re Duane Reade Inc. Securities Litigation*, No. 02 Civ. 6478(NRB), 2003 WL 22801416, at *7 (S.D.N.Y. Nov. 25, 2003), *aff'd sub nom. Nardoff v. Duane Reade, Inc.*, 107 F. App'x 250 (2d Cir. 2004).

569 *In re Duane Reade Inc. Securities Litigation*, No. 02 Civ. 6478(NRB), 2003 WL 22801416, at *7 (S.D.N.Y. Nov. 25, 2003), *aff'd sub nom. Nardoff v. Duane Reade, Inc.*, 107 F. App'x 250 (2d Cir. 2004) (quoting *Stransky v. Cummins Engine Co.*, 51 F.3d 1329, 1333 n.9 (7th Cir. 1995)).

570 *In re Time Warner Inc. Securities Litigation*, 9 F.3d 259, 267 (2d Cir. 1993) (holding that company's hopeful statements regarding strategic alliances "lack[ed] the sort of definite positive projections that might require later correction").

571 *See Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 164 n.12 (2d Cir.1980) ("Liability may follow where management intentionally fosters a mistaken belief concerning a material fact, such as its evaluation of the company's progress and earnings prospects."); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) ("[M]aterial facts include … information disclosing the earnings and distributions of a company.").

572 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981); *accord Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 949 (2d Cir. 1969) ("While a company may choose to correct a misstatement in the press not attributable to it, … we find nothing in the securities legislation requiring it to do so."); *see also Eisenstadt v. Centel Corp.*, 113 F.3d 738, 744 (7th Cir. 1997) (noting that "a corporation has no duty to correct rumors planted by third parties"). *But cf. In re Sharon Steel*, SEC Release No. 34-18271 (Nov. 19, 1981) (holding that a company must assume a duty to make corrective disclosure where there is either evidence that the rumors originated from within the company or trading by insiders in the company's shares).

573 *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 850 (2d Cir. 1981). While courts have required that rumors be attributable to corporate officials before imposing a duty upon companies to either correct or verify them, the NYSE and Nasdaq place more stringent obligations upon management of listed corporations. Section 202.03 of the NYSE LISTED COMPANY MANUAL states that "[i]f rumors or unusual market activity indicate that information on impending developments has leaked out, a frank and explicit announcement is clearly required," and "[i]f rumors are in fact false or inaccurate, they should be promptly denied or clarified." Furthermore, according to the NYSE LISTED COMPANY MANUAL, "if rumors are correct or there are developments, an immediate candid statement to the public as to the state of negotiations or of development of corporate plans in the rumored area must be made directly and openly." NYSE LISTED COMPANY MANUAL § 202.03. Nasdaq guidance is to the same effect. *See* NASDAQ Marketplace Rules, IM-5250-1, NASDAQ MANUAL. It is important to note that, while the NYSE and Nasdaq place more onerous duties upon companies in this regard, violations of their disclosure rules have been held not to give rise to private causes of action, no issuer's shares have been delisted for violation of the policy and many companies adhere to a no-comment policy if there are rumors of unusual market activity.

574 Selective Disclosure and Insider Trading, SEC Release No. 33-7881 (Aug. 15, 2000).

575 *See* § 4.10.

576 Voluntary compliance with Regulation FD became more widespread in response to several high profile enforcement actions brought by the SEC under the regulation, which are discussed below. In addition, a number of jurisdictions have similar regulations. For example, Korea has its own version of Regulation FD, and the EU has implemented legislation relating to insider dealing and market manipulation that also prohibits selective disclosure of inside information, subject to limited exceptions. See Articles 10(1) and 17(8) of Regulation No 596/2014 of the European Parliament and of the Council on market abuse, which came into effect on July 3, 2016, replacing Directive 2003/6/EC of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), which previously dealt with these matters.

577 Effective October 4, 2010, the SEC removed the specific exemption previously provided for communications with nationally recognized statistical rating organizations and credit rating agencies for the purpose of determining or monitoring credit ratings. The removal was carried out to implement § 939B of the Dodd-Frank Act. SEC Release No. 33-9146 (Sept. 29, 2010). An issuer providing material nonpublic information to a rating agency would be well advised to rely on the exemption provided under Regulation FD for confidential disclosures, unless it can conclusively determine that the rating agency does not fall within one of the specified categories of persons to whom disclosure is prohibited. The exemption for disclosures made to persons under a confidentiality obligation does not require that obligation to be in writing. However, we believe it would be prudent for issuers relying on this exemption to obtain written confidentiality agreements where practicable. Following the Dodd-Frank Act, the major credit rating agencies incorporated confidentiality clauses into their standard agreements to facilitate issuers' ability to disclose confidential information to them without violating Regulation FD.

578 Material nonpublic information may be disclosed to a market professional or a securityholder as long as the recipient expressly agrees to maintain confidentiality until the information is public. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Questions 101.04–101.06 (June 4, 2010).

579 SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.09 (June 4, 2010).

580 Recently there has been a renewed focus on prohibiting insider trading by government officials, particularly by members of Congress. The Stop Trading on Congressional Knowledge Act, Pub. L. No. 112-105, 126 Stat. 291 (2012), prohibits members of Congress and federal employees from trading securities based on material nonpublic information obtained from their work. Recent Congressional insider trading scandals, including trading of health care stocks by members of Congress with insider knowledge of Medicare developments, continue to draw media and regulatory attention to this issue.

581 Statements made by officials of an issuer not authorized to communicate information to market professionals and securityholders for Regulation FD purposes are made in breach of a duty of trust or confidence to the issuer and are not covered by Regulation FD. Such disclosure may, however, trigger insider trading liability. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.10 (June 4, 2010).

582 Selective confirmation of a forecast by an issuer can trigger the public reporting requirements of Regulation FD, depending on, among other things, the amount of time that has elapsed between the original forecast and the confirmation. If asked about a prior forecast, an issuer should be cautious about saying there is "no change" to, or that it is "still comfortable" with, the forecast because this is tantamount to a confirmation. If the issuer does not wish to confirm the forecast, it simply should say "no comment"; the issuer also may refer back to the prior estimate without implicitly confirming it by making clear that the forecast was as of the date it was given and is not then being updated. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.01 (June 4, 2010).

583 Regulation FD was controversial particularly for this reason, and concerns were expressed that it would reduce the flow of information to investors. In 2001, a senior member of the SEC's Division of Corporation Finance stated that the following nonexclusive factors increase the likelihood that the SEC will consider information released by an issuer to be material for the purposes of Regulation FD: (i) the issuer is releasing the information late in its earnings cycle, (ii) the issuer has not released information to the public in a relatively long period of time or (iii) major intervening news events affecting the issuer have occurred since the issuer's last public communication. Michael Bologna, *Disclosure: Most Companies Seeking to Comply with Reg FD Disclosure Requirements*, SEC. L. DAILY, Apr. 20, 2001. In *In re Fifth Third Bancorp*, the SEC determined that a redemption notice to the holders of Fifth Third's trust preferred securities was material nonpublic information, principally because of the significant disparity between the trading price of the securities and the redemption price. *In re Fifth Third Bancorp*, SEC Release No. 34-65808 (Nov. 22, 2011).

584 A disclosure is "intentional" when the person making it either knows, or is reckless in not knowing, that the information the person is communicating is both material and nonpublic. For example, if an official of an issuer did not plan on making a disclosure at a meeting but, after hearing the direction of the discussion, decided to make it and knew that the information was material and nonpublic, Regulation FD would be violated without simultaneous public disclosure. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.04 (June 4, 2010).

585 In general, any document publicly filed on EDGAR with the SEC within the timeframe required by Regulation FD would satisfy the rule. In considering whether disclosure is sufficient, however, companies must (i) take care to bring the disclosure to the attention of the readers of the document, (ii) not bury the information and (iii) not make the disclosure in a piecemeal fashion throughout the filing. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.02 (June 4, 2010).

Once a Form 8-K is publicly available on EDGAR, an issuer need not wait before making disclosure of the information in a nonpublic forum. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.03 (June 4, 2010).

586 When issuing a press release to satisfy the NYSE's immediate release policy, the exchange requires listed

companies (domestic and foreign) to contact Dow Jones & Company, Inc., Reuters Economic Services and Bloomberg Business News and suggests that the release also be given to a number of other news services. NYSE LISTED COMPANY MANUAL § 202.06(c).

587 *See* § 4.10[7] for a discussion of developments in Regulation FD and social media.

588 Although several days' notice may be reasonable for a quarterly earnings announcement made by an issuer on a regular basis, the notice period may be shorter when unexpected events occur and the information is critical or time-sensitive. In addition, if a transcript or rebroadcast of the analysts' call will be available, such as through an issuer's website, the SEC staff has encouraged issuers to indicate in the notice how, and for what length of time, such a record will be available to the public. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.01 (Aug. 14, 2009).

589 SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Questions 102.05−102.06 (Aug. 14, 2009). Regulation FD does not prohibit a director from speaking privately with a shareholder or group of shareholders. However, where a director speaks on behalf of the company, Regulation FD prohibits the selective disclosure of nonpublic information. Companies should consider implementing Regulation FD compliance procedures, including pre-clearing comments or having counsel participate, if a director is authorized to speak on behalf of the company and plans on speaking privately with investors. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Questions 101.11 (June 4, 2010).

590 Richard H. Walker, Director, SEC Division of Enforcement, Remarks at Compliance and Legal Division of the Securities Industry Association, Regulation FD—An Enforcement Perspective (Nov. 1, 2000).

591 *See In re Raytheon Co.*, SEC Release No. 34-46897 (Nov. 25, 2002) (CFO spoke directly to 11 securities analysts and, based on his knowledge of their earnings estimates, told them that those estimates were "too high," "aggressive" or "very aggressive"); *In re Siebel Systems, Inc.*, SEC Release No. 34-46896 (Nov. 25, 2002) (CEO spoke to a number of individuals at an invitation-only technology conference and disclosed that, contrary to public statements made three weeks earlier, Siebel expected its sales activity levels to be in line with previous years); *In re Secure Computing Corp.*, SEC Release No. 34-46895 (Nov. 25, 2002) (CEO, on calls with two separate portfolio managers (the first of which also involved a representative of a brokerage firm) and in an e-mail to a managing partner of the brokerage firm, disclosed (non-intentionally, and then intentionally) that Secure had entered into a new material supply agreement, and the company failed to publicly release the non-intentionally released information in a timely fashion).

592 *Section 21(a) Report of Investigation: Motorola, Inc.*, SEC Release No. 34-46898 (Nov. 25, 2002) (investor relations director spoke directly to a number of securities analysts and clarified to them that previous guidance that Motorola's sales and orders were experiencing "significant weakness" meant a "25% or more" decline in sales and orders for the quarter, while not making any timely public disclosure of this quantitative information based in part on erroneous advice from in-house counsel).

593 In *In re Schering-Plough Corporation*, the CEO met in separate private meetings with analysts and portfolio managers of four institutional investors, three of which were among Schering's largest investors, and, through a combination of words, tone, emphasis and demeanor, disclosed material nonpublic information, including the fact that analysts' earning estimates were too high and that next year's earnings would decline significantly. The CEO subsequently met with approximately 25 other analysts and portfolio managers and indicated that Schering's 2003 earnings would be "terrible." *In re Schering-Plough Corporation*, SEC Release No. 34-48461 (Sept. 9, 2003).

The charges in *SEC v. Siebel Systems, Inc.* were subsequently dismissed by the court. *SEC v. Siebel Systems, Inc.*, SEC Litigation Release No. 18766 (June 29, 2004); *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694 (S.D.N.Y. 2005). The significance of the court's ruling is discussed below.

In *In re Senetek PLC*, the CEO and CFO sent nonpublic information on two separate occasions to different research firms that was subsequently included in the firms' research reports on Senetek. *In re Senetek PLC*, SEC Admin. Proc. File No. 3-11668 (Sept. 16, 2004).

In *SEC v. Flowserve Corp.*, the CEO met privately with several analysts and reaffirmed publicly available earnings guidance. The SEC highlighted that the disclosure to the analysts had led to an increase in the price of and trading volume in Flowserve stock and that the director of investor relations waited more than 53 hours after the selective disclosure and nearly 26 hours after the dissemination of the analyst's report before filing a Form 8-K disclosing the information revealed to the analysts. *SEC v. Flowserve Corp.*, SEC Litigation Release No. 119154 (Mar. 24, 2005).

In *In re Electronic Data Systems Incorporated*, company personnel violated Regulation FD in selectively disclosing the cost of settling certain derivative contracts weeks before the amounts were made public in the company's Form 10-Q. *In re Electronic Data Systems Incorporated*, SEC Release No. 34-56519 (Sept. 25, 2007).

594 The SEC settled an enforcement action in September 2009 against the former CFO of American Commercial Lines Inc. after he sent a message to analysts from his personal email account on a Saturday indicating substantially reduced earnings expectations for the quarter. The following Monday, the issuer's stock price decreased nearly 10% on three times the normal trading volume. Notwithstanding his familiarity with Regulation FD, the CFO acted without prior consultation with counsel and without going through the proper investor relations channels for publicly disseminating material information. *SEC v. Black*, SEC Litigation Release No. 21222 (Sept. 24, 2009) (complaint); *In re Black*, SEC Admin. Proc. File No. 3-13625 (Sept. 24, 2009).

In October 2010, the SEC brought and settled enforcement actions against Office Depot, Inc., its CEO and former CFO after investor relations personnel, at the direction of the CEO and CFO, placed unprecedented private calls to analysts in advance of the release of quarterly earnings to signal that the company would not meet consensus earnings estimates. Company personnel did not explicitly state that estimates would not be met, but reminded analysts of prior statements made by company officials and also referred to other companies that had announced lower-than-expected results. Analysts concluded the company would not meet earnings estimates, and between the time calls were initially made and the company's public announcement on Form 8-K six days later that earnings would be negatively impacted by economic conditions, the price of the company's shares fell 7.7%. *SEC v. Office Depot, Inc.*, SEC Litigation Release No. 21703 (Oct. 21, 2010); *In re Office Depot, Inc.*, SEC Admin. Proc. File No. 3-14094 (Oct. 21, 2010); *In re Odland*, SEC Admin. Proc. File No. 3-14095 (Oct. 21, 2010); *In re McKay*, SEC Admin. Proc. File No. 3-14096 (Oct. 21, 2010).

In November 2011, the SEC issued a cease-and-desist order against Fifth Third Bancorp for violation of Regulation FD. In *In re Fifth Third Bancorp*, Fifth Third issued a redemption notice to the holders of a series of its trust preferred securities through DTC, but did not file a Form 8-K or issue a press release to alert the public to the redemption. The redemption price was significantly lower than the price at which the securities were then trading, which resulted in heavy sales of the trust preferred securities by existing holders. Fifth Third filed a Form 8-K announcing the redemption only after it learned of the impact its selective disclosure had on the market. The SEC determined that the redemption notice was material nonpublic information because a reasonable investor would consider it important that a security was to be redeemed at a price lower than the current market price. Without admitting or denying the SEC's findings, Fifth Third consented to the issuance of the cease-and-desist order. *In re Fifth Third Bancorp*, SEC Release No. 34-65808 (Nov. 22, 2011).

In September 2013, the SEC issued a cease-and-desist order against Lawrence D. Polizzotto, former Vice President of Investor Relations of First Solar Inc., for violation of Regulation FD. According to the SEC's order, Polizzotto revealed in phone calls with more than 30 analysts and investors that First Solar was unlikely to receive one of three loan guarantees totaling $4.5 billion from the U.S. Department of Energy for which the company had received conditional commitments, despite knowing the company had not yet publicly disclosed this information. When First Solar disclosed the loss of the loan guarantee the next morning, its stock price dropped by 6%. Without admitting or denying the SEC's findings, Polizzotto consented to the cease-and-desist order. *In the Matter of Lawrence D. Polizzotto*, SEC Admin. Proc. File No. 3-15458 (Sept. 6, 2013).

595 Although the former CFO in the *Black* proceeding agreed to a settlement comprised of a $25,000 civil penalty and a bar against future violations of Regulation FD, the SEC determined not to bring charges against American Commercial Lines itself due in part to its extraordinary cooperation with the SEC. The SEC indicated that it was not bringing charges against the issuer because: (i) prior to the selective disclosure, the issuer had cultivated an environment of compliance by providing Regulation FD training and implementing appropriate policies and controls designed to prevent violations, (ii) the CFO alone was responsible for the violation and he acted outside the control systems established by the issuer, (iii) the issuer acted promptly to correct the selective disclosure once it was discovered, filing a Form 8-K with the SEC on Monday afternoon, (iv) the issuer reported the selective disclosure to the SEC staff the day after it was discovered and provided extraordinary cooperation with the staff's investigation and (v) the issuer took remedial steps to address the improper conduct, including by adopting additional controls to prevent a repetition of similar conduct. *SEC v. Black*, S.D. Ind. Case No. 09-CV-0128 (Sept. 24, 2009); *In re Black*, SEC Admin. Proc. File No. 3-13625 (Sept. 24, 2009); *SEC v. Black*, SEC Litigation Release No. 21222 (Sept. 24, 2009).

In *In the Matter of Lawrence D. Polizzotto*, the SEC determined not to bring an enforcement action against the company, First Solar Inc., because, among other things, (i) the company cultivated an environment of compliance through the use of a disclosure committee that focused on compliance with Regulation FD; (ii) the company promptly issued a press release the morning after discovering Polizzotto's selective disclosure; and (iii) the company quickly self-reported the misconduct to the SEC. SEC Release No. 2013-174 (Sept. 6, 2013).

596 *Section 21(a) Report of Investigation: Motorola, Inc.*, SEC Release No. 34-46898 (Nov. 25, 2002). Recognizing that an officer may better understand the importance of information to investors, the SEC stated that consultation with counsel "will not relieve the officer from responsibility for disclosure of information that he or she personally knows, or is reckless in not knowing, is material and nonpublic." The SEC also noted that if counsel does nothing more than recite the legal standard and then ask the officer in question whether a reasonable investor would consider the information significant, the resulting judgment is the officer's, not counsel's. In addition, the SEC clarified that, although counsel's advice may initially provide an officer with a good faith basis for making a selective disclosure when the advice is received, that officer "may become aware of a very significant market reaction and may learn facts indicating that this reaction was a result of the selective disclosure. At that point, even though the officer's original selective disclosure was not intentional, the issuer has learned that it has made a non-intentional disclosure and must make the prompt public disclosure required by Regulation FD." *Section 21(a) Report of Investigation: Motorola, Inc.*, SEC Release No. 34-46898 (Nov. 25, 2002).

597 The cease-and-desist order to which Flowserve consented referred to the SEC's view that the selective disclosure had been "intentional" in this case. The SEC stated that "selective disclosure is ‘intentional’ when the person making the disclosure knows, or is reckless in not knowing, that the information being communicated is both ‘material’ and ‘nonpublic.’" SEC Release No. 34-51427 (Mar. 24, 2005). On the basis of that definition, the SEC concluded that the CEO's selective disclosure had been intentional. While in hindsight the information may have been material since the stock price and trading volume of Flowserve did in fact increase significantly following the publication of the research analyst report revealing the CEO's remarks, one could argue that the CEO could reasonably have thought that merely reaffirming previously issued publicly available earnings guidance would not be material to investors.

598 *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694 (S.D.N.Y. 2005).

599 *SEC v. Siebel Systems, Inc.*, SEC Litigation Release No. 18766 (June 29, 2004). Siebel's CFO and investor relations director were also charged with aiding and abetting the Regulation FD violations.

600 The SEC also charged Siebel with violating Rule 13a-15 under the Exchange Act, which requires issuers to maintain disclosure controls and procedures to ensure the proper handling of information required to be disclosed in reports filed or submitted under the Exchange Act and to ensure that management is provided the information necessary to make timely disclosure decisions. The SEC alleged that Siebel's failure to publicly disseminate the information in compliance with Regulation FD was evidence of inadequate

disclosure controls and procedures in violation of Rule 13a-15. This represented the first time the SEC had charged an issuer with a violation of Rule 13a-15, and it bears noting that this claim was made in connection with Regulation FD rather than financial statements or periodic reports. This charge highlights the need for companies to address the disclosure requirements under Form 8-K, because a failure to file, or a late filing of, a required Form 8-K may serve as the basis for allegations that the issuer's disclosure controls and procedures were inadequate.

601 *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694, 704 (S.D.N.Y. 2005).

602 *SEC v. Siebel Systems, Inc.*, 384 F. Supp. 2d 694, 705 (S.D.N.Y. 2005).

603 The court also dismissed the charge relating to the violation of Rule 13a-15 on the basis that there were no factual allegations providing independent support for this claim absent the alleged violation of Regulation FD. *See supra* Note 601. Because the court ruled that the SEC had failed to state a cause of action, the court did not have an opportunity to consider Siebel's constitutional claims.

604 *Commission Guidance on the Use of Company Websites*, SEC Release No. 34-58288, at Section II.A.2 (Aug. 1, 2008), 73 Fed. Reg. 45,862, 45,868 (Aug. 7, 2008).

605 *See* Netflix 8-K of Dec. 6, 2012 reporting receipt of the Wells Notice.

606 *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings*, SEC Release No. 34-69279 (Apr. 2, 2013).

607 The SEC's 2008 guidance set out several factors for companies to consider when determining whether a social media outlet is a "recognized channel of distribution," including (1) whether and how companies let investors and the markets know that the company has a website that should be looked to for information, (2) whether the company has provided awareness that it will post important information there and whether it has a pattern or practice of doing so, (3) whether the company's website is designed to lead investors and the market efficiently to information about the company, whether the information is prominently disclosed in a location known and routinely used for such disclosures and whether it is presented in a format readily accessible to the general public, (4) the extent to which information posted on the website is regularly picked up by the market and readily available media and reported there or the extent to which the company has advised the media about the information, (5) the steps the company has taken to make its website and the information accessible, (6) whether the company keeps its website current and accurate, (7) whether the company uses other methods to disseminate information and whether and to what extent those other methods are the predominant methods the company uses to disseminate information and (8) the nature of the information. *Commission Guidance on the Use of Company Web Sites*, SEC Release No. 34-58288, 20-22 (Aug. 1, 2008); 73 Fed. Reg. 45,862, 45,867-68 (Aug. 7, 2008).

608 *See* NYSE LISTED COMPANY MANUAL §§ 202.05, 202.06; NASDAQ Stock Market Rule 5250(b), IM-5250-1. Note in this regard that the NYSE continues to encourage the use of press releases when disseminating material information within the meaning of its rules.

609 Under a staff Compliance and Disclosure Interpretation, if a company's policy identified authorized spokespersons, it is not responsible for selective disclosures by others. SEC, *Compliance and Disclosure Interpretations*, Regulation FD, Question 101.10 (Aug. 14, 2009). While the guidance set forth in the SEC report on Netflix did not address its implications for this C&DI, creating a record of authorized social media channels nevertheless seems prudent.

610 Companies should be aware, however, that a policy that flatly prohibits employees from disclosing information through their personal social media is of questionable enforceability, as it could be construed as an unlawful work rule that would tend to chill employees when engaging in protected organizing activity under § 7 of the National Labor Relations Act. *See* Office of General Counsel, National Labor Relations Board, Memorandum OM 11-74 (Aug. 18, 2011), Memorandum OM 12-31 (Jan. 24, 2012) and Memorandum OM 12-59 (May 30, 2012) (finding certain restrictions and prohibitions in social media policies to be overbroad and unlawful under the National Labor Relations Act). Companies should be sure to clarify that social media restrictions are not intended to impinge on § 7 rights, in part by providing examples in their policies of acceptable versus unacceptable uses of social media.

611 *See*, *e.g.*, Rule 165 under the Securities Act (written communications made "in connection with or relating to" a business combination transaction where securities are offered as consideration) and Rule 14a-12 under the Exchange Act (solicitation before furnishing a proxy statement).

612 *See*, *e.g.*, Rule 135 under the Securities Act (press release notice of proposed public offering) and § 21E of the Exchange Act (forward-looking statement).

613 *Chiarella v. United States*, 445 U.S. 222 (1980).

614 *Dirks v. SEC*, 463 U.S. 646 (1983).

615 Although a decision in the district court for the Northern District of Texas cast doubt on whether a breach of a duty of trust and confidence requires an explicit agreement not to trade, in addition to an agreement to keep material nonpublic information confidential, the Fifth Circuit Court of Appeals reaffirmed in September 2010 that no explicit agreement is required if the parties understood that they were not to trade on the information when it was disclosed. *See supra* Note 517.

616 *Dirks v. SEC*, 463 U.S. 664 (1983).

617 *See* § 11.05[2][a][ii] for a discussion of recent cases on the nature of the personal benefit that must be received in the context of alleged selective disclosure to friends or family (rather than to securities analysts) to establish liability under the misappropriation theory.

618 *SEC v. Stevens*, SEC Litigation Release No. 12813 (Mar. 19, 1991).

619 The requirements and scope of Regulation FD are discussed above. *See* §§ 4.10[6] and [7].

620 According to the SEC staff, adequate advance notice under Regulation FD must include the date, time, subject matter and call-in information for the analysts' call. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.01 (June 4, 2010). Public notice should be provided a reasonable period of time in advance of the conference call. For example, while several days' notice may be reasonable for a quarterly earnings announcement made by an issuer on a regular basis, the notice period may be shorter when unexpected events occur and the information is critical or time sensitive. In addition, if a transcript or rebroadcast of the analysts' call will be available, such as through an issuer's website, the SEC staff has encouraged issuers to indicate in the notice how, and for what length of time, such a record will be available to the public. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 102.01 (Aug. 14, 2009).

621 A company may elect to submit nonpublic information required to be disclosed by Regulation FD pursuant to Item 8.01 of Form 8-K, providing for disclosure regarding "Other Events," rather than Item 7.01. Unlike information filed pursuant to Item 8.01, however, the information in a report furnished pursuant to Item 7.01 is not automatically incorporated by reference in short-form registration statements under the Securities Act or deemed to be "filed" for purposes of § 18 of the Exchange Act or otherwise subject to the liabilities of that section, unless the registrant specifically states the information is to be considered filed under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

622 *Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (1988).

623 A company subject to Regulation FD is required to disclose the information generally within 24 hours pursuant to a Regulation FD-compliant method of disclosure.

624 The NYSE LISTED COMPANY MANUAL requires listed companies promptly and publicly to release material information that has been inadvertently leaked to analysts and offers explicit instructions regarding such press releases. NYSE LISTED COMPANY MANUAL §§ 202.03–202.06. Section 202.06(C) states that such news must be disseminated "by the fastest available means," which ordinarily requires a "release to the public press by telephone, facsimile or hand delivery, or some combination of such methods." Adequate disclosure to the investment community requires companies to release information to the Dow Jones, Reuters and Bloomberg news services. NYSE LISTED COMPANY MANUAL § 202.06(C). The NYSE LISTED COMPANY MANUAL also encourages companies to promptly distribute their releases to the Associated Press and United Press International, as well as to newspapers in New York City and in cities in which the company has its headquarters, plants or other major facilities. Copies of such releases should be sent to

the company's NYSE representative.

A company listed on Nasdaq is obliged to disclose to the Nasdaq MarketWatch Department material information that the company is not otherwise disclosing to the investing public or the financial community. NASDAQ Marketplace Rules, IM-5250-1, NASDAQ MANUAL. Where changes in market activity indicate that information has become known to the investing public, Nasdaq may work with the company to effect a timely public release of such information, subject to the company's views as to the business advisability of disclosing the information and the nature of the event itself.

The importance of keeping the stock exchange on which the company is listed fully informed about inadvertent disclosures of material information was illustrated in *SEC v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976), and *State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843 (2d Cir. 1981). The Second Circuit ruled in *Geon* that an officer of the company had violated Rule 10b-5 because, when asked by an AMEX representative if there were any developments regarding the previously announced merger of Geon with Burmah Oil Co., Ltd. to account for the imbalance of sell orders in Geon stock, the officer failed to disclose information that would indicate the possible collapse of the merger. *See Geon Industries, Inc.*, 531 F.2d 39, 47 (2d Cir. 1976). On the other hand, in *Fluor*, the Second Circuit's decision that the company was not liable under Rule 10b-5 relied, in part, on the fact that company officials had informed a NYSE representative that the unannounced award of a substantial contract could be the reason for increased trading volume in company securities. *See State Teachers Retirement Board v. Fluor Corp.*, 654 F.2d 843, 851 (2d Cir. 1981). Following an inadvertent disclosure of material information to an individual or group of individuals, the company should also consider contacting the stock exchange on which it is listed to discuss the possible need for a halt in trading of the company's securities pending dissemination of the press release. *In Fluor*, the Second Circuit's decision that the company was not liable under Rule 10b-5 also emphasized that the company had acted in "good faith" by endorsing the NYSE decision to halt trading.

625 *SEC v. Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976).

626 *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47 (2d Cir. 1976).

U.S. Regulation of the International Securities and Derivatives Markets, § 4.11, DEREGISTRATION AND DELISTING

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 § 4.11 (11th and 12th Editions 2014-2017)
11th and 12th Editions

[1] Delisting from an Exchange

A foreign private issuer can withdraw a class of securities from listing on a national securities exchange (such as the NYSE or Nasdaq) by filing an

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application on Form 25 with the SEC. [627] The delisting of the security will be effective ten days after a Form 25 is filed with the SEC. [628] The withdrawal from registration under § 12(b) of the Exchange Act will take effect 90 days after the filing of the Form 25, or such shorter period as the SEC may determine. [629]

In addition, Rule 12d2-2(c) under the Exchange Act requires an issuer filing a Form 25 to satisfy the following requirements: (i) comply with the applicable exchange's rules for delisting and applicable state laws, (ii) submit a written notification to the exchange no fewer than ten days before the issuer files a Form 25 of its intent to withdraw its security from listing and/or registration on such exchange, [630] and (iii) contemporaneously with providing a written notice to the exchange, issue a public notice of its intent to delist and/or withdraw its security from § 12(b) registration via a press release, and if it has a publicly accessible website, post such notice on that website. Moreover, the applicable exchange is required to provide notice on its own website of the issuer's intent to delist by the next business day after it receives such notice from the issuer. [631] The notices by the issuer and the exchange on their respective websites must remain posted until the delisting becomes effective. [632]

The NYSE allows a company to delist a security pursuant to Rule 12d2-2(c) upon approval by its board of directors. [633] Nasdaq allows an issuer to voluntarily terminate its listing upon compliance with all requirements of Rule 12d2-2(c). [634]

[2] Termination and Suspension of Periodic Reporting

[a] Termination

The SEC adopted rules in 2007 that make it easier for foreign private issuers to exit the Exchange Act reporting regime. [635] The SEC proposed and adopted

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these rule amendments out of concern that, due to several trends, including the increased internationalization of the U.S. securities markets in recent decades, it has become difficult for foreign private issuers to exit the Exchange Act reporting system even when there is relatively little U.S. trading interest in its U.S.-registered securities. [636] The rules allow a foreign private issuer to terminate Exchange Act reporting for its equity securities by meeting a quantitative benchmark provision based on its U.S. trading volume relative to its worldwide trading volume, as an alternative to the 300 record holder standard. [637] The rules also enable a foreign private issuer to terminate, rather than merely suspend, its § 15(d) reporting obligations and to claim the benefits of Rule 12g3-2(b) exemption immediately upon the effectiveness of its termination of reporting pursuant to Rule 12h-6. [638]

Under Rule 12h-6, a foreign private issuer is able to terminate its Exchange Act registration and reporting obligations regarding a class of equity securities if it satisfies (i) the quantitative benchmark condition, (ii) the prior reporting condition, (iii) the one-year dormancy condition and (iv) the foreign listing condition, each as described below.

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The quantitative benchmark condition can be satisfied by meeting either one of the following tests:

- The average daily trading volume (the "ADTV") of the class of equity securities in the United States has been no greater than 5% of the ADTV of that equity security on a worldwide basis during a recent 12-month period; [639] or
- There are less than 300 holders of record on a worldwide basis or less than 300 holders of record resident in the United States. [640]

A foreign private issuer that has delisted a class of equity securities from a U.S. national securities exchange or automated inter-dealer quotation system or that has terminated a sponsored ADR facility will be subject to a one-year waiting period before it may file Form 15F to deregister unless it satisfied this trading volume test on the date of its delisting or termination. [641]

The prior reporting condition requires that the issuer have had SEC reporting obligations for at least one year before deregistration, have filed or furnished all reports required for such period, and have filed at least one annual report. [642]

The one-year dormancy condition prohibits sales of a foreign private issuer's securities in the United States in a registered offering during the 12 months preceding the deregistration, subject to certain exceptions. [643] The primary purpose of this condition is to preclude a foreign private issuer from exiting the

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Exchange Act reporting system shortly after it has engaged in U.S. capital-raising through a public offering. [644]

The foreign listing condition requires that the foreign private issuer have maintained for at least 12 months a listing of the subject class of equity securities on an exchange in a foreign jurisdiction, which, either singly or together with one other foreign jurisdiction, constitutes the primary trading market for such securities. [645] The purpose of this foreign listing condition is to help assure that there is a non-U.S. jurisdiction that principally regulates and oversees the issuance and trading of the issuer's securities and the issuer's disclosure obligations to investors. [646]

Rule 12h-6 enables a foreign private issuer to terminate its Exchange Act reporting obligations regarding a class of debt securities as long as the issuer has filed or furnished all reports required under § 13(a) or § 15(d) of the Exchange Act, including at least one Exchange Act annual report on Form 20-F, and has its class of debt securities held of record by less than 300 holders either on a worldwide basis or who are U.S. residents. [647]

Under Rule 12h-6, a foreign private issuer has to file a Form 15F with the SEC to certify its compliance with the requirements for termination of its Exchange Act reporting obligations. As with the filing of Form 15 under the previous rules, the filing of Form 15F automatically suspends an issuer's reporting duties. If the SEC has not objected, the suspension would become a permanent termination 90 days after the filing of the Form 15F. If the Form 15F is subsequently withdrawn or denied, the issuer will be required, within 60 days of the date of the denial or withdrawal, to file or submit all reports that would have been required had it not filed the Form 15F. [648] After filing the Form 15F, an issuer has no continuing obligation to make inquiries concerning the information contained in the Form 15F, including its assessment of trading volume or ownership of its securities. However, if, during the 90-day waiting period, the issuer has actual knowledge of information that causes it reasonably to believe that, at the date of filing the Form 15F, it was not qualified to deregister under Rule 12h-6, the issuer must withdraw its Form 15F. [649]

Under Rule 12h-6, a foreign private issuer must publish, either before or on the date that it files its Form 15F, a notice in the United States that discloses its intent to terminate its Exchange Act reporting obligations. The issuer must publish the notice, such as a press release, through a means reasonably designed to provide broad dissemination of the information to the public in the United

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States. The issuer is also required to submit a copy of the notice, either under cover of a Form 6-K, before or at the time of filing of the Form 15F, or as an exhibit to the Form 15F. [650]

The SEC has indirectly indicated that companies that terminate their reporting obligations under Rule 12h-6 are not issuers for purposes of the Sarbanes-Oxley Act. [651] They should not be considered as such, because they no longer have securities registered under § 12 of the Exchange Act and are not required to file reports under § 15(d) of the Exchange Act. We believe the termination of a company's issuer status in this context should be effective when a certification on Form 15F is filed. These companies would again become subject to the Sarbanes-Oxley Act if and when they have reporting duties at the beginning of any fiscal year or have filed a Securities Act registration statement. [652]

[b] Suspension

[i] *General*

As a consequence of having a registration statement declared effective under the Securities Act, an issuer becomes a reporting company under § 15(d) of the Exchange Act. Section 15(d) provides that an issuer's duty to report is automatically suspended, if at the beginning of any fiscal year (other than the year in which the relevant registration statement became effective), the class of securities covered by the relevant registration statement is held of record by fewer than 300 persons worldwide. In determining the number of record holders, an issuer may treat a custodian as a single record holder and holders of securities pursuant to a deposit agreement or similar arrangement as record holders. [653] It is

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not necessary to "look through" any securities held by any such holders to ultimate beneficial owners.

Suspension of an issuer's reporting duty on the basis of § 15(d) requires, but is not conditioned on, the filing of a notice on Form 15, within 30 days of the beginning of the first fiscal year in which the duty is suspended, and depends on the number of holders as of the beginning of the issuer's fiscal year. [654] If the limit on the number of holders is exceeded on the first day of a subsequent fiscal year, the issuer's reporting obligations will cease to be suspended as of that day. [655] As noted above, by availing themselves of Rule 12h-6 when they qualify, foreign issuers can terminate, rather than merely suspend, their § 15(d) obligations. For this reason, the availability of Rule 12h-6 should reduce the number and complexity of situations for foreign issuers involving suspension of reporting obligations under § 15(d).

The SEC has stated that a company whose duty to report under § 15(d) is automatically suspended would not be an issuer subject to the Sarbanes-Oxley Act during the time that the duty is suspended, regardless of whether it filed a notice on Form 15. [656] Such a company would, however, again become subject to the Sarbanes-Oxley Act if and when it no longer meets the requirements for suspension of reporting duties at the beginning of any fiscal year (unless it has terminated its Exchange Act registration and reporting obligations pursuant to Rule 12h-6) or if it files a Securities Act registration statement. [657]

[ii] *Issuers Emerging from Bankruptcy*

While companies in bankruptcy are not relieved of their Exchange Act reporting obligations, the SEC will generally accept modified Exchange Act reports from issuers subject to proceedings under the U.S. Bankruptcy Act. [658]

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Although foreign private issuers have not requested or obtained relief from the SEC in these circumstances, in all likelihood the SEC would apply the same standards to such companies as it applies to U.S. companies, discussed in detail below, as modified to apply to annual reports on Form 20-F and current reports on Form 6-K.

In deciding whether to accept modified Exchange Act reports, the SEC considers (i) how difficult it is for the issuer to obtain the information necessary to complete the reports, (ii) the issuer's financial condition, (iii) the issuer's efforts to advise its securityholders and the public of its financial condition and activities and (iv) the nature and extent of the trading in the issuer's securities. However, generally speaking, as soon as such conditions cease, unless relief is granted, the full requirements of the Exchange Act again apply, including the requirement for audited financial statements for all required periods even though the issuer may have been subject to bankruptcy proceedings during some portion of those periods. The SEC has further indicated that, in deciding whether to grant relief, it looks to (i) the timeliness of an issuer's Form 8-K announcing its bankruptcy filing and (ii) whether an issuer files a Form 8-K announcing that its reorganization plan has become effective, including a "fresh-start" audited balance sheet as of the date of the issuer's release from Chapter 11 under the U.S. Bankruptcy Code. [659]

A limited number of SEC no-action letters have granted relief to particular issuers while still in bankruptcy modifying the requirements for their post-reorganization filings under the Exchange Act. [660] Such relief was granted on the basis that, while still in bankruptcy, the issuer would file its bankruptcy reports under cover of Form 8-K during the time it is required to file reports with the bankruptcy court, with each such Form 8-K filed no later than 15 days after such reports are required to be so filed. In addition, the relief required the issuer, upon release from proceedings under the U.S. Bankruptcy Code, to file the appropriate Form 8-K and its audited balance sheet and comply fully with its reporting obligations under the Exchange Act for all periods commencing after such release, presenting audited financials for such periods. In filings under the Securities Act, however, the SEC will not provide relief from audited financial statement requirements, even if some portion of the periods required to be audited include the period during which an issuer was subject to bankruptcy proceedings.

Footnotes

627 Rule 12d2-2(c) under the Exchange Act. Rule 12d2-2 has been amended in order to simplify the delisting procedure. *See* SEC Release No. 34-52029 (July 15, 2005).

628 Rule 12d2-2(d)(1) under the Exchange Act.

629 Rule 12d2-2(d)(2) under the Exchange Act.

630 The written notice to the exchange must include a description of the security involved together with a statement of all material facts relating to the reasons for filing such application for withdrawal from listing and registration. Because delisting would not become effective until ten days after filing the Form 25, the issuer should provide written notice to the exchange, as well as the public notice, at least 20 days before the planned delisting date. *See* SEC Release No. 34-52029 (July 15, 2005).

631 Rule 12d2-2(c)(3) under the Exchange Act.

632 Rule 12d2-2(c)(2)(iii) and (c)(3) under the Exchange Act.

633 NYSE Listed Company Manual § 806.02.

634 NASDAQ Marketplace Rules, Rule 5840(j), NASDAQ Manual.

635 SEC Release No. 34-55540 (June 4, 2007). The principal changes are set out in Rule 12h-6 under the Exchange Act adopted by the SEC pursuant to its exemptive authority under § 12(h) of the Exchange Act. The SEC also eliminated certain provisions of Rules 12g-4 and 12h-3 under the Exchange Act relating to foreign private issuers. As amended, Rule 12g-4 allows termination of registration of a class of securities under § 12(g) of the Exchange Act, and Rule 12h-3 allows suspension of a reporting obligation under § 15(d) of the Exchange Act, if the class of securities is held of record by less than 300 persons worldwide (or less than 500 persons worldwide where the total assets of the issuer have not exceeded $10 million on the last day of each of the issuer's most recent three fiscal years). Although Rules 12g-4 and 12h-3, as

amended, do not exclude foreign private issuers, few, if any, foreign private issuers are expected to proceed under these rules. As discussed below, while new Rule 12h-6 retains the 300 record holder standard for debt securities and as an alternative test for equity securities, it provides significant advantages to foreign private issuers compared to Rule 12g-4 or 12h-3. These advantages include: (i) an easier method of counting the record holders and (ii) the ability to terminate (rather than merely suspend) § 15(d) reporting obligations.

636 *See* SEC Release No. 34-53020 (Dec. 23, 2005); SEC Release No. 34-55005 (Dec. 22, 2006); SEC Release No. 34-55540 (Mar. 27, 2007). The adoption of Rule 12h-6 was driven in part by renewed interest in the deregistration rules, which arose both because companies with securities listed in the United States had been able to more readily turn to the non-U.S. and Rule 144A markets to raise capital, and because of the real or perceived burdens and risks of U.S. registration, including those associated with complying with the Sarbanes-Oxley Act. Foreign issuers had found that the "look-through" rules previously used to determine whether they had 300 U.S. shareholders were so difficult to implement that they often could not determine whether they qualified to terminate their registration. They had also objected to the previous rules on the basis that the 300 shareholder threshold was very low in a world of internet trading and global markets, and that, even after deregistration, Rule 12g3-2(a) required them to determine annually whether they had to re-register their securities.

637 Rule 12h-6 revised the method of counting record holders for securities issued by foreign private issuers. *See infra* Note 640.

638 *See* § 4.02[3][a][iv] for a discussion of the Rule 12g3-2(b) exemption.

639 Rule 12h-6(a)(4)(i) under the Exchange Act.

640 Rule 12h-6(a)(4)(ii) under the Exchange Act. Instead of having to look through the accounts of brokers, banks and other nominees on a worldwide basis to determine the number of its U.S. resident holders, as is required under Rule 12g3-2(a), a foreign private issuer can limit its inquiry to brokers, banks and other nominees located in the United States, the issuer's jurisdiction of legal formation and, if different, the jurisdiction of its primary trading market. Rule 12h-6(e) under the Exchange Act.

641 *See* Rule 12h-6(b) under the Exchange Act. Foreign issuers have employed a number of different strategies in the past to expedite deregistration, although the introduction of Rule 12h-6 has significantly facilitated the process. Deregistration can still present challenges to foreign issuers looking to satisfy the Rule 12h-6 requirements.

642 Rule 12h-6(a)(1) under the Exchange Act.

643 Rule 12h-6(a)(2) under the Exchange Act. Rule 12h-6(a)(2) excludes from this condition securities issued (i) to the issuer's employees, (ii) by selling securityholders in non-underwritten offerings, (iii) upon the exercise of outstanding rights granted by the issuer if the rights are granted *pro rata* to all existing securityholders of the class of the issuer's securities to which the rights attach, (iv) pursuant to a dividend or interest reinvestment plan, or (v) upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants issued by the issuer. However, the exceptions under clauses (iii), (iv) and (v) above do not apply to securities issued pursuant to a standby underwritten offering or other similar arrangement in the United States. *See* Note to Rule 12h-6(a)(2) under the Exchange Act.

644 SEC Release No. 34-55540 (Mar. 27, 2007).

645 *See infra* Note 25 for the definition of "primary trading market."

646 SEC Release No. 34-55540 (Mar. 27, 2007).

647 Rule 12h-6(c) under the Exchange Act.

648 Rule 12h-6(g) under the Exchange Act.

649 Form 15F, Item 11.

650 Rule 12h-6(h) under the Exchange Act.

651 *See* SEC Release No. 34-55540 (Mar. 27, 2007) (noting that, as a result of terminating their Exchange Act reporting obligations under Rule 12h-6, foreign firms may save costs required for an investment in an

internal control system in order to comply with the Sarbanes-Oxley Act). A company is an issuer for purposes of the Sarbanes-Oxley Act if it (i) has securities registered under § 12 of the Exchange Act, (ii) is required to file reports under § 15(d) of the Exchange Act or (iii) files or has filed a registration statement under the Securities Act that has not yet become effective and that has not been withdrawn.

652 *See* § 4.07 for a detailed discussion of the Sarbanes-Oxley Act.

653 Rule 12g5-1 under the Exchange Act. The SEC has stated that institutional custodians, such as Cede & Co. acting as nominee holder for The Depository Trust Company, are not single record holders for purposes of the Exchange Act's registration and periodic reporting obligations. Instead, each of the custodian's accounts for which the securities are held is a record holder (meaning, in the case of The Depository Trust Company, that participants are record holders while indirect participants are not). *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Rules, Question 152.01 (Sept. 30, 2008).

654 § 15(d) of the Exchange Act and Rule 15d-6 thereunder.

655 Rule 12h-3(e) under the Exchange Act. An issuer that has had a Securities Act registration statement declared effective by the SEC and has not filed a Form 15F pursuant to Rule 12h-6 would be required to monitor the number of U.S. holders of its securities in order to determine whether registration under § 12 would be required. While it is highly unlikely in this scenario that the SEC would bring an action requiring registration of such securities if the relevant shareholder limits were exceeded, a technical obligation for the issuer to register the securities would nevertheless exist unless such issuer (i) had terminated its obligation pursuant to Rule 12h-6, (ii) had obtained from the SEC an order terminating its § 15(d) obligation or (iii) met the criteria to avail itself of the Rule 12g3-2(b) exemption. *See Sun Healthcare Group, Inc.* (avail. Sept. 29, 2010); *Hungarian Telephone and Cable Corp*. (avail. Feb. 27, 2009); *Trio-Kenwood Corporation* (avail. Mar. 1, 1983) (permitting foreign private issuers with suspended § 15(d) reporting obligations to rely on Rule 12g3-2(b)).

656 SEC, Division of Corporation Finance, Sarbanes-Oxley Act of 2002—Frequently Asked Questions, Question 2 (Nov. 8, 2002, *rev'd* Nov. 14, 2002).

657 *See* § 4.07 for a detailed discussion of the Sarbanes-Oxley Act.

658 *See* SEC Release No. 34-9660 (June 30, 1972).

659 *See* SEC, Division of Corporation Finance, Staff Legal Bulletin No. 2 (Apr. 15, 1997), Fed. Sec. L. Rep. (CCH) ¶60,002.

660 *See*, *e.g.*, *Opticon Medical, Inc*. (avail. June 28, 2002).

U.S. Regulation of the International Securities and Derivatives Markets, § 5.01, 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 § 5.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Chapter 4 discusses the continuing disclosure obligations of a foreign private issuer that is a reporting company, meaning that it is required to file reports with the SEC under either § 13(a) or § 15(d) of the Exchange Act. This Chapter 5 discusses other kinds of requirements that apply to a reporting foreign private issuer—those mainly relating to corporate governance. Specifically, it addresses audit committees (§ 5.02), independent auditors (§ 5.03), internal controls and management certifications (§ 5.04) and other governance-related requirements (§ 5.05).

Most of these requirements apply to all reporting foreign private issuers, but one of the most important applies only to a foreign private issuer that has securities listed on a U.S. securities exchange: the audit committee requirements discussed in § 5.02[1]. Similarly, only a foreign private issuer with U.S. listed securities is subject to the requirements arising from other governance rules of the securities exchanges, which are discussed in § 5.05[8]. A reporting foreign private issuer that does not have securities listed on a U.S. exchange is not subject to the audit committee requirements or to these exchange rules.

The requirements discussed in this Chapter 5 also apply to U.S. domestic issuers— *i.e.*, reporting issuers that are not foreign private issuers. Those issuers, however, are also subject to extensive further governance-related requirements that arise principally from three sources: (a) exchange rules, which are an important source of governance requirements but which largely exempt a foreign private issuer if it follows home country practice; [1] (b) the SEC's requirements governing proxy statements and proxy solicitation, which impose extensive disclosure requirements relating to governance and extensive procedural requirements relating to the conduct of shareholder meetings, but which exempt foreign private issuers; [2] and (c) the corporate law of the state of incorporation. Because these requirements do not apply to foreign private issuers, the governance regime for foreign private issuers under U.S. law is less demanding than the rules applicable to a foreign issuer that lists securities in the local market in many jurisdictions outside the United States, and notably on the main listing venues in London and Hong Kong.

Footnotes

1 NYSE Listed Company Manual 303A.00 (exemption from most NYSE governance rules for foreign private issuers following home country practice); NASDAQ Listing Rules 5615(a)(3) (exemption from most Nasdaq governance rules for foreign private issuers following home country practice) and IM-5615-3 (requiring a foreign private issuer to provide an opinion of counsel concerning home country practice).

2 Rule 3a12-3(b) under the Exchange Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 5.02, AUDIT COMMITTEES

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 § 5.02 (11th and 12th Editions 2014-2017)
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[1] Listed Company Audit Committees

[a] General Requirements

A foreign private issuer with securities listed on a U.S. securities exchange is required to meet the audit committee requirements of Rule 10A-3 under the Exchange Act. Rule 10A-3 was adopted in 2003 to implement § 301 of the Sarbanes-Oxley Act, which is codified in § 10A(m) of the Exchange Act. The Rule operates through listing rules: rather than impose requirements directly on issuers, it requires the exchanges to adopt listing rules that impose requirements on listed issuers. The NYSE and Nasdaq, in turn, have adopted listing rules that, in the briefest of terms, require a listed issuer to have an audit committee that complies with Rule 10A-3. [3]

Rule 10A-3 requires that the audit committee have the following attributes:

- Each member of the audit committee must be a member of the board of directors. The rule does not specify the number of members of the audit committee.
- Each member of the audit committee must be independent, as defined in Rule 10A-3. Section 5.02[1][b] below describes the independence requirements and certain exceptions, including exceptions specifically for foreign private issuers. Disclosures relating to whether the audit committee includes an audit committee financial expert are discussed in § 5.02[2] below.
- The audit committee must be directly responsible for supervising the independent auditor. This includes "appointment, compensation, retention and oversight," and it includes resolving disagreements between management and the auditor regarding financial reporting. The auditor must report directly to the audit committee. These provisions of Rule 10A-3 may conflict with provisions of foreign law, as discussed in § 5.02[1][c] below.

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Separately, the SEC's auditor independence rules also impose requirements for audit committee administration of auditor engagements. These are discussed in § 5.03[1][e] below.

- The audit committee must establish procedures to receive and treat "complaints regarding accounting, internal accounting controls, or auditing matters" and to allow employees to submit confidentially "concerns regarding questionable accounting or auditing matters." The rule does not provide any guidance on the nature of the required procedures.
- The audit committee must have appropriate funding and the authority to engage independent counsel and other advisers.

A foreign private issuer may be exempt from these requirements if it has a similar body established under requirements of its home country law, and that body meets the requirements of paragraph (c)(3) of Rule 10A-3. This exemption is described in § 5.02[1][c] below. [4]

If an issuer relies on one of the exemptions from the independence requirements, or if it relies on the exemption for a foreign private issuer with a similar body under home-country law, it must disclose its reliance on the exemption and disclose an assessment as to whether, and if so how, such reliance would adversely affect the ability of the audit committee to act independently and to comply with other audit committee requirements. This disclosure is required in the annual report on Form 20-F. [5]

The listing rules of NYSE and Nasdaq contain extensive additional requirements for audit committees. [6] These requirements do not apply to a foreign private issuer, but they are a useful reference point for best practices. For example, the applicable NYSE rule requires that an audit committee have at least three members; that each member must be "financially literate"; that the board consider and disclose any instance of an audit committee member who is simultaneously on the audit committees of three or more companies; and that the company have an internal audit function. It also requires that the audit committee have a written charter that includes specific responsibilities listed in detail in the rule.

[b] Independence

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Rule 10A-3 requires that each audit committee member be independent under the standards set forth in the rule. The standards for independence address two issues: receipt of compensation from the issuer and affiliation with the issuer. There is no requirement, for either element, to "look back" to relationships in existence before the member was appointed to the audit committee. [7]

As to the compensation element, an audit committee member may not accept any consulting, advisory or other compensatory fee from the issuer or any subsidiary of the issuer, other than in his or her capacity as a member of the audit committee, the board of directors or another committee of the board. [8] This prohibition applies to indirect acceptance of fees, which includes compensation to certain family members. Indirect acceptance of fees also includes payments to a law firm, consulting firm, investment bank or financial advisor that provides services to the issuer or any subsidiary, if the audit committee member is a partner, member or officer of the service provider or occupies a similar position. [9]

As to the affiliation element, an audit committee member may not be an affiliated person of the issuer or any of its subsidiaries. [10] For this purpose, affiliation is defined in terms of control: an affiliate is a person that controls the issuer, is controlled by the issuer, or is under common control with the issuer. Under an express provision of the definition, beneficial ownership of 10% or less of an issuer's voting shares is deemed not to be control, as long as the beneficial owner is not an executive officer of the issuer.

Where an entity is an affiliate of the issuer, an individual is also deemed to be an affiliated person of the issuer if the individual is an executive officer, an inside director ("a director who also is an employee"), a general partner or a managing member of that entity. Under this definition, an outside director of an affiliate could be independent, and so could an employee of an affiliate who is not a director or executive officer of the affiliate. However, the SEC cautioned in adopting Rule 10A-3 that "an affiliate could not evade the prohibitions in the rule simply by designating a third party representative or agent that it directs to act in its place." [11]

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There is an exemption from the independence requirements for a newly-public company, providing for a transition period to achieve a fully independent audit committee. [12] All but one member of the audit committee may be exempt for the first 90 days from effectiveness, and a minority may be exempt for the first year from effectiveness. There is also an exemption that permits a person to be independent with respect to two or more affiliated issuers at the same time. [13]

Rule 10A-3 also provides three exemptions under the independence requirement specifically for foreign private issuers. The first is meant to accommodate the practice of requiring employee or union representation on the board of directors or the audit committee. It exempts a member of the audit committee who is an employee from the independence requirement, if the employee is not an executive officer and is elected or named to the board or audit committee pursuant to the company's governing documents or foreign law, an employee collective bargaining or similar agreement or home country legal or listing requirements. [14] The second exempts a member of the audit committee from the non-affiliation element of the independence requirement if the member has only observer status on the audit committee and is not a voting member or chair of the audit committee. [15] The third exempts a member from the non-affiliation element of the independence requirement if the member (who cannot be an executive officer) is a representative or designee of a foreign government or foreign governmental entity. [16]

[c] Exemption for an Alternative Mechanism

In implementing the audit committee requirement under § 301 of the Sarbanes-Oxley Act, the SEC acknowledged that many jurisdictions outside the United States have legal or listing requirements that contemplate a different mechanism for auditor oversight, separate from the board of directors. It established an exemption from the audit committee requirements for a foreign private issuer that has a board of auditors (or similar body), or that has statutory auditors, if that board or body, or the statutory auditors, meet the requirements listed below. [17] This is a significant example of the SEC accepting compliance with

foreign law to meet a U.S. statutory mandate, and it has been relied on by issuers in several jurisdictions, notably in Brazil.

In order to qualify for the exemption, the body or the statutory auditors must:

- be established and selected pursuant to home-country legal or listing requirements that expressly require or permit such a body;
- be required under home-country legal or listing requirements to be either separate from the board of directors or mixed (composed of one or more board members and one or more non-board members); [18]
- not be elected by management, and not include any executive officers;
- be subject to independence standards under home-country law or listing provisions;
- be responsible for the appointment, retention and oversight of the work of any registered public accounting firm engaged to prepare and issue audit reports or perform an audit, review or attest services for the foreign company, including, to the extent permitted by local law, the resolution of disagreements between management and the auditor regarding financial reporting; and
- to the extent permitted by law, establish complaint procedures, have authority to engage advisers, and have appropriate funding, in each case as an audit committee must do under the general audit committee requirements.

[d] Conflicts Between Audit Committee Attributes and Foreign Law

The general audit committee regime under Rule 10A-3 requires that the audit committee have certain powers with respect to the auditor and accounting matters. Similarly, the exemption for an alternative mechanism requires that the body or the statutory auditors have certain powers. In many jurisdictions, however, those powers may be reserved to the shareholders, or they may be powers of the board of directors that it is not permitted to delegate. In some jurisdictions, those powers may be vested, for some issuers, with a governmental entity or tribunal.

To minimize these conflicts, Rule 10A-3 includes three instructions stating that the requirements that the audit committee have these powers "do not conflict" with requirements under the issuer's home-country law or listing requirements. If the home-country requirement gives power to the shareholders, the applicable instruction states that the requirements of Rule 10A-3 relate to the division of responsibility between the audit committee and management, and any recommendation or nomination to the shareholders should be provided by the audit committee. [19] If the home-country requirement prohibits the full board from delegating, or it recognizes a government entity or tribunal, the instruction states that the audit committee must have such responsibilities, including advisory powers, as are permitted by law. [20]

[2] Audit Committee Financial Expert Disclosure

[a] Disclosure Requirement

A reporting foreign private issuer is required to disclose in its annual report on Form 20-F whether its audit committee includes at least one person who meets the definition of "audit committee financial expert." [21]

The disclosure requirement has led most issuers to identify an audit committee financial expert, but there is no requirement to do so. If there is no audit committee financial expert on the audit committee, the issuer must disclose why not. Such disclosure is not common, but while it can be delicate to prepare it does comply with the rule.

The disclosure requirement applies even if the issuer is not subject to the requirement to have an audit committee—for example, because it has no U.S.-listed securities. If the issuer has a two-tier board of directors, the disclosure requirement applies to the supervisory, or non-management, board. [22] If the issuer is exempt from the requirement to have an audit committee because it has an alternative body that qualifies under Rule 10A-3 under the Exchange Act, then it must disclose whether the alternative body has an audit committee financial expert. [23]

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If there is an audit committee financial expert, the issuer must disclose that person's name and whether that person is independent, as defined for this purpose. If the issuer has more than one audit committee member who meets the definition, it is only required to identify one, but if it identifies more than one it must disclose whether each is independent. [24] Independence, for the purpose of this disclosure requirement, is as defined in the U.S. listing rules applicable to the issuer. If the issuer is not listed, it must use the independence definition of a U.S. exchange and disclose what definition it uses. [25]

[b] Definition of Audit Committee Financial Expert

The audit committee financial expert is defined in Item 16A based on attributes the person must have and the experience by which such attributes are required. The attributes include: (i) an understanding of generally accepted accounting principles and financial statements; (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) experience in preparing, auditing, analyzing or evaluating financial statements with a breadth and level of complexity in accounting issues that are reasonably expected to be comparable to the company's financial statements (or experience actively supervising a person engaged in the same); (iv) an understanding of internal control over financial reporting; and (v) an understanding of audit committee functions. When the definition refers to "generally accepted accounting principles," it means the accounting principles the issuer uses in its primary financial statements filed with the SEC. [26]

The experience may come from education or experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or in similar functions; experience actively supervising any of those positions; or experience overseeing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements. The experience may also derive from "other relevant experience," but if so the disclosure must describe that experience. The experience may not come solely from previous audit committee experience. [27]

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Item 16A includes several additional instructions, collectively designated "Safe Harbor," which are intended to ensure that the designation of an audit committee financial expert does not affect other legal liabilities or responsibilities. They provide that the designation does not make the designee an "expert" for liability purposes under the Securities Act, or increase the duties of the designee, or affect the duties of the other members of the audit committee or the board of directors. [28]

Footnotes

3 NYSE LISTED COMPANY MANUAL 303A.06; NASDAQ LISTING RULES 5605(c). The SEC stated in adopting Rule 10A-3 that it did not intend to consider requests for exemptions, waivers or no-action letters. SEC Release No. 33-8220 (Apr. 9, 2003). Rule 10A-3(b)(1)(iv)(F) provides that in addition to the enumerated exemptions, the SEC may exempt a particular relationship from the independence requirements, discussed below, as the SEC determines appropriate in light of the circumstances. This provision implements the exemptive authority granted to the SEC in § 301 of the Sarbanes-Oxley Act.

4 Rule 10A-3 also provides other exemptions, including: an exemption for listing securities of a foreign government (paragraph (c)(6)(iii)); an exemption for a subsequent listing by an issuer that is already subject to Rule 10A-3 (paragraph (c)(1)); and an exemption for the listing of debt securities by a subsidiary of an issuer that is already subject to Rule 10A-3 (paragraph (c)(2)).

5 Item 16D of Form 20-F; Rule 10A-3(d)(2) under the Exchange Act. For a domestic issuer, this disclosure would also be required in any proxy or information statement.

6 NYSE LISTED COMPANY MANUAL 303A-07; NASDAQ LISTING RULES 5605(c).

7 By contrast, the independence standards for domestic issuers impose a three-year "look-back." NYSE LISTED COMPANY MANUAL 303A.02; NASDAQ LISTING RULES 5605.

8 Rule 10A-3(b)(1)(ii)(a) under the Exchange Act. There is an exception for fixed, non-contingent compensation under a retirement plan.

9 Rule 10A-3(b)(1)(ii)(A) under the Exchange Act. "Indirect acceptance" is defined in Rule 10A-3(e)(8).

10 Rule 10A-3(b)(1)(ii)(B) under the Exchange Act. "Affiliated person" is defined in Rule 10A-3(e)(1).

11 SEC Release No. 33-8220 (Apr. 25, 2003). The SEC had originally proposed that a "designee" of an affiliate would be deemed to be an affiliate, and it deleted that word in the final rule but included the quoted language in the release.

12 Rule 10A-3(b)(1)(iv)(A) under the Exchange Act.

13 Rule 10A-3(b)(1)(iv)(B) under the Exchange Act.

14 Rule 10A-3(b)(1)(iv)(D) under the Exchange Act.

15 Rule 10A-3(b)(1)(iv)(D) under the Exchange Act.

16 Rule 10A-3(b)(1)(iv)(E) under the Exchange Act. In the adopting release, the SEC acknowledged the practice of foreign governmental representatives sitting on audit committees of foreign private issuers, and it sought to balance independence concerns and foreign practices by permitting the practice so long as the "no compensation" prong of the independence requirement is met and the person in question is not a member of management.

17 Rule 10A-3(c)(3) under the Exchange Act.

18 A body composed entirely of board members, or permitted to be composed entirely of board members, would not meet this requirement. We understand, however, that some issuers have received informal comfort from the SEC staff that they may rely on the exemption where the body is mixed, even though home-country law would permit it to be composed entirely of board members.

19 Rule 10A-3, Instruction 1.

20 Rule 10A-3, Instruction 2.

21 Form 20-F, Item 16A. This disclosure requirement, which implements § 407 of the Sarbanes-Oxley Act, is essentially identical to the requirement for proxy statements of domestic issuers, which appears in Item 407(d)(5) of Regulation S-K. The requirement does not apply to a registration statement under the Securities Act or the Exchange Act.

22 Form 20-F, Item 16A, Instruction 3.

23 Form 20-F, Item 16A, Instruction 3.

24 Form 20-F, Item 16A, Instruction to paragraph (a).

25 Form 20-F, Item 16A, paragraph (a)(2).

26 Form 20-F, Item 16A, Instruction 3.

27 SEC Release No. 33-8177 (Jan. 23, 2003). The release also notes that "the fact that a person has experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer or experience in a similar position does not, by itself, justify the board of directors in deeming the person to be an audit committee financial expert." Form 20-F, Item 16A, Instruction 3.

28 Form 20-F, Item 16A, Safe Harbor.

U.S. Regulation of the International Securities and Derivatives Markets, § 5.03, AUDITS AND AUDITORS

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 § 5.03 (11th and 12th Editions 2014-2017)
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[1] Auditor Independence

[a] Overview

In general, maintaining independence from the audit client is a regulatory requirement applicable to auditors, and auditors are responsible for monitoring compliance and may be subject to penalties for failing to do so. [29] A full discussion of U.S. regulation of the auditing profession is beyond the scope of this chapter.

However, independence rules affect a reporting company in important ways. First, the SEC's rules require an issuer to file audited financial statements in annual reports and in registration statements, and the auditor must be independent. [30] If the auditor was not independent, the issuer that filed the audited financial statements violated its obligations under the securities laws. [31] In rare cases,

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the issuer may need to replace its auditor, if the condition that impairs independence is continuing, or to obtain a new audit of a past period by a different auditor. Second, the independence rules require that the issuer have certain governance measures in place; these are separate from the audit committee requirements discussed in § 5.02, but they are closely related in practice. Third, the independence rules affect how the auditor interacts with the company. This § 5.03[1] discusses the independence matters that most regularly affect a reporting foreign private issuer.

Auditor independence is sometimes a major issue in the initial public offering of a foreign private issuer, because SEC standards concerning the independence of auditors are more stringent than those in many other jurisdictions. A foreign issuer, together with its counsel, may need to discuss these standards with the SEC staff in order to confirm that its practices comply or understand what needs to be done to ensure that its practices will comply prior to registering any securities in the United States. If the SEC is not satisfied that auditors are independent, it may request that a second audit be conducted by a different auditing firm covering all periods subsequent to the date on which it deems the auditors to have lost independence. In special circumstances, however, the SEC may permit an issuer to proceed using financial statements for the most recent fiscal year audited either by a different auditor (or the same auditor if it is independent throughout the audit of that fiscal year), even though financial statements for prior years remain "tainted" by the non-independence of the auditors. This may be the case if, for example, the previous auditors lost independence inadvertently and such non-independence for U.S. purposes was permitted by home-country law, or if the issuer had not contemplated a U.S. listing or offering during the period in question.

An audit client already subject to the Exchange Act's ongoing reporting obligations faces potentially serious consequences if its auditor is determined not to be independent. The practical difficulties in resolving such a problem are substantial, and there is also the risk of SEC enforcement action. In the past, in independence cases the SEC has generally pursued remedies against the auditor and not against the issuer, but issuers (and particularly audit committees) would be prudent to exercise reasonable care to ensure that relationships with auditors comply with the independence rules.

Rule 2-01 of Regulation S-X governs independence for SEC purposes. It reflects two major rulemaking exercises in the early 2000s. The first was the Commission's reaction to the growth and diversification of auditing firms, which

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led to the adoption of a comprehensive new rule in November 2000. [32] The second was the enactment in 2002 of Title II of the Sarbanes-Oxley Act, [33] which led the SEC to adopt amendments in January 2003. [34] The rule has not been significantly amended since 2003. The rule generally applies to foreign private issuers in the same way as to domestic issuers. Within the SEC, the Office of Chief Accountant has primary responsibility for applying and interpreting the rules on auditor independence, and it has published on the SEC's website a detailed set of answers to Frequently Asked Questions on the subject. [35]

The independence requirements in Rule 2-01 apply not only to the principal firm that signs the audit report, but also to any other accounting firm or accountant performing services in connection with an engagement for which independence is required. Many of its provisions also refer to "covered persons," which includes auditor personnel who play specified roles related to the audit. In addition to the SEC's rule, the PCAOB has independence rules that apply to the auditor of any reporting company. [36]

Rule 2-01 sets forth a general standard of independence: an auditor is not independent if it is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that it is not, capable of exercising objective and impartial judgment on all issues encompassed within its engagement. [37] A preliminary note to Rule 2-01 identifies four factors to be considered in determining whether a relationship between the auditor and the audit client, or the provision of a service by the auditor, is consistent with independence: (i) whether there is a mutual or conflicting interest between the auditor and the audit client; (ii) whether the auditor will be in the position of auditing its own work; (iii) whether the auditor will be acting as management or an employee of the audit client; and (iv) whether the auditor is in a position of being an advocate

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for the audit client. [38] The "audit client" for purposes of Rule 2-01 is defined to include the issuer and its affiliates.

In addition to the general standard, Rule 2-01 also provides that in order to maintain independence:

- the auditor may not provide certain specified non-audit services to the audit client, as discussed in §§ 5.03[1][b] and 5.03[1][c] below; [39]
- the audit client may not employ former auditor personnel in certain positions unless certain conditions are met, as discussed in § 5.03[1][d] below;
- the issuer's audit committee must administer the engagement of the auditor to provide audit and non-audit services, as discussed in § 5.03[1][e] below;
- partners involved in the audit must rotate every five or seven years, depending on the partner's role in the audit; [40]
- an audit partner may not be compensated based on non-audit services provided to the audit client; [41]
- the auditor, and covered persons and their family members, may not have various forms of investment or other financial interest in the audit client; [42]
- the auditor, and covered persons and their family members, may not have various forms of business relationships with the audit client; [43] and

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- the auditor may not receive contingent fees from the audit client for any services. [44]

The specific requirements of the independence rules are not exclusive, and the general standard and the PCAOB rules must also be taken into account in evaluating independence. [45] For example:

- The SEC takes the position that an audit client's agreement to indemnify the auditor is inconsistent with auditor independence. [46]
- PCAOB rules prohibit an independent auditor from advising on confidential or aggressive tax transactions, and from providing tax reporting services to an individual in a financial reporting oversight role at the audit client. [47]

[b] Prohibited Non-Audit Services

Rule 2-01(c)(4) lists ten categories of non-audit services that are inconsistent with independence. [48] The rule (i) governs the provision of non-audit services by an accountant to an audit client during the audit and professional engagement period and (ii) defines "audit client" broadly to include subsidiaries

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and affiliates. Section 201(b) of the Sarbanes-Oxley Act provides that the PCAOB may, on a case-by-case basis, exempt any person, issuer, public accounting firm or transaction from the prohibition of a given service to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors. Such exemptions are subject to review by the SEC.

Bookkeeping. Under the rules, an auditor's independence is impaired if the auditor provides the audit client with bookkeeping or other services related to accounting records or financial statements, including:

- maintaining or preparing the audit client's accounting records;
- preparing the audit client's financial statements that are filed with the SEC or form the basis of financial statements filed with the SEC; or
- preparing or originating source data underlying the audit client's financial statements;

unless, in each case, it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [49] The SEC has stated that the preparation of statutory financial statements by the auditor of a foreign private issuer on behalf of its audit client is prohibited if the statutory financial statements later form the basis of financial statements filed with the SEC. [50]

Information Technology. An independent auditor may not provide its audit client with design or implementation of financial information systems, including:

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- directly or indirectly operating or supervising the operation of the audit client's information system or managing the audit client's local area network; or
- designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client's financial statements or other financial information systems taken as a whole;

unless, in each case, it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [51] The rules do not preclude an accounting firm from working on hardware or software systems that are unrelated to the audit client's financial statements or accounting records, so long as those services are pre-approved by the audit committee.

The SEC has stated that information will be considered significant to an audit client's financial statements as a whole if such information is reasonably likely to be "material" to the financial statements. The SEC has further stated that since materiality determinations may not be complete before financial statements are generated, the audit client and accounting firm will need to evaluate the general nature of the information rather than only system output during the period of the audit engagement. The SEC noted, for example, that an accounting firm will not be deemed independent of an audit client for which it designs an integrated Enterprise Resource

Planning system. [52]

Appraisals, Valuations, Fairness Opinions, Contribution Reports. An independent auditor may not provide any appraisal service, valuation service or service involving a fairness opinion or contribution-in-kind report for its audit client, in each case unless it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [53] Appraisal and valuation services include any process of valuing assets (tangible or intangible) or liabilities. This includes valuing, among other things, in-process research and development, financial instruments, assets and liabilities acquired in a merger and real estate, and would include due diligence services to the extent valuation, or the development of assumptions relating to valuation, are involved. [54] Fairness opinions and contribution-in-kind

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reports include any opinion or report in which an accounting firm provides its opinion on the adequacy of consideration in a transaction.

The SEC has stated that the rule does not prohibit an accounting firm from providing services for nonfinancial reporting purposes, such as preparing transfer pricing studies or cost segregation studies. The SEC has further stated that the rule does not prohibit an accounting firm from using its own valuation specialist to review the work done by an audit client itself or an independent, third-party specialist employed by the audit client, if the audit client or the third-party specialist provides the technical expertise used in determining the required amounts recorded in the financial statements. [55]

The SEC has noted that a strict application of the rule related to contribution-in-kind reports might create conflicts in certain foreign jurisdictions, where laws or regulations require the auditor to provide contribution-in-kind reports in connection with designated transactions of its audit client. Although the SEC has declined to provide a categorical exception for such conflicts, it indicated that it is sensitive to the issue and will work with other regulatory agencies to resolve such conflicts. [56]

Actuarial Services. An auditor's independence is impaired if the auditor provides any actuarially-oriented advisory service involving the determination of amounts recorded in an audit client's financial statements and related accounts, other than assisting a client in understanding the methods, models, assumptions and inputs used in computing an amount, unless it is reasonable to conclude that the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [57] The SEC has clarified that the rules permit an accounting firm to use its own actuaries to assist in conducting an audit, provided that the audit client uses its own actuaries or third-party actuaries to provide management with the primary actuarial capabilities. [58]

Internal Audit. An independent auditor may not provide any internal audit service relating to the internal accounting controls, financial systems or financial statements of the audit client, unless it is reasonable to conclude that

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the results of such service will not be subject to audit procedures during an audit of the audit client's financial statements. [59] The SEC has clarified that the rule does not apply to nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function, nor does it include operational internal audits unrelated to internal accounting controls, financial systems or financial statements. The SEC has further noted that during the conduct of an audit in accordance with generally accepted auditing standards or when providing audit services related to internal controls, the auditor is expected to evaluate and make recommendations with respect to an audit client's internal controls, and has indicated that such services would not constitute an internal audit outsourcing engagement. [60]

Management Functions. An auditor's independence is impaired if he or she acts, temporarily or permanently, as a director, officer or employee of an audit client or performs any decision-making, supervisory or ongoing monitoring function for the audit client. [61] With respect to management of internal controls, the SEC has noted that its rule on management functions continues to permit an independent auditor to assess the effectiveness of an audit client's internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls. However, the actual design and implementation of internal controls and risk management controls are prohibited. [62]

Human Resources. An auditor's independence is impaired if the auditor provides any of the following services to an audit client:

- searching for or seeking out prospective candidates for managerial, executive or director positions;
- engaging in psychological testing or other formal testing or evaluation programs;
- undertaking reference checks of prospective candidates for an executive or director position;

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- acting as a negotiator on the audit client's behalf, such as determining positions, status or title, compensation, fringe benefits or other conditions of employment; or
- recommending or advising a client to hire a specific candidate for a specific job (except that an accounting firm may, upon request by an audit client, interview candidates and advise the audit client on a candidate's competence for financial accounting, administrative or control positions). [63]

Broker-Dealer, Investment Adviser or Investment Banking Services. An independent auditor may not provide any of the following services to an audit client:

- acting as a broker-dealer (registered or unregistered), promoter or underwriter on behalf of an audit client;
- making investment decisions on behalf of an audit client or otherwise having discretionary authority over an audit client's investments;
- executing a transaction to buy or sell an audit client's investment; or
- having custody of assets of an audit client, such as taking temporary possession of securities purchased by the audit client. [64]

Legal Services. An independent auditor may not provide a service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided. [65] The rule may create conflicts where an auditor provides a service in a foreign jurisdiction, and the service must be performed by a licensed legal practitioner, even though it could be provided by a non-lawyer in the United States. The SEC has stated that, as a general matter, the rule is not intended to prohibit foreign auditing firms from providing services that an auditing firm in the United States may provide. Thus, in determining whether a service would impair the auditor's independence solely because the service is labeled a legal service in a foreign jurisdiction, the SEC will consider whether the provision of the service would be prohibited in the United States, as well as in the foreign jurisdiction. [66]

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Expert Services. An independent auditor may not provide an expert opinion or other expert service for an audit client or an audit client's legal representative for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. [67] The prohibition covers any service that is intended to result in an accounting firm's specialized knowledge, experience or expertise being used to support the contentions of an audit client in adversarial proceedings. Thus, for example, an auditor cannot be engaged by an audit client's legal counsel to provide expert witness or other services, including forensic accounting services, in connection with the client's participation in a legal, administrative or regulatory proceeding. [68]

The independence rule does not, however, prohibit an auditor from testifying as a fact witness with respect to its audit work for a particular audit client. It expressly provides that in any litigation or regulatory or administrative proceeding or investigation, an auditor's independence will not be impaired if the auditor provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service for the audit client. [69]

The SEC has stated that the rule does not prohibit an auditor from assisting a company's audit committee or its legal counsel by performing internal investigations or fact finding engagements that may result in the issuance of a report to the audit client. [70] If, subsequent to the completion of such an engagement, a proceeding or investigation is initiated, the accountant may allow its work product to be used by the audit client and its legal counsel without impairing the accountant's independence. The accountant, however, may not then provide additional services, with the exception of providing factual accounts or testimony about the work performed.

An auditor would not be considered independent if, at any time during the audit and professional engagement period, the auditor provided translation services in connection with SEC filings to its audit clients based in foreign jurisdictions or U.S. clients with foreign operations. The SEC staff explained that translation services require decisions and judgments on behalf of management on the selection and application of words, phrases, and specific accounting, business and industry terms. In conveying the meanings as expressed by management in the original language, it could create a mutual or conflicting interest between the auditor and the audit client and may put the auditor in the position of auditing its own work. [71]

[c] Tax Services

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Section 10A(h) of the Exchange Act specifies that tax services are among the non-audit services that an independent auditor may provide. The SEC's independence rule itself, consequently, is silent on tax services, but the SEC has stated that under its rule an accounting firm may provide tax services to its audit clients, such as tax compliance, tax planning and tax advice. [72] The SEC has, however, emphasized that classifying a service as a "tax service" does not necessarily mean that the service is permitted; for example, providing representation before a tax court, district court or federal court of claims, although it is tax-related, is inconsistent with independence.

With respect to the formulation of tax strategies designed to minimize an audit client's tax obligations, the SEC warned in 2003 that an issuer's audit committee should "scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations." [73] Subsequently the PCAOB adopted a rule providing that an audit firm is not independent if it provides services to its audit client on specified classes of tax-motivated transactions. To define the suspect categories of transactions, the PCAOB relies in part on existing regulations of the Department of Treasury, but it also includes any transaction initially recommended by an auditor or tax advisor "a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws." [74]

PCAOB rules also provide that an audit firm is not independent if it provides any tax service to an officer in a financial reporting oversight role at the audit client. It does not matter who pays for the service. The rule does not apply to tax services provided to directors who are in a financial reporting oversight role solely by virtue of their role as directors, or to other employees that do not have a financial reporting oversight role. [75]

[d] Conflicts of Interest Resulting from Employment Relationships

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Movement of personnel between an auditing firm and its audit client is not unusual, but it must be monitored so it does not compromise the auditor's continuing independence. The issue that arises most often is employment at the audit client of people who have some current or former connection with the auditor. [76]

In particular, it is inconsistent with independence for the audit client to employ someone who is currently a partner, principal, shareholder or professional employee of the auditor. Such a person also may not serve on the board of directors of the audit client. [77] Even a former partner, principal, shareholder or professional employee of the auditor may not be employed in any accounting role or a "financial reporting oversight role" [78] at the audit client if he or she has a continuing financial interest in the auditor or is in a position to influence its operations or financial policies. [79] These prohibitions apply even if the person has had no involvement in the auditor's work for the issuer.

Employment of former auditor engagement team members in a financial reporting oversight role is subject to a more specific prohibition. The independence rule prohibits employment in such a role of a former partner, principal, shareholder or professional employee of the auditor, if he or she was a member of the audit engagement team of the issuer during the one-year period preceding the date that audit procedures commenced for the fiscal period that included his or her date of initial employment by the issuer. [80] Audit procedures are deemed to commence for a given fiscal period on the day following the filing with the SEC

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of the issuer's annual report on Form 10-K, Form 20-F or Form 40-F, as applicable, covering the previous fiscal period. [81]

Accordingly, an auditing firm is not independent if a member of the audit engagement team moves into a financial oversight role at the issuer, unless a cooling-off period has passed between the person's last participation in the audit engagement team and his or her first employment with the issuer. Although the formulation of the cooling-off period is complex, in most cases [82] it will last from the time the person ceases to be part of the audit engagement team through the filing of the next annual report, and then until the next fiscal year-end. [83]

These rules on conflicts of interest do not apply to:

- a person, other than the lead partner and the concurring partner, who provides ten or fewer hours of audit, review or attest services during the relevant one-year period preceding the date that audit procedures commenced;
- an individual employed by the issuer as a result of a business combination between an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the successor issuer is aware of the prior employment relationship; and
- an individual employed by the issuer due to an emergency or other unusual situation, provided the audit committee determines that the relationship is in the interest of investors. [84]

[e] Audit Committee Administration of the Engagement

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An auditor is not independent unless the audit committee administers the auditor's engagement. [85] The audit committee has other duties relating to the supervision of auditors, which are not directly related to independence but are set forth in the audit committee requirements of Rule 10A-3, discussed in § 5.02 above. If the issuer does not have an audit committee because it is not subject to Rule 10A-3, the requirement for audit committee administration of the engagement must be met by the board of directors as a whole. [86] If instead of an audit committee the issuer relies on an alternative body such as a board of statutory auditors to meet the requirements of Rule 10A-3, then the requirement for audit committee administration of the engagement must be met by that body. [87]

Under this requirement, each engagement of the auditor to provide any service to the audit client or any subsidiary must be either (i) specifically approved in advance by the audit committee or (ii) entered into pursuant to pre-approval policies and procedures established by the audit committee. [88] This requirement applies to audit services and to non-audit services, and it includes the engagement of statutory auditors for non-U.S. subsidiaries.

If the audit committee establishes pre-approval policies and procedures, they must be detailed as to the specific services that may be engaged, and they may not delegate audit committee responsibilities to management. [89] Any engagement pursuant to the pre-approval policies and procedures must be reported to the audit committee. An issuer must also disclose the audit committee's pre-approval policies and procedures in the annual report on Form 20-F. [90]

There is a limited exception from the pre-approval requirement for small, inadvertent engagements for non-audit services. The pre-approval requirement is waived for non-audit services that meet three conditions: (i) the aggregate amount of all such non-audit services provided to the company is not more than

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five percent of the total amount of revenues paid by the company to its auditor in the year the services are rendered; (ii) the services were not recognized by the company at the time of the engagement to be non-audit services; and (iii) the services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee to whom authority to grant such approvals has been delegated by the audit committee. [91] Any engagements that fall within this provision must be disclosed in the annual report on Form 20-F. [92]

[2] Auditor Reports to the Audit Committee

Auditors are required to report to the audit committee, pursuant to a variety of separate requirements of the SEC and the PCAOB. As a practical matter, the most important of these is the PCAOB's Auditing Standard No. 1301, which requires the auditor to (i) communicate with the audit committee regarding certain matters related to the conduct of the audit, (ii) obtain certain information from the audit committee relative to the audit, (iii) establish an understanding with the audit committee of the terms of the audit engagement, and (iv) record that understanding in an engagement letter. [93] The communications specified in the standard must occur prior to the issuance of the audit report, and they must be documented in the auditor's work papers and, for some but not all matters, delivered in writing.

The SEC also has a separate rule requiring the auditor to report to the audit committee, prior to the filing of its audit report with the SEC:

- all critical accounting policies and practices used by the issuer;
- all alternative treatments relating to material items that have been discussed with the issuer's management, including the ramifications of using the alternative treatment and the treatment the auditor preferred; and
- other material written communications between the auditor and management, such as any management letter or schedule of unadjusted differences. [94]

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In addition, there are many PCAOB standards requiring auditors to communicate specific matters to the audit committee. [95] For example, the auditor is required to make certain specific annual communications to the audit committee concerning its independence. [96] These communication requirements can have an impact on how the auditor and management interact; examples include the requirement that the auditor communicate any disagreements with management, the requirement that the auditor provide the schedule of unadjusted differences and discuss their materiality, or the requirement that it communicate its views about any matter about which it is aware that management has consulted with other accountants.

[3] Change-of-Auditor Disclosure

An issuer is required to provide specific disclosures if its auditor has resigned, or declined to stand for re-election, or been dismissed, and if it has engaged a new auditor. For a foreign private issuer, the disclosure requirement is set forth in Item 16F of Form 20-F, and it is required in any annual report and in any registration statement under the Securities Act or the Exchange Act. [97] The disclosure requirements are virtually identical to those that apply to a domestic issuer, except that a domestic issuer must disclose the information more promptly. [98]

Some of the information required by Item 16F is simple background, and for many changes of auditor no further information is required. [99] The purpose of the disclosures, however, is to elicit information about disagreements with the old auditor and about pre-engagement consultations with the new auditor that might represent "opinion shopping." To that end, Item 16F sets forth an extensive list of matters that must be reported if they have occurred, centering around

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whether there were disagreements with the former auditor and whether there were consultations with the new auditor before its engagement. It also requires that the old auditor provide a letter to the SEC stating whether it agrees with the disclosures, and this letter must be filed as an exhibit to the annual report or registration statement containing the disclosures.

The principal U.S. securities exchanges also require a listed issuer to notify the exchange about a change in its auditors, but neither has substantive disclosure requirements concerning a change of auditors similar to Form 20-F. [100]

[4] Auditor Response to Evidence of Illegality

Section 10A(b) of the Exchange Act requires an auditor, if it encounters evidence of illegal acts in the course of conducting an audit, to take certain specific steps that can culminate in reporting the evidence to the SEC. These are sometimes referred to as "up-the-ladder reporting." These obligations have an important impact on how an issuer and its auditor deal with certain kinds of information that may come up in connection with the audit of the financial statements.

Section 10A(b) is triggered if, in the course of conducting an audit, the auditor discovers or becomes aware of information indicating an illegal act has or may have occurred, whether or not the illegality is perceived to have a material effect on the financial statements. [101] In that event, the auditor must determine whether it is likely an illegal act occurred and if so, determine the possible effect on the financial statements, including the possibility of consequences such as fines, penalties and damages. As soon as practicable, the auditor must inform management and assure that the audit committee is adequately informed, unless the illegal act is "clearly inconsequential." If there is no audit committee, the auditor must assure that the board of directors is adequately informed.

Further consequences under § 10A(b) depend on whether the illegality is material to the financial statements and whether the issuer responds with appropriate remedial actions. The auditor has an obligation to report to the board of directors if it concludes that (i) the illegal act has a material effect on the financial statements, (ii) neither senior management nor the board of directors has taken "timely and appropriate remedial actions" and (iii) the failure to take remedial actions is reasonably expected to warrant departure from the standard report of the auditor, or warrant resignation from the audit engagement. [102] If the board of directors receives such a report from its auditors, it is obligated to notify the

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Office of the Chief Accountant at the SEC within one business day of receipt and provide a copy of that notice to its auditors; if the auditor does not receive a copy of that notice within one business day, it must either resign from the engagement or furnish its report in writing to the SEC within one business day. [103]

[5] Prohibited Conduct Involving Audits

Rule 13b2-2 under the Exchange Act specifically prohibits certain representations and conduct by issuer personnel in its dealings with auditors. In general terms, paragraph (a) of the Rule prohibits false or misleading statements or omissions by an officer or director to an accountant in connection with a required audit, review or examination or a required filing. [104]

Paragraph (b) of Rule 13b2-2 also specifically prohibits actions to coerce, manipulate, mislead or fraudulently influence an auditor. The directors and officers of a reporting issuer, and any person acting at their direction, may not take any direct or indirect action to coerce, manipulate, mislead or fraudulently influence an auditor in an audit or review of the issuer's financial statements required to be filed with the SEC, if such person knows or should know that such action could, if successful, result in rendering the financial statements materially misleading. [105] This prohibition would capture conduct whether or not it succeeds in affecting the audit or review. It is the act of coercing, manipulating, misleading or fraudulently influencing the auditor, for the purpose of rendering misleading financial statements, that is unlawful, and there is no requirement that the purpose be achieved. [106] Rule 13b2-2 is enforceable in civil proceedings exclusively by the SEC. [107]

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In addition to officers and directors, Rule 13b2-2(b) regulates the activities of persons acting "under the direction of" officers and directors. The SEC has stated that it interprets the term "direction" as encompassing a broader category of behavior than "supervision" and that persons acting "under the direction" of an officer or director could include persons outside the issuer's hierarchy who improperly influence the conduct of an audit. Such persons may include customers, vendors and creditors of the issuer, attorneys, securities professionals and other professional advisors and partners and other employees of the issuer's accounting firm. [108]

Rule 13b2-2(b) provides that actions that, if successful, could result in rendering an issuer's financial statements materially misleading, include but are not limited to, actions taken at any time, with respect to the professional engagement period, to coerce, manipulate, mislead or fraudulently influence an auditor:

- to issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards or other professional or regulatory standards);
- not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;
- not to withdraw an issued report; or
- not to communicate matters to an issuer's audit committee.

Types of conduct that the SEC believes could constitute improper influence (whether engaged in directly or indirectly, but only if the person engaged in that conduct knows or should know that the conduct, if successful, could result in rendering the issuer's financial statements materially misleading) include, but are not limited to:

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- offering or paying bribes or other financial incentives, including offering future employment or contracts for nonaudit services;
- providing an auditor with an inaccurate or misleading legal analysis;
- signing misleading management representation letters addressed to the auditor;
- threatening to cancel or canceling existing nonaudit or audit engagements if the auditor objects to the issuer's accounting;
- seeking to have a partner removed from the audit engagement because the partner objects to the

issuer's accounting;

- blackmailing; and
- making physical threats. [109]

With respect to the time frame of the prohibited conduct, the term "engaged in the performance of an audit" should be read broadly and should encompass both the professional engagement period and any other time the auditor is called upon to make decisions regarding an issuer's financial statements. [110] This would therefore include improperly influencing an auditor during negotiations for retention of the auditor, during a review of interim financial statements or in connection with the issuance of a consent to the use of the auditor's report. In limited circumstances, this time frame could also include conduct occurring before the professional engagement period begins—for example, if an officer offers to engage an accounting firm subject to a condition that could result in rendering the financial statements materially misleading, such as a condition that the firm issue an unqualified audit report on financial statements that do not conform with generally accepted accounting principles, or a condition that the firm limit the scope or performance of audit or review procedures in violation of generally accepted auditing standards. [111]

[6] Regulation of the Auditing Profession

Before the Sarbanes-Oxley Act, the auditing profession in the United States was largely self-regulated, and auditing standards were adopted by the AICPA. The PCAOB was established in 2002 pursuant to the Sarbanes-Oxley Act with a mandate to:

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- register public accounting firms that prepare audit reports for issuers;
- establish auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports; and
- conduct inspections, investigations and disciplinary proceedings of and take enforcement action against public accounting firms. [112]

The Sarbanes-Oxley Act prohibits the issuance of audit reports, or participation in the preparation of an audit report, with respect to any reporting issuer by any accounting firm that has not registered, as required, with the PCAOB. [113]

The PCAOB has five members, who serve full-time and are appointed to staggered five-year terms. They are appointed by the SEC, after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, and the SEC has continuing oversight of the PCAOB. [114]

Except for the information required to be provided in the initial registration and subsequent annual reports filed with the PCAOB (including information regarding fees paid to the public accounting firms by each issuer client for audit and nonaudit services), which will be publicly available, [115] other information received by the PCAOB is required to be maintained confidentially, although

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information with respect to an inspection or investigation may be shared with the SEC and, if deemed to be necessary by the PCAOB, with the U.S. Attorney General or other specified federal and state regulators. [116]

A foreign public accounting firm that prepares or furnishes audit reports with respect to any reporting issuer is required to register with the PCAOB just as a U.S. firm would be, and it is subject to the same inspection, investigation and disciplinary powers. [117] For most reporting foreign private issuers, the audit reports that the issuer files with the SEC are signed not by a U.S. auditing firm but by a local firm in the issuer's home jurisdiction, which must be independently registered with the PCAOB even if it is a member of a global network. In addition, even a foreign public accounting firm that does not furnish audit reports may be required to register if it plays a substantial role in the preparation of audit reports—for example, where a U.S. issuer has major French operations, and the French member of the global network does the audit work relating to those operations.

The PCAOB regularly conducts inspections of non-U.S. firms, and it has also conducted investigations and taken disciplinary actions against non-U.S. firms. [118] Furthermore, any foreign public accounting firm that performs material services relied on by a registered public accounting firm is required to produce its workpapers to the PCAOB. [119]

The conduct of inspections and investigations outside the United States, and the production of workpapers by non-U.S. auditing firms, have proven highly controversial. Some foreign accounting firms are organized in jurisdictions where by law the provision of workpapers requires the consent of the audit client. The PCAOB takes the position that an auditor must choose whether (i) to satisfy itself in advance that the non-U.S. client will provide any necessary consent if and when the PCAOB demands documents or information concerning the client, (ii) to proceed without such assurance and take a risk that it may later have to choose between providing information without the client's consent and facing a PCAOB sanction for failing to provide the information or (iii) to decline the audit engagement. Even if an accounting firm obtains advance assurance that the

client will provide consent, it may still be subject to sanctions if the client ultimately refuses to provide the promised consent at the time the PCAOB requests documents from the auditor. [120]

In other jurisdictions, local law may be understood to prohibit the provision of workpapers or other aspects of cooperation by a local auditing firm with PCAOB inspections and investigations. This difficulty has led to protracted administrative proceedings and international negotiations involving the Chinese members of global auditing networks. [121]

The PCAOB has also faced objections from foreign auditor-oversight authorities in response to its attempts to carry out joint inspections of PCAOB-registered accounting firms located outside the United States, and it has sought to address these objections by entering into formal cooperative arrangements with foreign audit regulators. [122]

Footnotes

29 Rule 10A-2 under the Exchange Act provides that it is unlawful for an auditor not to be independent under the SEC's independence rules. Rule 10A-2 was adopted following the Sarbanes-Oxley Act to clarify that the auditor has a separate obligation to be independent. *See* § 208(b) of the Sarbanes-Oxley Act (providing that it is unlawful for an auditor to issue and audit report if it has violated specified independence requirements set forth in the Act or the SEC's rules thereunder). A failure of independence is a violation by the auditor, but an issuer might also be in violation of the rule to the extent it aided, abetted or caused the auditor to lose independence, and in any case failure of the auditor to be independent often results in failure of the issuer to comply with its Exchange Act reporting obligations, as discussed below.

30 *E.g.*, Item 8.A of Form 20-F (requiring financial statements audited by an independent auditor); Rule 1-02(a)(1)g of Regulation S-X (defining an "accountant's report" as a report of an independent public accountant).

31 SEC enforcement cases finding auditor independence violations have generally found that the issuer violated the Exchange Act but have not imposed sanctions on the issuer. *See*, *e.g.*, *In the Matter of Ernst & Young LLP and Gregory S. Bednar, CPA*, SEC Admin Proc. File No. 3-17552 (Sept. 19, 2016) and *In the Matter of Ernst & Young LLP, Robert Brehl, CPA Pamela J. Hartford, CPA and Michael T. Kamienski, CPA*, SEC Admin Proc. File No. 3-17553 (Sept. 19, 2016) (finding, in administrative proceedings against an auditor but not the audit client, that independence violations arising from improperly close personal relationships between auditor personnel and audit client personnel caused the audit client to violate § 13(a) of the Exchange Act and Rule 13a-1 thereunder); *In the Matter of KPMG LLP*, SEC Admin. Proc. File No. 3-15687 (Jan. 24, 2014) (finding, in administrative proceedings against an auditor but not the audit clients, that

independence violations arising from prohibited non-audit services, employment relationships and investments cause three audit clients to violate § 13(a) of the Exchange Act and Rule 13a-1 thereunder).

32 SEC Release No. 33-7919 (Nov. 21, 2000).

33 §§ 201-204 and 206 of the Sarbanes-Oxley Act are codified as paragraphs (g)-(l) of § 10A of the Exchange Act. § 208(b) of the Sarbanes-Oxley Act separately provides that it is unlawful for an auditor to issue an audit report if it has engaged in conduct prohibited by paragraphs (g)-(l) or SEC rules adopted thereunder.

34 SEC Release No. 33-8183 (Jan. 28, 2003). Much of what § 201 required was already contained in the rule as adopted in 2000, so the 2003 amendments were fairly limited in scope.

35 *See* SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions (Dec. 13, 2004).

36 PCAOB Rules 3520–3526. These PCAOB rules notably prohibit an auditor from accepting contingent fees, from advising on confidential or aggressive tax transactions, and from providing tax reporting services to an individual in a financial reporting oversight role at the audit client. They also impose audit committee pre-approval requirements for certain services relating to tax and to internal controls, and they require auditors to communicate with audit committees concerning independence.

37 Rule 2-01(b) of Regulation S-X.

38 Preliminary Note 2 to Rule 2-01 of Regulation S-X.

39 *See*, *e.g.*, *In the Matter of KPMG*, *LLP*, SEC Release No. 71389 (Jan. 24, 2014) (finding that auditor violated independence rules by providing prohibited non-audit services such as bookkeeping and expert services to affiliates of audit clients).

40 Rule 2-01(c)(6) of Regulation S-X.

41 Rule 2-01(c)(8) of Regulation S-X.

42 Rule 2-01(c)(1). *See*, *e.g.*, *In the Matter of KPMG, LLP*, SEC Release No. 71389 (Jan. 24, 2014) (KPMG violated auditor independence rules because, among other things, KPMG personnel owned stock in companies or affiliates of companies that were KPMG audit clients). The prohibition on "other financial interests" can have far-reaching impact when the audit client provides financial services or is related to entities that do. *See*, *e.g.*, *Fidelity Management & Research Company*, *et al.* (avail. June 20, 2016) (no-action letter addressing whether lending relationships between auditor and an investment company complex are inconsistent with auditor independence). Paragraph (c)(1) also prohibits the audit client having an investment in the auditor.

43 Rule 2-01(c)(3) of Regulation S-X. *See*, *e.g.*, *In the Matter of Ernst & Young LLP*, SEC Release No. 34-49615 (Apr. 26, 2004) (suspending auditor from accepting audit engagements from new public audit clients for a period of six months as a result of auditor's joint business relationships with its audit client).

44 Rule 2-01(c)(5) of Regulation S-X. PCAOB Rule 3521 also provides that a registered public accounting firm is not independent if it enters into contingent fee arrangements, directly or indirectly, with the audit client. In 2002, the SEC settled an auditor independence case with PricewaterhouseCoopers related to violations spanning a five-year period from 1996 to 2001 arising from (i) PwC's use of prohibited contingent fee arrangements with 14 different audit clients for which PwC's broker-dealer affiliate provided investment banking services and (ii) PwC's participation with two other audit clients in an improper accounting of costs that included PwC's own consulting fees. *In the Matter of Avon Products, Inc.*, SEC Release No. 34-46215 (July 17, 2002); *In the Matter of PricewaterhouseCoopers LLP*, SEC Release No. 34-46216 (July 17, 2002).

45 For example, in 2014, an SEC investigation found that Ernst & Young violated auditor independence rules because an Ernst & Young subsidiary lobbied congressional staff on behalf of two audit clients. Ernst & Young agreed to pay more than $4 million to settle the charges. *In the Matter of Ernst & Young LLP*, SEC Release No. 72602 (July 14, 2014). *See In the Matter of Ernst & Young Accountants*, SEC Release No. 34-46130 (June 27, 2002).

46 SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions (Dec. 13, 2004). While the staff generally has not objected to the

indemnification of a former auditor for costs incurred in the successful defense of claims (provided that the current auditor has opined on at least the most recent fiscal year and the indemnification arrangement is fully disclosed), the staff will not permit indemnification of a current auditor under any circumstances. *See also* SEC Codification of Financial Reporting Policies § 602.02.i.i., Fed. Sec. L. Rep. (CCH) ¶3874.

47 PCAOB Rules 3522 and 3523.

48 Section 10A(g) of the Exchange Act lists nine categories, which the SEC reworked into ten in Rule 2-01(c)(4). The 2000 version of the Rule established very similar categories (but it excluded expert services). In debating the Sarbanes-Oxley Act, Congress, like the SEC in the 2000 rulemaking, considered a range of approaches, ranging from the prohibition of any non-audit work (*see* S. Amdts. 4193, 4238, 4239, to S. 2673 (Senators Sarbanes, McCain, et al); "Auditor Independence Act of 2002," S. 1896, 107th Cong., Section 3 (2002) (Senator Boxer)) to permitting all non-audit work subject to audit committee pre-approval (*see* "Investor Confidence in Public Accounting Act of 2002," S.2004, 107th Cong., Section 201 (2002) (Senators Dodd, Corzine, *et al*.)).

49 Rule 2-01(c)(4)(i) of Regulation S-X. The qualification "unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements'" appears in the SEC's prohibitions on (i) bookkeeping, (ii) financial information systems design and implementation, (iii) appraisal or valuation services, fairness opinions or contribution-in-kind reports, (iv) actuarial services and (v) internal audit outsourcing. This language establishes a rebuttable presumption that the services in question are subject to audit procedures. *See* 2003 Auditor Independence Release, 68 Fed. Reg. 6006, 6030 (Feb. 5, 2003) ("2003 Auditor Independence Release"). The SEC has stated that an example of a situation where it would be reasonable to conclude that the results would not be subject to audit procedures would be where an accounting firm provides a prohibited service to an affiliate of the client, but the accounting firm is not the auditor of the entity that controls the accounting firm's client or its affiliate.

50 2003 Auditor Independence Release.

51 Rule 2-01(c)(4)(ii) of Regulation S-X.

52 2003 Auditor Independence Release.

53 Rule 2-01(c)(4)(iii) of Regulation S-X.

54 Due diligence services are generally regarded as permissible by the SEC if they do not involve valuation. *See* 2003 Auditor Independence Release (discussing "assurance and related services (*e.g.*, due diligence services) that traditionally are performed by the independent accountant" in terms of permissible services). Such services could include reviewing the reasonableness of assumptions and performing calculations based on those assumptions.

55 2003 Auditor Independence Release.

56 *See* SEC Release No. 33-8183 (Jan. 28, 2003) ("[W]e understand that laws and regulations in certain foreign countries require auditors to provide contribution-in-kind reports or valuation services. The Commission has historically addressed conflicts between U.S. and foreign requirements regarding non-audit services on an ad hoc basis. Commission staff has previously afforded relief from proscriptions against appraisal and valuation services where, among other things, the auditor and issuer were able to demonstrate that the auditor was not providing an opinion on the fairness of a given transaction. The Commission will continue to take this ad hoc approach, and will continue to consider requests for exemptive relief from foreign auditors.")

57 Rule 2-01(c)(4)(iv) of Regulation S-X.

58 2003 Auditor Independence Release.

59 Rule 2-01(c)(4)(v) of Regulation S-X. An engagement to provide services related to internal control over financial reporting is also subject to special pre-approval requirements under PCAOB Rule 3525.

60 2003 Auditor Independence Release. Existing auditing standards require an accountant to consider and evaluate an audit client's internal controls. *See* AICPA, CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Auditing Standards (AU) § 319, Consideration of Internal Control in a Financial

Statement Audit and Statement on Auditing Standards (AU) § 325, Communication of Internal Control Related Matters Noted in an Audit. In addition, rules under § 404(b) of the Sarbanes-Oxley Act require an auditor to opine on the effectiveness of an issuer's internal control over financial reporting. *See* § 4.06[2].

61 Rule 2-01(c)(4)(vi) of Regulation S-X.

62 2003 Auditor Independence Release.

63 Rule 2-01(c)(4)(vii) of Regulation S-X.

64 Rule 2-01(c)(4)(viii) of Regulation S-X.

65 Rule 2-01(c)(4)(ix) of Regulation S-X.

66 2003 Auditor Independence Release.

67 Rule 2-01(c)(4)(x) of Regulation S-X.

68 2003 Auditor Independence Release.

69 Rule 2-01(c)(4)(x) of Regulation S-X.

70 2003 Auditor Independence Release.

71 *See* SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence—Frequently Asked Questions (Dec. 14, 2004).

72 2003 Auditor Independence Release. The SEC noted that reviewing the tax accrual included in an audit client's financial statements is part of audit services and is not, in and of itself, deemed to be a tax compliance service.

73 2003 Auditor Independence Release, *see also* Letter from Donald T. Nicolaisen, Chief Accountant, SEC, to Bruce P. Webb, Chair, AICPA Professional Ethics Executive Committee, (May 21, 2004) (confirming the SEC's view that, notwithstanding the AICPA's assertion to the contrary, the receipt by an auditor of contingent fees for tax services provided to an audit client would impair the auditor's independence with respect to that client). PCAOB rules also treat registered public accounting firms as not independent if they enter into contingent fee arrangements, directly or indirectly, with audit clients.

74 PCAOB Rule 3522.

75 PCAOB Rule 3523. *See infra* Note 78 and the definition of "financial reporting oversight role."

76 Employment at the auditor of former issuer personnel can also impair independence. In particular, a former officer, director or employee of the audit client may not participate in, or be in a position to influence, the audit of the audit client covering any period the individual was associated with the issuer. Rule 2-01(c)(2)(iv) of Regulation S-X.

77 Rule 2-01(c)(2)(i) of Regulation S-X. It is also inconsistent with independence for a "close family member" of a "covered person in the firm" to act in an accounting role or a financial reporting oversight role at the audit client. Rule 2-01(c)(2)(ii) of Regulation S-X. The terms in quotation marks are defined in Rule 2-01(f) of Regulation S-X.

78 A "financial reporting oversight role" is defined as a role in which a person is in a position to, or does, exercise influence over the contents of an issuer's financial statements, such as when a person is a member of the board of directors, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer or any equivalent position. Rule 2-01(f)(3)(ii) of Regulation S-X. The SEC has stated that a person who has direct responsibility for overseeing those who prepare a registrant's financial statements and related information, such as the MD&A, is in a financial reporting oversight role. 2003 Auditor Independence Release.

79 Rule 2-01(c)(2)(iii) of Regulation S-X.

80 Rules 2-01(c)(2)(iii)(A) and 2-01(c)(2)(iii)(B) of Regulation S-X. The Exchange Act also specifically provides that it is unlawful for an auditor to perform any audit service for a company if the company's chief executive officer, controller, chief financial officer or chief accounting officer, or any person serving in an equivalent position, was employed by the auditor and participated in any capacity in the audit of the company during

the one-year period preceding the date of initiation of the audit. § 10A(1) of the Exchange Act, codifying § 206 of the Sarbanes-Oxley Act.

81 Rule 2-01(c)(2)(iii)(B)(3) of Regulation S-X.

82 The cooling-off period could differ from the paraphrase in the text above, where the filing date of the annual report changes from one year to the next (so that there is not exactly one year between annual reports), and the person leaves the audit engagement team during the period between the filing date and the date that is one year before the next filing date.

83 There are, however, some interpretive difficulties that could require clarification from the SEC staff. For example, on the face of the rule, the bar would appear to be permanent—if a person moves from the audit engagement team to a financial oversight position before the cooling-off period ends, the auditing firm can never be independent again. The SEC staff has informally indicated that the bar is only intended to last until the end of the cooling-off period, which is all the language of the Sarbanes-Oxley Act requires. The bar also seems to apply if a member of the audit engagement team moves to a nonfinancial-oversight position within the cooling-off period, and then moves into a financial oversight position after the end of the cooling-off period. This result is probably also unintended.

84 Rule 2-01(c)(2)(iii)(B)(2) of Regulation S-X. This particular exception was intended to address issues that may arise in foreign jurisdictions making it extremely difficult or costly to comply, but the SEC has noted that it expects the emergency exception to the rules to be invoked very rarely. 2003 Auditor Independence Release.

85 Rule 2-01(c)(7) of Regulation S-X. This requirement implements § 202 of the Sarbanes-Oxley Act, which is codified in § 10A(i) of the Exchange Act.

86 *See* § 3(a)(58) of the Exchange Act (defining "audit committee" to mean the full board where there is no separate audit committee).

87 SEC Release No. 33-8220 (Apr. 9, 2003).

88 In addition to SEC independence rules, PCAOB independence rules require audit committee pre-approval for certain tax services and for services related to internal control over financial reporting. PCAOB Rules 3524 and 3525.

89 Published guidance of the SEC's Office of Chief Accountant addresses the level of detail necessary, stating that monetary limits and broad, categorical approvals are not sufficient, and that while the level of detail will depend on the circumstances of the issuer, it must be sufficient so that there is no delegation to management and the audit committee can make a well-reasoned assessment of the impact of the services on independence. *See* SEC, Office of the Chief Accountant, Application of the Commission's Rules on Auditor Independence Frequently Asked Questions (Dec. 13, 2004).

90 Item 16C(e) of Form 20-F.

91 Rule 2-01(c)(7)(i)(C) of Regulation S-X, implementing § 10A(i)(1)(B) of the Exchange Act.

92 Item 16C(e) of Form 20-F, implementing § 10A(i)(2) of the Exchange Act.

93 Auditing Standard No. 1301, Communications with Audit Committees. Appendix C to Auditing Standard No. 1301 includes matters that are required to be included in the engagement letter.

94 Rule 2-07 of Regulation S-X ; § 10A(k) of the Exchange Act, codifying § 204 of the Sarbanes-Oxley Act. The communications required by Rule 2-07 are also required by Auditing Standard No. 1301.

95 These are listed in Appendix B to Auditing Standard No. 1301.

96 PCAOB Rule 3526.

97 Item 16F of Form 20-F. Item 16F was based on the disclosure requirements for domestic issuers in Item 4.01 of Form 8-K, Item 304(a) of Regulation S-K and Item 9 of Form 10-K. *See* SEC Release No. 33-8959 (Sept. 23, 2008). Disclosure must be provided in a registration statement at effectiveness, as well as in prospectuses used in connection with a shelf offering. *See* Item 5 of Form F-3.

98 A domestic issuer must file a current report on Form 8-K within four business days after the auditor resigns

(or indicates it will not stand for re-election) or is dismissed and within four business days after the new auditor is appointed. The information required to be disclosed is set forth in Item 304 of Regulation S-K under the Securities Act, which is substantially identical to Item 16F of Form 20-F. *See also* Foreign Issuer Reporting Enhancement, 73 Fed. Reg. 58,300, 58,310 (Oct. 6, 2008) (discussing why the SEC chose not to impose a current reporting requirement on foreign issuers).

99 Such information includes the names of the old and new auditors, the date of the change and whether the change was recommended or approved by the audit committee or the board of directors. *See* Item 16F(a)(1)(i), (iii) and Item 16F(a)(2) of Form 20-F.

100 NYSE LISTED COMPANY MANUAL § 204.03; NASDAQ LISTING CENTER, FREQUENTLY ASKED QUESTIONS.

101 § 10A(b)(1) of the Exchange Act.

102 § 10A(b)(2) of the Exchange Act.

103 § 10A(b)(3) of the Exchange Act. Rule 10A-1 under the Exchange Act provides procedures for notices to the Office of Chief Accountant by either the issuer or the auditor. An auditor complying with its obligations under § 10A(b) will not be liable in a private action for any finding, conclusion or statement in its report to the board of directors or the SEC. § 10A(c) of the Exchange Act.

104 Rule 13b2-2(a) under the Exchange Act.

105 Rule 13b2-2(b) under the Exchange Act. The SEC adopted paragraph (b) of Rule 13b2-2 in 2003 to implement § 303 of the Sarbanes-Oxley Act. The SEC has stated that paragraph (b) establishes a negligence standard. SEC Release No. 34-47890 (May 20, 2003).

106 SEC Release No. 34-47890 (May 20, 2003).

107 § 303(b) of the Sarbanes-Oxley Act. A willful violation could also result in criminal penalties under § 32(a) of the Exchange Act. The SEC has brought a number of proceedings against individuals alleging violations of Rule 13b2-2, generally together with other violations. *See*, *e.g.*, *SEC v. Kipp and Viard*, SEC Litigation Release No. 23544 (May 24, 2016) (alleging the company's former CFO and former director of external reporting violated Rule 13b2-2 by manipulated acquisition-related reserves and expenses in order to increase earnings to predetermined targets tied to the expectations of lenders as the basis for future acquisition financing); *United States v. Lundstrom*, SEC Litigation Release No. 23499 (Mar. 25, 2016) (former chairman and CEO sentenced to 11 years in federal prison and ordered to pay a $1.2 million fine for orchestrating a scheme to defraud shareholders and mislead regulators by concealing more than $100 million in losses on loans and declining real estate); *SEC v. Neil*, SEC Litigation Release No. 23192 (Feb. 6, 2015) (alleging the former CEO directed an effort to fraudulently underreport money paid to walnut growers by delaying the recognition of related expenses into later fiscal periods); *In the Matter of Michael Mendes* and *SEC v. Neil*, SEC Litigation Release No. 22902 (Jan. 9, 2014) (alleging that a company's CEO and CFO violated Rule 13b2-2 by making false and misleading statements to external auditors in signed management representation letters); *SEC v. Forman,* SEC Litigation Release No. 21677 (Sept. 30, 2010) (alleging that a company's controller violated Rule 13b2-2 by providing independent auditors with false information and statements regarding prepaid transaction revenue); *SEC v. Gupta*, SEC Litigation Release No. 21451 (Mar. 15, 2010) (alleging that two of the company's CFOs knowingly signed management representation letters to its external auditors containing materially false or misleading statements or omissions); *SEC v. Stanard*, SEC Litigation Release No. 20875 (Jan. 30, 2009) (finding that the former CEO made false or misleading statements to external auditors in signed management representation letters and in providing them with false information about insurance claims).

108 SEC Release No. 34-47890 (May 20, 2003).

109 SEC Release No. 34-47890 (May 20, 2003).

110 SEC Release No. 34-47890 (May 20, 2003).

111 SEC Release No. 34-47890 (May 20, 2003).

112 § 101(c) of the Sarbanes-Oxley Act. The original authority of the PCAOB over audits of reporting "issuers" was extended by the Dodd-Frank Act, which amended the Sarbanes-Oxley Act to give the PCAOB

oversight authority over audits of SEC-registered broker-dealers. The PCAOB adopted implementing amendments to its rules in December 2013. PCAOB Release No. 2013-010 (Dec. 4, 2013).

113 § 102(a) of the Sarbanes-Oxley Act; *see also* SEC Release No. 34-48180 (July 16, 2003). U.S. public accounting firms were required to register with the PCAOB by October 22, 2003; foreign firms were required to register by July 19, 2004. *See* SEC Release No. 34-48180 (July 16, 2003); SEC Release No. 34-49473 (Mar. 25, 2004). The prohibition in § 102(a) applies to audit reports with respect to an "issuer" as defined in § 2(a)(7) of the Sarbanes-Oxley Act, which includes a reporting company but not, for example, a company that is exempt from reporting under Rule 12g3-2(b) under the Exchange Act.

114 § 107 of the Sarbanes-Oxley Act. *See Free Enterprise Fund v. Public Company Accounting Oversight Board*, 130 S. Ct. 3138 (2010) (upholding the constitutionality of the PCAOB, but holding unconstitutional certain tenure provisions, or "removal restrictions," in the Sarbanes-Oxley Act allowing removal of the PCAOB's members only for "good cause" by the SEC).

115 The public availability of PCAOB registration applications and annual reports, or any portion thereof as may be designated by the PCAOB, is subject to the rules of the PCAOB or the SEC and to legal restrictions relating to confidentiality of proprietary or personal information. § 102(e) of the Sarbanes-Oxley Act. The PCAOB has accommodated foreign firms insofar as the scope of information required to be included in their registration applications is reduced and such firms may withhold certain information if they can demonstrate that providing the information would conflict with non-U.S. law (by providing an English copy or translation of the non-U.S. law, a legal opinion that submitting the information would violate the law and an explanation of the firm's efforts to seek consents or waivers to eliminate the conflict). *See* PCAOB Rules, Rules 2105, 2207; *see also* SEC Release No. 34-60497 (Aug. 13, 2009) (approving rules on annual and special reporting by registered public accounting firms proposed by the PCAOB).

116 § 105(b)(5) of the Sarbanes-Oxley Act.

117 § 106(a)(1) of the Sarbanes-Oxley Act.

118 For example, in December 2016, the PCAOB issued orders imposing sanctions on Deloitte Touche Tohmatsu Auditores Independentes, the Brazilian auditing firm in the Deloitte global network, and 12 individuals associated with that firm, arising from violations of U.S. securities laws and PCAOB rules in connection with audits of two reporting foreign private issuers. PCAOB Release No. 105-2016-031 (Dec. 5, 2016).

119 § 106(b) of the Sarbanes-Oxley Act, as amended by § 929J of the Dodd-Frank Act. Such foreign firms are subject to the jurisdiction of the U.S. courts for purposes of enforcing such production of workpapers.

120 PCAOB, Frequently Asked Questions Regarding Issues Relating to Non-U.S. Accounting Firms, Question 4 (Dec. 15, 2016).

121 The proceedings were settled in February 2015. *In the Matter of BDO China Dahua CPA Co.*, SEC Admin. Proc. File Nos. 3-14872, 3-15116 (Feb. 6, 2015) (finding that five auditing firms willfully violated § 106 of the Sarbanes-Oxley Act, and imposing among other things specified undertakings and other relief relating to the production of documents in response to future PCAOB requests).

122 In July 2010, the Dodd-Frank Act amended § 105 of the Sarbanes-Oxley Act to provide that the PCAOB may, in certain circumstances, share information with non-U.S. auditor oversight authorities. As of late 2016, the PCAOB reported that it had entered into cooperative arrangements with regulators in 23 countries, that it had conducted inspections in 45 non-U.S. jurisdictions on a cumulative basis, and that in 12 jurisdictions it was denied access to the information necessary to conduct inspections on the basis of asserted restrictions under local law or objections based on national sovereignty. PCAOB Cooperative Arrangements with Non-U.S. Regulators, Jurisdictions Where the PCAOB has Conducted Inspections of Registered non-U.S. Firms (June 30, 2015), and Registered Firms not yet Inspected even though Four or More Years have Passed since Issuance of an Audit Report while Registered (June 30, 2015), PUB. CO. ACCOUNTING OVERSIGHT BD. (Dec. 15, 2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 5.04, CONTROLS, OFFICERS CERTIFICATIONS AND RELATED DISCLOSURES

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 § 5.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Books and Records Requirement

The Foreign Corrupt Practices Act ("FCPA"), first adopted in 1977, has two parts: (i) the anti-bribery provisions, which prohibit the bribery of non-U.S. government officials, and (ii) the accounting provisions, which require issuers to keep accurate books and records and to maintain a system of internal accounting controls. The FCPA is codified in § 13(b) of the Exchange Act and enforced by the SEC and, in criminal cases, by the Department of Justice (the “DOJ”). The anti-bribery provisions are discussed in § 11.

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The accounting provisions apply only to "issuers," which are defined as companies that have shares registered under § 12 of the Exchange Act or file periodic reports under § 15(d) of the Exchange Act. [123] An issuer is responsible for compliance with the accounting provisions by its controlled subsidiaries. [124] An issuer that controls 50% or less of the "voting power" of an affiliate must use its influence, in good faith and to the extent reasonable under the circumstances, to cause the affiliate to maintain internal accounting controls that meet the FCPA standard. [125]

The accounting provisions of the FCPA require an issuer to keep books, records and accounts that, in reasonable detail, accurately reflect corporate payments and transactions. [126] An issuer must also maintain systems of internal accounting controls able to provide reasonable assurances that (i) transactions are executed in accordance with management's authorization; (ii) transactions are recorded as necessary both to permit the preparation of financial statements in conformity with generally accepted accounting principles and to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences. [127]

U.S. authorities frequently use the accounting provisions of the FCPA to impose liability on non-U.S. issuers, even where there might not be jurisdiction

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to apply the anti-bribery provisions. [128] A bribe payment by an issuer or its consolidated subsidiary, if falsely recorded, creates liability for the issuer, and no other tie with the United States is needed to establish accounting provision jurisdiction. [129] And bribe payments are almost invariably falsely recorded in the payor's accounting records as "sales expense," "commission," "agent fees," or similar terms. [130]

[2] Internal Control Over Financial Reporting

[a] Overview

One of the central innovations in the Sarbanes-Oxley Act was internal control reporting under § 404. Section 404 directed the SEC to adopt rules requiring that each annual report under the Exchange Act contain an internal control report stating that management is responsible for establishing internal controls, containing management's evaluation of their effectiveness, and providing the auditor's attestation as to that assessment. The SEC developed the expression "internal control over financial reporting"—sometimes shortened to "ICFR"—to describe the subject of this reporting requirement. The development of internal control reporting under § 404 involved, in addition to extensive rulemaking by the SEC, the adoption by the PCAOB of a new standard governing the related auditor attestation. [131] These reporting requirements were controversial, with many issuers and other commentators contending that they imposed excessive burdens; with respect to foreign issuers in particular, they were characterized as a significant deterrent to accessing the U.S. public markets. They have, however, come to be an accepted feature of reporting by public companies.

The principal elements of the framework for internal control reporting, as it applies to a reporting foreign private issuer, are listed below. A new reporting

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company is not subject to these requirements until it has filed at least one annual report. [132]

- The issuer must maintain internal control over financial reporting. [133]
- Management must evaluate the effectiveness of ICFR as of the end of each fiscal year. [134] This evaluation must be made with the participation of the principal executive officer and the principal financial officer, or persons performing similar functions. It must be based on "a suitable, recognized control framework," as defined in the applicable SEC rule. [135]
- Management must also evaluate any change in ICFR that occurred during the fiscal year and that has materially affected, or is reasonably likely to materially affect, the issuer's ICFR. [136] This evaluation must be made with the participation of the chief executive officer and the chief financial officer. Any change that is identified must be disclosed in the annual report on Form 20-F. [137]
- The officer certifications that accompany the annual report on Form 20-F must include specified information about ICFR, as discussed in § 5.04[4] below.
- The annual report on Form 20-F must include a management report on the issuer's ICFR. [138] The report must include a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, and it must identify the framework management used to

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  evaluate effectiveness. It must also state whether or not ICFR was effective as of the end of the fiscal year, as discussed in § 5.04[2][c] below.
- The annual report on Form 20-F must also include an auditor's report on management's assessment of effectiveness. Smaller issuers—issuers that are not "accelerated filers" or "large accelerated filers" [139]—are exempt from this requirement. [140]

The SEC staff has published answers to frequently asked questions on ICFR reporting that address a number of recurring issues in the application of the rules. Among other things, the staff addresses how ICFR reporting applies to an equity method investment or a proportionally consolidated investment. [141] The SEC staff also acknowledges that, where an issuer has recently acquired a business, it may be unable to conduct an assessment of ICFR at the newly acquired business in time to include it in management's report on ICFR. In such a case, the staff will not object to the issuer excluding the acquired business from the scope of the report, for not more than one year from the date of acquisition, provided it makes specified disclosures. [142]

[b] Definition

Internal control over financial reporting is defined as a process designed by, or under the supervision of, an issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. [143] Internal control over financial reporting includes those policies and procedures that:

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- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of an issuer;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and receipts and expenditures of the issuer are made only in accordance with authorizations of management and directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

[c] Effectiveness

A foreign private issuer must disclose under Item 15 of Form 20-F whether its internal control over financial reporting was effective as of the end of the fiscal year. When the conclusion is affirmative, the language used for this disclosure is highly standardized. The SEC staff has objected in comment letters when an issuer provides a partial summary of the definition of ICFR or qualifies management's conclusion about effectiveness.

The determination whether ICFR is effective relies on two concepts that were developed by the PCAOB to govern the auditor's attestation relating to internal control: "significant deficiency" and "material weakness." [144] A material weakness is "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis." If management identifies a material weakness, it must disclose the material weakness and may not conclude that internal control over financial reporting is effective. [145] A conclusion that ICFR is

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not effective does not affect the issuer's eligibility to use short-form registration. [146]

A significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." There is no requirement to disclose a significant deficiency. However, certain process implications are the same as for a material weakness: management is required to certify that it has communicated any significant deficiency to the board of directors, and the auditor is also required to communicate with the audit committee concerning any significant deficiency.

[3] Disclosure Controls and Procedures

The regulatory requirements concerning disclosure controls and procedures are parallel in some ways to the requirements concerning internal control over financial reporting, but there are important differences. [147] Disclosure controls and procedures are not limited to financial reporting, so they are broader in scope than internal control over financial reporting; but with respect to financial reporting, ICFR has a much more developed regulatory framework and an auditor attestation requirement. Auditors do not report on disclosure controls and procedures, and perhaps for that reason compliance has proven to be less burdensome than for internal control over financial reporting.

Disclosure controls and procedures are defined as those controls and other procedures of an issuer that are designed to ensure that information, both financial and nonfinancial, required to be disclosed in reports filed or submitted by such issuer under the Exchange Act is recorded, processed, summarized and reported within the required time periods. These controls and procedures include, without limitation, measures designed to ensure that information required to be

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disclosed in Exchange Act reports is accumulated or communicated to an issuer's management, including its principal executive and financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. [148] In discussing how the DC&P requirements are broader than the ICFR requirements, the SEC has stated that disclosure controls and procedures should be designed, in particular, to capture the following types of information:

- information potentially subject to disclosure under Regulation S-X, Regulation S-K and Form 20-F;
- information relevant to an assessment of the need to disclose developments and risks that pertain to an issuer's businesses (including, in some cases, an assessment and evaluation of operational and regulatory risks); and
- information that must be evaluated for disclosure pursuant to Rule 12b-20 under the Exchange Act, which requires that Exchange Act reports include any material information necessary to make the required statements, in the light of the circumstances under which they are made, not misleading. [149]

The requirements for DC&P reporting, as they apply to a reporting foreign private issuer, are as follows:

- The issuer must maintain disclosure controls and procedures. [150]
- Management must evaluate the effectiveness of the issuer's disclosure controls and procedures as of the end of each fiscal year. [151] The evaluation must be conducted with the participation of the principal executive officer and the principal financial officer, or persons performing similar functions.
- The officer certifications that accompany the annual report on Form 20-F must include specified information about DC&P, as discussed in § 5.04[4] below.
- The annual report on Form 20-F must disclose the conclusions of the principal executive officer and the principal financial officer concerning the effectiveness of the issuer's DC&P as of the end of the fiscal year. [152]

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SEC rules do not provide procedures for the conduct of the evaluation of DC&P, but the SEC has stated that it expects each issuer to develop a process that is consistent with its business and internal management and supervisory practices. [153] In practice, the procedures are generally designed to provide a basis for the certifications the CEO and CFO must provide, as discussed in § 5.04[4] below. The SEC has also recommended, but not required, that an issuer establish a disclosure committee, which would be responsible for considering the materiality of information and determining disclosure obligations on a timely basis. According to the SEC, a disclosure committee might be expected to include the issuer's (i) principal accounting officer or controller, (ii) general counsel or other senior legal officer with responsibility for disclosure matters who reports to the general counsel, (iii) principal risk management officer, (iv) chief investor relations officer (or an officer with equivalent responsibilities) and (v) other officers or employees, including individuals associated with the issuer's business units, to the extent deemed appropriate. [154]

[4] Officer Certifications

[a] Section 302 Certifications

SEC rules adopted pursuant to § 302 of the Sarbanes-Oxley Act require that an issuer's annual and quarterly reports under the Exchange Act must include personal certifications of the issuer's principal executive officer and principal financial officer, or persons performing similar functions. [155] The certification must be filed as an exhibit to the report. For a foreign private issuer, this requirement applies to the annual report on Form 20-F but not to reports on Form 6-K. [156] § 302 certifications are considered filed as part of the report, and are subject to the civil antifraud provisions under § 18 of the Exchange Act and automatically incorporated in the issuer's Securities Act registration statements.

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The language of the certification is specifically set forth in Form 20-F. [157] It requires each certifying officer to state that he or she has reviewed the report, and that based on his or her knowledge, the report contains no material misstatements or omissions.

The certification then requires each officer to state that based on his or her knowledge, the financial statements and other financial information included in the relevant report fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report. The information captured by this "fair presentation" standard is not just the financial statements and related notes. It also includes selected financial data, MD&A and other financial information included in the report. The SEC has stated that this standard addresses the financial information in a report viewed in its entirety and is broader than a requirement to present financial information in conformity with generally accepted accounting principles. It encompasses the selection of appropriate accounting policies, proper application of those policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events, and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows. [158]

The certification then requires each certifying officers to acknowledge responsibility for establishing, maintaining and "properly" designing disclosure controls and procedures and internal control over financial reporting for the issuer. Each officer must state that he or she has (i) evaluated the effectiveness of DC&P and presented conclusions about such effectiveness; and (ii) disclosed in the report any change in ICFR, occurring during the period covered by the report, that has materially affected or is reasonably likely to materially affect ICFR. Each officer must also state that he or she has disclosed, based on the most recent evaluation of ICFR, to the issuer's auditors and audit committee (i) all significant deficiencies and material weaknesses in the design or operation of ICFR that are reasonably likely to adversely affect the issuer's ability to record, process, summarize and report financial information and (ii) any fraud (regardless of materiality) involving management or other employees having a significant role in such internal control.

The terminology used in the certification reflects the requirements of SEC rules relating to internal control over financial reporting and disclosure controls

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and procedures. [159] The wording of the certification must be in the form specified and may not be changed in any respect, even if the change would appear to be inconsequential in nature. [160] It must be signed directly by the specified officers and may not be signed pursuant to a power of attorney. [161]

In addition to being subject to liability under the Exchange Act generally in connection with the filing of a report, an officer providing a false certification could be subject, in his or her personal capacity, to SEC actions for violating § 13(a) or § 15(d) of the Exchange Act and to private actions for violating §§ 18 and 10(b) of the Exchange Act and Rule 10b-5 thereunder. [162]

[b] Section 906 Certifications

A separate set of officer certifications is required pursuant to § 906 of the Sarbanes-Oxley Act. [163] Section 906 requires that each periodic report containing financial statements filed by an issuer with the SEC must be "accompanied by" a written statement of the issuer's chief executive officer and chief financial

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officer (or equivalent thereof). The statement must certify that the report fully complies with the requirements of § 13(a) or § 15(d) of the Exchange Act and that the information it contains fairly presents, in all material respects, the financial condition and results of operations of the issuer. Unlike the certification required by § 302 and Rules 13a-14 and 15d-14, the certification required by § 906 does not contain a qualification relating to the "knowledge" of the certifying officer. Nevertheless, it is common practice to include such a qualification, particularly in light of the qualification contained within § 302 itself and because knowledge is a requirement for the criminal penalties under § 906.

Like § 302 certifications, § 906 certifications must be filed as exhibits to an annual report on Form 20-F, [164] but are not required to be filed with a report on Form 6-K. However, § 906 certifications are furnished to, rather than filed with, the SEC. [165] Accordingly, § 906 certifications do not give rise to liability under § 18 of the Exchange Act, and they are not automatically incorporated by reference into an issuer's Securities Act registration statements. [166]

Section 906 imposes criminal liability for inaccurate certifications knowingly or willfully furnished by a certifying party. [167] The penalties consist of up to (i) 20 years' imprisonment and a fine of U.S. $5,000,000 for anyone who willfully certifies such statements or (ii) ten years' imprisonment and a fine of U.S. $1,000,000 for anyone who otherwise certifies such statements, in either case, knowing that the report does not comport with all the relevant requirements.

Footnotes

123 § 13(b)(2) of the Exchange Act. In contrast, the FCPA's anti-bribery provisions apply both to issuers and to "domestic concerns," which is defined as all U.S. citizens, nationals and residents, and all companies that have their principal place of business in the United States or are organized under U.S. law. 15 U.S.C. § 78dd-2(h)(1). The anti-bribery provisions apply to a domestic concern regardless of whether the activity related to the bribe has any other connection to the United States. 15 U.S.C. § 78dd-2(i)(1). For an issuer that is not a "domestic concern," the anti-bribery provisions only apply if the bribe occurs in connection with U.S. interstate commerce. 15 U.S.C. § 78dd-1(a). In addition, the FCPA's anti-bribery provisions apply to a non-U.S. person or company if it, or any person acting on its behalf, performs any part of the acts of bribery while in the territory of the United States. 15 U.S.C. § 78dd-3(a). For corporate entities, in summary, the FCPA's anti-bribery provisions apply to any company that (i) is organized under U.S. law or has its principal place of business in the United States, (ii) is an issuer and uses U.S. interstate commerce in furtherance of a bribe, or (iii) acts within U.S. territory in aid of a bribe. *See* § 11.08[1][a] for a more detailed discussion of the FCPA.

124 *See* Criminal Division of the U.S. Department of Justice and the Enforcement Division of the U.S. Securities and Exchange Commission, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT (2102) ("The FCPA Guide") ("Although the FCPA's accounting requirements are directed at "issuers," an issuer's books and records include those of its consolidated subsidiaries and affiliates.").

125 15 U.S.C. § 78m(b)(6).

126 § 13(b)(2)(A) of the Exchange Act.

127 § 13(b)(2)(B) of the Exchange Act.

128 *See supra* Note 123.

129 *See*, *e.g.*, Order, *In re GlaxoSmithKline plc*, SEC Release No. 79005 (Sept. 30, 2016) (bribes by GSK's China-based subsidiary and a China-based joint-venture result in accounting provision violations by GSK itself; no anti-bribery provision liability is imposed).

130 *See*, *e.g.*, Order, *In re LAN Airlines, S.A.*, SEC Release No. 78402 (July 25, 2016) (payment to consultant for a "study" when company knew that no actual study would be performed); FCPA GUIDE at 39 ("Bribes are often concealed under the guise of legitimate payments, such as commissions or consulting fees.").

131 PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated

with An Audit of Financial Statements, was adopted in PCAOB Release No. 2007-005 (May 24, 2007). The PCAOB's initial standard for internal control reporting, adopted in 2004, was Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, adopted in PCAOB Release No. 2004-001 (Mar. 9, 2004). Auditing Standard No. 5 revised the standards in response to extensive criticism of the burdens imposed on issuers and auditors by internal control reporting.

132 The initial holiday for a new reporting company is reflected in Rules 13a-15 and 15d-15 and in Instruction 1 to Item 15 of Form 20-F.

133 Rule 13a-15(a) and Rule 15d-15(a) under the Exchange Act.

134 Rule 13a-15(c) and Rule 15d-15(c) under the Exchange Act. The SEC provided extensive guidance on how to evaluate effectiveness in Release No. 34-55929 (June 20, 2007).

135 Issuers generally use the framework developed by an organization called the Committee of Sponsoring Organizations of the Treadway Commission or "COSO." The current version of the COSO framework is Committee of Sponsoring Organizations of the Treadway Commission, Internal Control–Integrated Framework (2013). *See* SEC Release Nos. 34-47986 (June 5, 2003) and 34-55929 (June 20, 2007) (each specifically identifying the 1992 COSO framework as meeting the criteria in Rules 13a-15(c) and 15d-15(c) under the Exchange Act, but stating that other control evaluation frameworks could also be acceptable).

136 Rule 13a-15(d) and Rule 15d-15(d) under the Exchange Act. This requirement applies to changes in any fiscal year for a foreign private issuer and in any fiscal quarter for a domestic issuer. The separate requirement to evaluate changes was adopted not to implement § 404, but to track language in the officer certification requirement in § 302 of the Sarbanes-Oxley Act. For a domestic issuer, this is a significant additional requirement because it is quarterly as well as annual.

137 Item 15(d) of Form 20-F.

138 Item 15(b) of Form 20-F.

139 *See* § 3.01 at Note 22 for a discussion of the definition "large accelerated filers."

140 Item 15(c) of Form 20-F. When the auditor's report on internal control is included in a Securities Act registration statement, the auditor's consent is required under Rule 436 under the Exchange Act. Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports-Frequently Asked Questions (rev. Sept. 24, 2007) ("2007 FAQs"), Question 9.

141 2007 FAQs, Questions 2 and 15.

142 2007 FAQs, Question 3.

143 Rules 13a-15(f) and 15d-15(f) under the Exchange Act. The expression "internal control over financial reporting," is arguably narrower than the term "internal controls" used in § 404 itself, because it relates only to financial reporting. *Cf.*, *e.g.*, Auditing Standard No. 12, Identifying and Assessing Risks of Material Misstatement (Public Company Accounting Oversight Board, 2010) (including controls over the completeness and accuracy of operating and other nonfinancial information used as audit evidence). The SEC's definition of internal control over financial reporting distinguishes the subject of § 404 reporting from the separate requirements concerning "disclosure controls and procedures"—sometimes referred to as "DC&P"—that the SEC had developed independently of the Sarbanes-Oxley Act. *See infra* § 5.04[3].

144 The terms are defined in Item 1.02(a)(4) of Regulation S-X and Rule 12b-2 under the Exchange Act. The terminology was developed based on prior auditing standards in Auditing Standard No. 2, adopted by the PCAOB in 2004, and then incorporated in Auditing Standard No. 5, which replaced Auditing Standard No. 2 in 2007. It was then added to SEC rules in 2007. SEC Release No. 33-8809 (June 20, 2007) and SEC Release No. 33-8810 (June 20, 2007) (adopting definition of material weakness); SEC Release No. 34-56203 (Aug. 3, 2007) (adopting definition of significant deficiency). The analogous requirements applicable to a domestic issuer are in Item 9A of Form 10-K and Item 307 of Regulation S-K.

145 Item 15(b)(3) of Form 20-F. *See* SEC, Staff Statement on Management's Report on Internal Control Over

Financial Reporting (May 16, 2005), Part E (guidance on disclosures required when reporting a material weakness). The definition of material weakness refers to the preparation of interim financial statements, but the SEC staff takes the view that this reference is not applicable to a foreign private issuer. 2007 FAQs, Question 13.

146 2007 FAQs Question 4.

147 Prior to enactment of the Sarbanes-Oxley Act, the SEC had proposed rules under which (a) the CEO and CFO of a reporting company would be required to certify certain matters in connection with the company's quarterly and annual reports under the Exchange Act and (b) a reporting company would be required to maintain disclosure controls and procedures. SEC Release No. 34-46079 (June 14, 2002). Section 302 of the Sarbanes-Oxley Act included a certification requirement that differed from the SEC's proposals. SEC Release No. 34-46300 (Aug. 2, 2002) (summarizing the differences between the SEC proposals and the statutory requirements). When the SEC implemented the § 302 certification requirement, it also adopted its prior proposal to require an issuer to maintain and report on DC&P. SEC Release No. 33-8124 (Aug. 28, 2002).

148 Rules 13a-15(e) and 15d-15(e) under the Exchange Act.

149 SEC Release No. 33-8124 (Aug. 28, 2002), 67 Fed. Reg. 57,276, at 57,281 (Sept. 9, 2002) (text accompanying nn.72–74).

150 Rules 13a-15(a) and 15d-15(a) under the Exchange Act.

151 Rules 13a-15(b) and 15d-15(b) under the Exchange Act.

152 Item 15(a) of Form 20-F.

153 SEC Release No. 33-8124 (Aug. 28, 2002).

154 SEC Release No. 33-8124 (Aug. 28, 2002).

155 Rules 13a-14 and 15d-14. These rules apply to any reporting company, including a company that files Exchange Act reports "voluntarily," for example with a suspended reporting obligation under § 15(d). SEC Division of Corporation Finance: Sarbanes-Oxley Act of 2002—Frequently Asked Questions (Nov. 8, 2002, revised Nov. 14, 2002), Question 9. The persons performing the specified functions at the time of filing must provide certification, whether or not they had those functions during the period covered by the report. *See* Questions 13–15.

156 Domestic issuers are required to provide certifications in annual reports on Form 10-K and quarterly reports on Form 10-Q.

157 Form 20-F, Instructions as to Exhibits, paragraph (12). The analogous requirements for domestic issuers are in Regulation S-K, Item 601(b)(31). *See* Form N-CSR, Item 11(a) for certifications applicable to registered management investment companies. *See* Rules 13a-14(d), 13a-14(e), 15d-14(d) and 15d-14(e) under the Exchange Act and Item 601(b)(31)(ii) of Regulation S-K for certification requirements applicable to asset-backed issuers, as defined in Regulation AB.

158 SEC Release No. 33-8124 (Aug. 28, 2002), 67 Fed. Reg. 57,276, 57,279 & n.56 (Sept. 9, 2002) (citing Rule 12b-20 under the Exchange Act).

159 *See supra* §§ 5.04[2] and 5.04[3].

160 *See* SEC Release No. 33-8238 (June 5, 2003).

161 Rules 13a-14(c) and 15d-14(c) under the Exchange Act. A number of considerations arise in connection with the application of Rules 13a-14 and 15d-14 to foreign private issuers. Some foreign private issuers must make nuanced determinations as to which persons serve as principal executive officer and principal financial officer and which body functions as the audit committee. In certain countries, such as Germany, different corporate bodies and officials have primary responsibility for disclosure and financial reporting and cannot, under home-country law, delegate such responsibility. In those instances, certifications by principal executive officers and principal financial officers could expose such officers to liability in the United States for misconduct by those different corporate bodies and officials.

162 In various cases, the SEC has sought monetary penalties and injunctive relief against officers who allegedly signed false certifications. In two cases filed not long after the Sarbanes-Oxley Act came into force, the SEC alleged that the issuer filed reports purporting to contain unqualified audit opinions although, in fact, the auditors had not provided signed audit opinions. *SEC v. Cedric Kushner Promotions, Inc.*, SEC Litigation Release No. 19485 (Dec. 5, 2005); *SEC v. Rica Foods*, SEC Litigation Release No. 18293 (Aug. 18, 2003). In a number of more recent cases, the SEC has sought civil penalties for false certifications under Rules 13a-15 and 15d-15. *See*, *e.g.*, *SEC v. Gupta*, SEC Litigation Release No. 21451 (Mar. 15, 2010) (SEC action against executives who understated extent of company funds paid as executive perquisites in certified disclosure documents); *SEC v. Jenkins*, SEC Litigation Release No. 21149A (July 23, 2009) (SEC civil action against CEO who allegedly received bonuses and stock sale profits while company was committing accounting fraud); *SEC v. Sherman*, SEC Release No. 34-72723 (July 30, 2014) and *SEC v. Cummings*, SEC Release No. 34-72722 (July 30, 2014) (SEC action against executives for misrepresenting to external auditors and the investing public the state of its internal controls over financial reporting); and *SEC v. Ormand*, SEC Release No. 77346 (Mar. 10, 2016) and *SEC v. Krueger*, SEC Release No. 77344 (Mar. 10, 2016) (SEC action against executives who failed to evaluate applicable internal control over financial reporting standards and concluded the company had no material weaknesses).

163 Rules 13a-14(b) and 15a-14(b). § 906 of the Sarbanes-Oxley is codified as 18 U.S.C.1350.

164 Although, read literally, § 906 would apply to reports on Form 11-K required to be filed by certain employee benefit plans, the SEC and DOJ have concluded that § 906 certifications do not need to accompany reports on Form 11-K. *See* SEC Release No. 33-8400 (Mar. 16, 2004) 69 Fed. Reg. 15,594, 15,609 n.146 (Mar. 25, 2004).

165 Form 20-F, paragraph (13)(b) to instructions as to Exhibits.

166 Form 20-F, paragraph (13)(b) to instructions as to Exhibits; *see also* SEC Release No. 33-8238 (June 5, 2003).

167 One interesting aspect of § 906 is that the penalties apply to noncompliance with the terms of the certification, but the statute does not explicitly provide that a failure to file triggers the potential liability. *But see* Letter from Daniel J. Bryant, Assistant Attorney General, Department of Justice, to the Honorable Joseph R. Biden, Jr. (Dec. 26, 2002) (stating that willful failure to file a § 906 certification would trigger the criminal provisions of 15 U.S.C. § 78ff).

U.S. Regulation of the International Securities and Derivatives Markets, § 5.05, OTHER CORPORATE GOVERNANCE REQUIREMENTS

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 § 5.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Prohibition on Personal Loans to Executive Officers and Directors

Section 402(a) of the Sarbanes-Oxley Act [168] prohibits an issuer [169] and its subsidiaries from directly or indirectly extending, maintaining, renewing or

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arranging for an extension of credit in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of the issuer. [170] There is no materiality threshold or de minimis exception. [171]

Section 402(a) raises a number of interpretive issues with respect to practices that involve the provision by an issuer of a benefit that may have some but not all of the features of a loan. Among the practices it may prohibit are loans inherent in split-dollar life insurance arrangements, after-tax leveraged co-investment programs and certain cashless exercises of options. Practitioners have sought to clarify the scope of § 402's prohibitions by interpreting the statutory language, most notably with respect to the words "arranging" and "extension of credit in the form of a personal loan." [172]

The concept of "arranging" for purposes of § 402(a) is generally believed to require some level of issuer involvement in the making of a loan by a third party to the director or executive officer. Limited facilitation of a personal loan, such as providing information or confirming that the issuer will comply with its existing obligations to a director or executive officer, should not constitute "arranging," but more substantial levels of facilitation or participation by the issuer may be deemed to be "arranging." [173] Given the conflict of interest-oriented policy of § 402(a), the use of issuer assets, or facilitation by the issuer of any transaction that could influence directors or executive officers, is more likely to involve "arranging." There may also be circumstances in which an

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issuer arranges a transaction but should not be viewed as "arranging" a "personal loan," particularly if the nature of the loan feature is incidental to the transaction (for example, an issuer could permissibly develop a broad-based employee benefit program involving incidental loans that are available on the same terms to all participants). [174]

The wording of § 402(a) suggests that only certain "extensions of credit" are subject to its prohibition and that they must meet two separate requirements. First, the transaction must take the form of a loan, and not merely be an extension of credit. [175] A transaction that involves an element of extension of credit but that is primarily intended to confer an immediate or deferred compensation benefit on the individual for services rendered (analogous to salary or bonus), and does not require repayment of fixed amounts, would presumably not be deemed a loan. Second, the loan must be a "personal loan." Presumably, if the primary purpose of the loan from the perspective of the issuer is to advance its business (other than merely through benefiting executive officers and directors of the issuer), it would not be deemed a "personal loan." Where an extension of credit is made in the ordinary course of business primarily for business purposes, but involves limited ancillary personal credit, it would also presumably not be considered to be a "personal loan." For example, business travel advances and use of company credit cards and company cars may involve limited ancillary personal use but presumably would not be subject to the § 402(a) prohibition because the arrangements are primarily for the benefit of the issuer, not the employee, and are not personal loans within the ordinary meaning of that term. [176]

Section 402(a) provides limited exceptions for extensions of credit for home improvement, manufactured housing, consumer credit, open-end credit, charge cards and margin loans by a broker or dealer registered under the Exchange Act to an employee of that broker or dealer (other than to acquire stock of the broker or dealer). [177] Extensions of credit pursuant to any of these exceptions must be (i) provided in the ordinary course of a consumer credit business, (ii) of a type generally made available by the issuer to the public and (iii) made

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on market terms that are no more favorable than those offered by the issuer to the general public. [178] These exceptions may not, however, be available to most issuers because, among other reasons, most issuers that are not financial institutions cannot meet the ordinary course of consumer credit business requirement.

Section 402(a) also exempts loans made by Federal Deposit Insurance Corporation (the "FDIC") insured banks subject to certain existing U.S. insider lending restrictions. The SEC extended this exemption to qualifying foreign banks and their affiliates under certain circumstances. [179] A foreign bank qualifies for the exemption if the laws or regulations of the foreign bank's home country require the bank to insure its deposits or be subject to a deposit guarantee or protection scheme or the Federal Reserve Board has determined that the foreign bank or another bank in its home jurisdiction is subject to comprehensive consolidated supervision by its home-country supervisor. [180] The exemption requires that the loans must (i) be on arm's-length, market terms, (ii) be made pursuant to a benefit or compensation program that is widely available to employees and does not give preference to executive officers or directors over other employees or (iii) have received the express approval of the bank supervisor in the foreign bank's home jurisdiction.

[2] Disgorgement of Incentive Compensation Following Restatements

Three different provisions of the federal securities laws provide for a mechanism colloquially referred to as a "clawback"—a requirement that issuer personnel return compensation to the issuer after a restatement of the issuer's financial statements. First, § 304 of the Sarbanes-Oxley Act requires the chief executive officer and chief financial officer of an issuer to reimburse it for all bonuses and other incentive-based or equity-based compensation received, as well as all profits realized from sales of issuer securities, in the 12-month period following the first public issuance or filing of reported financial statements that are later restated due to material noncompliance with any financial reporting requirement as a result of misconduct. [181]

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The term "misconduct" is not defined in the Sarbanes-Oxley Act, but it is generally understood not to be limited to personal misconduct of the chief executive officer or chief financial officer, and the SEC has brought a number of proceedings against chief executive officers and chief financial officers under § 304 when such officers were not personally charged with the underlying misconduct. [182] The phrase "profits realized" is also not defined, so it is unclear how the cost basis of securities sold during the 12-month period is to be determined, whether by means of a matching concept similar to § 16(b) of the Exchange Act or otherwise. [183] Similarly, the reference to compensation "received" during the 12-month period leaves unanswered questions regarding whether, in the case of option compensation for example, it is the grant of the compensation, its vesting or its payment that will control.

The Sarbanes-Oxley Act also does not specify the means of enforcement for § 304, which provides that the chief executive officer and chief financial officer of a company required to prepare an accounting restatement as a result of misconduct "shall reimburse" the issuer. However, the Ninth Circuit has provided some guidance by holding that there is no private right of action under § 304. Only the SEC is entitled to bring actions under the provision. [184] In addition, a company is not permitted to release or indemnify its chief executive officer or chief financial officer for disgorgement liability arising under § 304. [185]

The second "clawback" requirement is under § 10D of the Exchange Act (introduced by § 954 of the Dodd-Frank

Act), which directs the SEC to impose an analogous obligation in respect of all executive officers of all listed issuers. Rule 10D-1, implementing § 10D, has been proposed by the SEC but not adopted as of year-end 2016. [186] The proposed rule would require national security exchanges to adopt listing rules requiring all listed issuers to adopt, disclose and implement written policies to recover any incentive-based compensation from current and former executive officers that was received based on materially erroneous financial information. As proposed, Rule 10D-1 would apply to foreign private issuers.

The clawback under proposed Rule 10D-1 would be triggered by an accounting restatement and apply to incentive-based compensation received by

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an executive officer [187] during the three fiscal years preceding the date the accounting restatement is triggered. The clawback amount would be the pre-tax amount received by the current or former executive officer to the extent it exceeds what the executive would have received if compensation were determined based on the restated financial statements. Indemnification of executive officers by the issuer is prohibited with respect to clawback liabilities. [188] Under the proposed rule, issuers would have limited discretion to choose not to pursue a clawback claim, [189] although foreign private issuers would be permitted to forgo recovery as impracticable if the recovery would violate the home country's laws. [190] Further, the proposed rule would require disclosure of specified information regarding completed, ongoing and forgone recoveries, with executive officer names and specified amounts.

There are a number of important differences between these proposed listing rule and the obligation in § 304 of the Sarbanes-Oxley Act. First, the proposed rule would require the issuer to seek reimbursement, rather than requiring the issuer's officers to make reimbursement. Issuers, rather than just the SEC, would have the right (and obligation) to pursue their officers. Second, reimbursement would be sought from all current and former executive officers, rather than just the current chief executive officer and chief financial officer. Third, there would be no requirement of misconduct on the part of either the issuer or the individual in connection with the restatement. Fourth, the measure for recovery would be the amount of incentive-based compensation in excess of that which would have been paid to the executive officer based on the restated financial statements, rather than the entire amount of such compensation, plus proceeds of stock sales. Finally, the recovery period would be three years before the date the issuer becomes required to prepare restated accounts, rather than one year following the first public issuance or filing of the financial statements that were later restated.

The third clawback provision is § 956 of the Dodd-Frank Act, which charges appropriate federal regulators with jointly issuing rules regulating incentive-based compensation at certain covered financial institutions. [191] The rules must prohibit incentive-based compensation arrangements that encourage inappropriate risks by providing excessive compensation or that could lead to a material financial loss and must require financial institutions to disclose

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incentive-based compensation arrangements to the appropriate federal regulator. [192] The National Credit Union Administration, the Office of the Comptroller of the Currency, the FDIC, the Federal Housing Finance Agency, the Board of Governors of the Federal Reserve System and the SEC have each released versions of the proposed rule. The proposals apply to banks and a broad range of financial institutions with average total consolidated assets over $1 billion, with a tiered applicability for institutions with average total consolidated assets of between $50 billion and $250 billion (Level 2) and those with assets above $250 billion (Level 1). [193]

Among other things, the proposed rules would require incentive-based compensation payable to senior executive officers or "significant risk-takers" at a Level 1 or Level 2 institution to be subject to a seven-year clawback of between 40-60% of incentive compensation, depending on the employee title and the level of the institution, with a substantial portion of incentive-based compensation payable to be deferred. [194] Potential amounts of incentive-based compensation are limited to specific target measures. The rules would also require governance oversight, with boards of directors, or a committee delegated therefrom, to approve all incentive-based compensation payable to senior executive officers and charge the board with maintaining records documenting guidelines to approving and implementing incentive-based compensation-related decisions. [195]

[3] Lawyers' Professional Responsibility Rules

The Sarbanes-Oxley Act required the SEC to promulgate rules setting forth minimum standards of professional conduct for lawyers appearing and practicing before the SEC in the representation of an issuer. [196] Among other things, rules adopted by the SEC to implement § 307 of the Sarbanes-Oxley Act adopt so-called "up-the-ladder" reporting requirements and clarify, through the means

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of a safe harbor, the extent to which the conduct of foreign attorneys is regulated. [197]

The principal features of the SEC's up-the-ladder reporting procedures are:

- An attorney appearing and practicing before the SEC [198] in the representation of an issuer [199] owes his or her professional and ethical duties to the issuer as an organization, and not to the issuer's officers, directors or employees.
- Whenever an attorney appearing and practicing before the SEC in the representation of an issuer becomes aware of evidence of a material violation [200] of securities laws or breach of fiduciary duty, or a similar violation, by the issuer or by any officer, director, employee or agent of the issuer, the attorney must report the evidence to the issuer's chief legal officer ("CLO") or to both the CLO and the chief executive officer.
- Upon receiving such a report, the CLO must cause such inquiry into the reported matter as he or she reasonably believes is appropriate to determine if a material violation has occurred, is ongoing or is about to occur, and (i) if the CLO reasonably finds no material violation, or concludes after being advised by outside counsel (and consulting the audit committee) that the issuer has a colorable defense to the reported violation, then he or she must notify the reporting attorney of that conclusion and its basis or (ii) if, instead, the CLO concludes that a material violation has occurred, is ongoing, or is

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  about to occur, he or she must take reasonable steps to ensure the issuer adopts remedial measures, including sanctions if appropriate.
- A reporting attorney who receives what he or she reasonably believes to be an appropriate and timely response from the CLO has no further obligation. If the reporting attorney does not receive an appropriate and timely response from the CLO, or if the attorney believes that it would be futile to report to the CLO or chief executive officer because either or both may be implicated in the misconduct, the attorney must report the evidence to either the audit committee of the issuer's board of directors or to another board committee consisting solely of independent directors. If the issuer has neither an audit committee nor such an independent committee, the attorney must, in the absence of an appropriate response from the issuer's CLO, report the evidence to the full board of directors. The CLO must inform the reporting attorney of any course of action taken in response to the attorney's report.
- A reporting attorney who receives what he or she reasonably believes to be an appropriate response from the audit committee, independent committee of the board of directors or the board itself has no further reporting obligation. If the reporting attorney does not reasonably believe the issuer has made an appropriate response within a reasonable time, the attorney must inform the CLO, the chief executive officer and directors to whom the attorney originally reported that belief and the reasons behind it. [201]
- An attorney may avail himself or herself of an alternative reporting procedure under which an attorney may report evidence of a material violation to a qualified legal compliance committee ("QLCC") established by the issuer, rather than to the issuer's CLO (the CLO may also refer reports to the QLCC),

if the issuer has elected to establish a QLCC, thereby satisfying his or her obligations (with no requirement to assess the appropriateness of the issuer's response to the reported evidence).

- (i) An attorney retained to investigate reported evidence of a material violation must inform the CLO of the results of the investigation, (ii) unless the investigating attorney and the CLO each reasonably believes that no material violation has occurred, is ongoing or is about to occur, the CLO must notify the issuer's board of directors, an independent board committee, or the QLCC

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of the results of the investigation, (iii) if the CLO does not do so, the investigating attorney must report up-the-ladder and (iv) the investigating attorney has no duty to make such a report if such attorney was retained or is directed by the CLO to assert, consistent with his or her professional obligations, a colorable defense on behalf of the issuer in any investigation or proceeding arising from the alleged misconduct, in which case the CLO must nevertheless keep the board informed as to the progress and outcome of the investigation or proceeding. [202]

In response to widespread concerns raised by non-U.S. attorneys over the reach of § 307, the SEC created a safe harbor from the reporting requirements for a "non-appearing foreign attorney." To qualify as a "non-appearing foreign attorney," an attorney:

- must be admitted to practice in a foreign jurisdiction;
- cannot hold himself or herself out as practicing, or give legal advice regarding, U.S. federal or state securities or other laws; [203] and
- must conduct activities that would constitute appearing and practicing before the SEC only (i) incidentally to, and in the ordinary course of, his or her foreign law practice or (ii) in consultation with U.S. counsel.

Attorneys who satisfy the above conditions are exempt from the reporting requirements set forth in the rules. [204] Although the rules do not exempt all foreign attorneys, the scope of the work customarily performed by most foreign attorneys should allow them to qualify for the exemption. In addition, attorneys practicing outside the United States are not required to comply with the requirements set forth in the rules to the extent that such compliance is prohibited by applicable foreign law. [205]

[4] Conflicts Between Whistleblower Procedures and Foreign Law

The requirement that the audit committee maintain whistleblower procedures—a channel for confidential, anonymous submissions by employees

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of concerns regarding questionable accounting or auditing matters [206]—may raise concerns under privacy, personal data and labor laws in other jurisdictions, particularly the European Union ("EU"). Similar concerns could arise with respect to the protections and financial incentives for whistleblowers introduced pursuant to the Sarbanes-Oxley Act and the Dodd-Frank Act. [207]

In particular, whistleblower procedures implemented by EU affiliates of U.S.-listed companies must comply with the requirements set out by the national personal data protection laws of the EU member states transposing Directive 95/46 [208] (the "Data Protection Directive"). An advisory body established under the Data Protection Directive, called the Article 29 Data Protection Working Party, adopted an opinion (the "Article 29 Opinion") providing guidance on the application of the EU's data protection laws to whistleblowing programs in the areas of accounting, internal controls, auditing matters, antibribery, banking and financial crimes. The Article 29 Opinion emphasizes, among other matters, the provision of clear and complete information about the whistleblowing programs, the rights of incriminated persons and security of data processing operations.

Although the Article 29 Opinion is not binding on the courts or data protection authorities of the EU member states, it has played an important role in the interpretation and application of national personal data protection laws by the data protection authorities and jurisdictions in the various EU member states. As an illustration, the Article 29 Opinion is substantially similar to the "unified authorization" adopted by the French *Commission Nationale de l'Informatique et des Libertés*, the authority responsible for administering the French personal data protection law ("CNIL"), [209] under which the CNIL will deem authorized certain whistleblower procedures required to be implemented pursuant to the Sarbanes-Oxley Act establishing internal control procedures in the areas of finance, accounting, banking and anti-corruption matters, provided that they meet certain criteria for the protection of personal data.

The SEC staff raised several concerns as the Article 29 Opinion relates to whistleblower requirements under the Sarbanes-Oxley Act, which include (i) local handling of reports, (ii) discouragement of anonymous reporting,

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(iii) possible limitation in the scope of employees covered and (iv) time limits for data retention. [210]

[5] Code of Ethics

Item 16B of Form 20-F requires a registrant to disclose in an annual report on Form 20-F whether it has adopted a code of ethics that applies to the principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions. If it has not adopted such a code of ethics, it must explain why it has not. [211] If a registrant has a broad code of ethics that applies widely, the requirements of Item 16B apply only to the portions of the document that apply to the senior officers described. [212]

If the registrant has a code of ethics, it must either file the code as an exhibit to the annual report on Form 20-F, post the text of the code on its website [213] and disclose in the annual report on Form 20-F that it has been so posted, or undertake in the annual report on Form 20-F that it will provide the code to any person who requests a copy and explain how to obtain it.

The term code of ethics is defined as written standards reasonably designed to deter wrongdoing and promote:

- Honest and ethical conduct, including ethical handling of actual or apparent conflicts of interests between personal and professional relationships.
- Full, fair, accurate, timely and understandable disclosure in SEC-filed or submitted reports and documents, as well as other public communications.
- Compliance with applicable governmental laws, rules and regulations.
- Prompt internal reporting of code violations to the persons identified in the code or other appropriate persons.
- Accountability for adherence to the code.

A registrant is required to disclose in its annual report on Form 20-F if during the fiscal year it has granted a waiver, explicit or implicit, from the code of ethics to one of the specified persons to whom it applies. The registrant must

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disclose the name of the waiver grantee and the nature of the waiver. [214] It must also disclose any amendment in the annual report. [215] There is an exception for a registrant that discloses the waiver or amendment on its website within five business days following the event, if the website address where the information can be found appears in its most recent annual report on Form 20-F and the information remains on its website for at least 12 months. The registrant must also retain the information for at least five years. [216]

[6] Shareholder Approval of Stock Issuances

The NYSE and Nasdaq each has a policy requiring a listed company to obtain shareholder approval for any issue of common stock (with exceptions including public offerings or certain private offerings for cash) equal to 20% or more of its voting power outstanding prior to such issue. [217] The NYSE has historically not applied this policy to foreign private issuers. Nasdaq permits companies to follow home country practice so long as companies meet certain disclosure and opinion requirements. [218]

[7] Trading Windows

Many listed issuers adopt policies restricting directors, officers and often other employees from trading in the issuer's securities during specified periods when there is a heightened risk that the company, or the individuals subject to the policy, have access to material non-public information about the company. These restricted periods are often referred to as "blackout periods," and they usually begin around the end of each fiscal quarter and end several days after results for the period are announced. The converse period, when trading is permitted, is often referred to as a an "open window" or "window period." These policies are not required by law, but trading by such persons on the basis of material non-public information may violate the law. The policies are a common prophylactic that serves to protect individuals from the risk of insider trading, to support disciplinary action if insider trading occurs, to protect the issuer's general counsel or others from having to make case-by-case judgments on the permissibility of

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trading, and to protect the issuer from controlling person liability in the event of insider trading. [219]

[8] Disclosure of Corporate Governance Differences

A U.S. exchange-listed foreign private issuer is required to provide, in its annual report on Form 20-F, a concise summary of significant ways in which its corporate governance practices differ from those followed by U.S. companies under the exchange's listing standards. [220] The instructions specify that this disclosure is intended to be a brief and general discussion, as opposed to a detailed item-by-item analysis. In practice, companies typically disclose this information in a table illustrating the differences.

Practices of reporting foreign private issuers in meeting this requirement vary. Some use a tabular presentation that tracks the requirements of the applicable listing rules and sets forth the issuer's corresponding practices, which are typically based on the legal or listing requirements of its home jurisdiction. Others present a more synthetic discussion of the U.S. requirements and refer to the issuer's own, more complete description of its corporate governance practices appearing elsewhere in its annual report. The principal areas of focus in these disclosures would typically include: [221] the requirement that the majority of the board consist of independent directors, except for the board of a "controlled company" as defined in the exchange rules (generally, where more than 50% of the voting power is held by an individual, group or other company); different independence standards for directors; the requirement that the board meet periodically in "executive session," i.e., without management representatives; the requirement for majority-independent nominating and governance committees, except at a controlled company; the requirement for a fully independent compensation committee, except at a controlled company; the requirement to hold a shareholder vote on equity compensation plans; and the requirements to disclose corporate governance guidelines and a code of business conducts and ethics.

[9] Exchange Certification and Affirmation Requirements

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As noted *supra* in § 5.01, both NYSE and Nasdaq exempt foreign private issuers from most of their corporate governance-related rules. [222] However, each of them requires certain certifications, affirmations or disclosures.

A NYSE-listed foreign private issuer is subject to two certification requirements under exchange rules. First, the chief executive officer must promptly notify the NYSE in writing if he or she becomes aware of any non-compliance with any applicable corporate governance rule of the NYSE. [223] Second, the issuer must submit an executed written affirmation annually and an interim written affirmation under specified circumstances. [224] The contents of each affirmation, and the circumstances under which an interim affirmation is required, are set forth in forms published on the NYSE website. The annual affirmation must describe the issuer's compliance with the audit committee requirements of Rule 10A-3 and its disclosure of significant differences between its corporate governance practices and those required of listed domestic issuers. The interim affirmation is required within five business days if:

- An audit committee member who was deemed independent is no longer independent;
- A new member is added to the audit committee;
- The company or a member of the audit committee is no longer eligible to rely on or choosing to no longer rely on a previously applicable exemption from Rule 10A-3 on audit committees;
- A member has been removed from the audit committee resulting in the issuer no longer having a Rule 10A-3 compliant audit committee; or
- The company determines it no longer qualifies as a foreign private issuer. [225]

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A Nasdaq-listed foreign private issuer is required to provide Nasdaq with prompt notification after an executive officer becomes aware of any noncompliance with the requirements of any corporate governance requirements under Nasdaq's listing rules. [226] A Nasdaq-listed foreign private issuer is also subject to the rule providing that voting rights cannot be disparately reduced or restricted through any corporate action or issuance. [227]

Footnotes

168 § 13(k)(1) of the Exchange Act. Investment companies registered under § 8 of the Investment Company Act are exempt from § 402(a).

169 "Issuer" is defined for this purpose to include any issuer that has filed a registration statement that it has not withdrawn, even if the registration statement has not yet become effective, so an issuer going public must address any outstanding loans earlier in the registration process than might otherwise be expected.

170 *See*, *e.g.*, *In the Matter of Goodfellow*, SEC Admin. Proc. File No. 3-12117 (Dec. 1, 2005). In *Goodfellow*, the SEC alleged that the chief executive officer and the chief financial officer of a foreign private issuer (later acquired by a U.S. issuer) authorized interest-free loans to themselves from the issuer and imposed a cease-and-desist order. In response to the officers' claim that the loans were mere "advances," the SEC noted that § 402(a) does not distinguish between loans and advances. *But see infra* Note 176 regarding indemnification advances.

171 This prohibition became effective immediately upon the passage of the Sarbanes-Oxley Act, but it grandfathered loans outstanding at that time, so long as no material modification to any term or renewal of those loans occurs. The prohibition on "maintaining" loans means that any extension of credit must be extinguished before a foreign company becomes a U.S. reporting issuer, for example by conducting a U.S. public offering.

172 While these words are the same as those used in §§ 7 and 11(d) of the Exchange Act, the policies behind §§ 7 and 11(d) are fundamentally different from the policy underlying § 402(a). Accordingly, many practitioners believe that § 402(a) does not necessarily require the same reading of the concepts of "extension of credit" and "arrange". *See* outline authored by a group of 25 leading law firms, including ours, *Sarbanes-Oxley Act Interpretive Issues Under § 402—Prohibition of Certain Insider Loans* (Oct. 15, 2002) (the "§ 402 Outline").

173 *See RingsEnd Partners, LLC/EBIC Program* (avail. Mar. 4, 2013). While the no-action letter addresses a specific compensatory program, it does provide examples of "ministerial or administrative activities" in which an issuer may engage without running afoul § 402(a).

174 *See generally* § 402 Outline.

175 As a result, the fact that a transaction may, for example, be deemed for other purposes under the Exchange Act (including under the margin regulation provisions of § 7 and prohibitions on extensions of credit for new issues contained in § 11(d)) to involve an extension of credit is not sufficient to trigger the § 402(a) prohibition.

176 *See generally* § 402 Outline. In 2006, the Southern District of New York addressed directly the issue of indemnification advances, declaring that "[t]he Court need not for present purposes define "personal loan," but an advance of defense costs pursuant to state law and corporate by-laws is not within that term. The Sarbanes-Oxley Act does not prohibit such advances." *Envirokare Tech, Inc. v. Pappas*, 420 F. Supp. 2d 291, 294 (S.D.N.Y. 2006).

177 Read literally, however, the exception does not apply to margin loans to employees of the parent of the broker or dealer.

178 § 402(a) of the Sarbanes-Oxley Act.

179 Rule 13k-1 under the Exchange Act.

180 *See*, *e.g.*, the Federal Reserve Board Order *HSH Nordbank AG, Hamburg/Kiel, Germany*, 89 Fed. Res. Bull. 344.

181 The SEC has relied on the equitable relief provisions of § 305(b) of the Sarbanes-Oxley Act to extend this disgorgement power to include all compensation received after allegedly fraudulent conduct has occurred. For examples of cases in which the SEC has sought disgorgement of profits resulting from misconduct, *see*, *e.g.*, *SEC v. Gupta*, SEC Litigation Release No. 21451 (Mar. 15, 2010) and *SEC v. Mercury Interactive, LLC*, SEC Litigation Release No. 20964 (Mar. 20, 2009).

182 *See SEC v. Moore*, SEC Litigation Release No. 22241 (Jan. 30, 2012); *SEC v. O'Leary*, SEC Litigation Release No. 22074 (Aug. 30, 2011); *SEC v. Jenkins*, SEC Litigation Release No. 21149A (July 23, 2009). The Ninth Circuit has also held that § 304 "allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers." *SEC v. Jensen*, 835 F.3d 1100, 1114-1115 (9th Cir. 2016).

183 Under the short swing profit rules of § 16(b), multiple purchases and sales may be matched to create profit even where no net economic gain is realized. *See* § 6.04[2][b].

184 *In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223 (9th Cir. 2008).

185 *See Cohen v. Viray*, 622 F.3d 188 (2d Cir. 2010). The rationale for this position was that such agreements frustrate the SEC's power to pursue the public's interests in § 304 enforcement actions.

186 SEC Release No. 33-9861 (July 1, 2015).

187 Section 10D of the Exchange Act does not define executive officers, but the proposed rule applies to officers subject to §16 of the Exchange Act.

188 SEC Proposed Rule 10D-1(b)(1)(iv) of the Exchange Act. The proposal would not preclude executives from purchasing insurance. SEC Release No. 33-9861 (July 1, 2015).

189 Non-pursuit of claims would be permissible only if it were impracticable because it would impose undue costs to the issuer or its shareholders. *See* SEC Release No. 33-9861 (July 1, 2015).

190 SEC Release No. 33-9861 (July 1, 2015).

191 § 956 of the Dodd-Frank Act.

192 § 956 of the Dodd-Frank Act.

193 76 Fed. Reg. 21170 (Apr. 14, 2011).

194 76 Fed. Reg. 21170 (Apr. 14, 2011). Awards that vest solely on the basis of continued employment are not considered incentive-based compensation.

195 76 Fed. Reg. 21170 (Apr. 14, 2011).

196 § 307 of the Sarbanes-Oxley Act; *cf.* Letter from Giovanni P. Prezioso, General Counsel, SEC, to J.

Richard Manning, President, Washington State Bar Association, and David W. Savage, President-Elect, Washington State Bar Association (July 23, 2003) (citing federal case law, in response to a proposed ethics opinion of the Washington State Bar Association counseling lawyers against making disclosure permitted by the SEC's rules implementing § 307 of the Sarbanes-Oxley Act, for the proposition that rules adopted by the SEC, as a federal agency, would preempt any conflicting state rules governing attorney professional conduct).

197 17 C.F.R. § 205.1–205.7.

198 "Appearing and practicing" before the SEC consists of (i) transacting any business with the SEC, including communications in any form, (ii) representing an issuer in a SEC administrative proceeding or in connection with any SEC investigation, inquiry, information request or subpoena, (iii) providing advice in respect of the U.S. securities laws or SEC rules or regulations regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC (this includes providing such advice in the context of preparing, or participating in the preparation of, any such document), or (iv) advising an issuer as to whether information or a statement, opinion or other writing is required to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the SEC. 17 C.F.R. § 205.2(a).

199 "Representation of an issuer" is defined as "providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer." 17 C.F.R. § 205.2(g). Counsel to underwriters would not be covered by the reporting requirements because such counsel do not provide legal services to the issuer. *See* SEC Release No. 33-8185 (Jan. 29, 2003).

200 "Evidence of a material violation" is credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur. 17 C.F.R. § 205.2(e). This standard, while objective, takes into account the fact that there may be a range of views an attorney could hold without being unreasonable.

201 In 2003, the SEC proposed for comment two alternative provisions that would have extended the obligations of a reporting attorney. These came to be referred to as "noisy withdrawal" (where an attorney is obligated under specified circumstances to resign and notify the SEC of having done so) and "reporting out" (where an attorney is obligated to resign and the issuer must notify the SEC). This proposal was never withdrawn or acted upon. *See* SEC Release No. 33-8186 (Jan. 29, 2003) (solicitation of public comments).

202 17 C.F.R. § 205.1–205.7

203 One example of conduct that might constitute holding oneself out as practicing U.S. federal or state securities laws might be distributing business cards highlighting one's admission to a U.S. state bar.

204 Although a CLO who qualifies as a non-appearing foreign attorney is exempt from the reporting requirements under § 307 of the Sarbanes-Oxley Act, he or she is required to conduct an investigation upon receiving a report of a violation from a reporting attorney.

205 17 C.F.R. § 205.6(d).

206 § 5.0[2][a].

207 § 11.07[1][c].

208 Directive 95/46/EC of the European Parliament and of the Council of October 24, 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data. As from May 25, 2018, this Directive will be replaced by Regulation (EU) 2016/679 of the European Parliament and of the Council of April 27, 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (the "General Data Protection Regulation").

209 CNIL unified authorization n° AU-004 adopted December 8, 2005, as amended on October 4, 2010.

210 *See* Letter from Ethiopis Tafara, SEC Director, Office of International Affairs, to Peter Schaar, Chairman of Article 29 Data Protection Working Party (June 8, 2006).

211 Item 16B of Form 20-F.

212 Instruction 2 to Item 16B of Form 20-F.

213 The code of ethics must remain accessible on the website for as long as the registrant chooses to disclose its code of ethics via its website and is obligated to file an annual report on Form 20-F. Instructions to Item 16B of Form 20-F.

214 Item 16B(e) of Form 20-F.

215 Item 16B(d) of Form 20-F.

216 Instruction 4 to Item 16B of Form 40-F.

217 NYSE LISTED COMPANY MANUAL 312A.03(c); NASDAQ LISTING RULES 5635(d).

218 NASDAQ LISTING RULES 5615(a)(3), 5615(b).

219 Section 306(a) of the Sarbanes-Oxley Act and Regulation BTR (Blackout Trading Restrictions) also restrict trading in issuer securities by directors and executive officers during a pension plan blackout period. *See* § 6.06[3].

220 Item 16G of Form 20-F. Both NYSE and Nasdaq also require this disclosure. NYSE LISTED COMPANY MANUAL 303A.11; NASDAQ LISTING RULES 5615(a)(3)(B). In addition, Nasdaq requires a foreign private issuer conducting an IPO to disclose in its registration statement and on its website each requirement it does not follow and describe home country practice. NASDAQ LISTING RULES 5615(a)(3)(B)(ii).

221 This description uses NYSE listing requirements by way of illustration; Nasdaq listing requirements differ in their details but cover essentially the same matters. *See supra* Note 6.

222 NYSE LISTED COMPANY MANUAL 303A.00 (exemption from most NYSE governance rules for foreign private issuers following home country practice); NASDAQ LISTING RULES 5615(a)(3) (exemption from most Nasdaq governance rules for foreign private issuers following home country practice) and 5615-3 (requiring a foreign private issuer to provide an opinion of counsel concerning home country practice). Both exchanges have rules requiring notice to the exchange under specified circumstances, which may include circumstances relating to governance. *E.g.*, NYSE LISTED COMPANY MANUAL 204.10 (requiring notice to the exchange of any change in officers or directors).

223 NYSE LISTED COMPANY MANUAL 303A.12(b).

224 NYSE LISTED COMPANY MANUAL 303A.12(c).

225 NYSE, Instructions for Submission of Foreign Private Issuer § 303A Written Affirmations.

226 NASDAQ LISTING RULES 5625.

227 NASDAQ LISTING RULES 5640.

U.S. Regulation of the International Securities and Derivatives Markets, § 6.01, 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 § 6.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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This chapter discusses considerations relevant to directors, officers and major shareholders of public companies in the United States, with a focus principally on foreign private issuers. [1]

Section 6.02 discusses corporate governance requirements applicable to the directors and officers of a foreign private issuer that has registered its equity securities under the Exchange Act.

Section 6.03 discusses disclosure required in an issuer's filings regarding directors, officers and significant shareholders.

Section 6.04 discusses certain U.S. reporting requirements under the Exchange Act, including for:

- shareholders beneficially owning more than 5% of a class of voting equity securities registered pursuant to § 12 of the Exchange Act, §§ 13(d) and 13(g), which are intended to keep investors aware of significant accumulations of shares that may lead to a change in control of an issuer; [2] and
- directors and officers of a U.S. issuer (but not a foreign private issuer) with equity securities registered pursuant to § 12 of the Exchange Act, and for shareholders beneficially owning more than 10% of a class of voting equity issued by such an issuer, § 16(a), which generally requires these "insiders" to report equity trading activity to facilitate enforcement of § 16(b)'s "short-swing" profit recovery provision.

Section 6.05 discusses potential liabilities under the federal securities laws for material misstatements or omissions in disclosure, as well as for insider trading.

Section 6.06 discusses resales by directors, officers and significant shareholders, including "affiliates," of an issuer.

Footnotes

1 *See* § 3.01, Note 1 for a discussion of the definition of "foreign private issuer."

2 The 13(d) shareholder reporting requirements for significant accumulations of shares were added to the Exchange Act by the Williams Act of 1968. Williams Act of 1968, Pub. L. No. 90-439, 82 Stat. 454 (1968).

U.S. Regulation of the International Securities and Derivatives Markets, § 6.02, REQUIREMENTS AFFECTING DIRECTORS AND OFFICERS RELATING TO CORPORATE GOVERNANCE

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 § 6.02 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The U.S. securities laws impose corporate governance requirements on the directors and officers of a foreign private issuer that has registered its equity

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securities under the Exchange Act. These requirements, which are discussed in detail elsewhere in this book, [3] include:

- Rule 13b2-2 under the Exchange Act, as amended by the SEC to implement § 303 of the Sarbanes-Oxley Act, which prohibits the directors and officers of an issuer, and any person acting at their direction, from taking any direct or indirect action to coerce, manipulate, mislead or fraudulently influence any independent public or certified public accountant in an audit or review of the issuer's financial statements required to be filed with the SEC, if such person knew or should have known (a negligence standard) that such action could, if successful, result in rendering the financial statements materially misleading (*see* § 5.03[5]);
- Rules 13a-15(f) and 15d-15(f) under the Exchange Act, relating to internal control over financial reporting, which is a process designed by, or under the supervision of, an issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (*see* § 5.04[2]);
- §§ 302 and 906 of the Sarbanes-Oxley Act, which require an issuer's principal executive officer(s) and principal financial officer(s), or persons performing similar functions, to make certain certifications in the issuer's annual report (*see* § 5.04[4]);
- § 402(a) of the Sarbanes-Oxley Act, which prohibits an issuer and its subsidiaries from directly or indirectly extending, maintaining, renewing or arranging for an extension of credit in the form of a personal loan to or for any executive officer or director of the issuer (*see* § 5.05[1]);
- § 304 of the Sarbanes-Oxley Act, which requires the chief executive officer and chief financial officer of an issuer to reimburse it for all bonuses and other incentive-based or equity-based compensation received, as well as all profits realized from sales of issuer securities, in the 12-month period following the first public issuance or filing of reported financial statements that are later restated due to material noncompliance with any financial reporting requirement as a result of misconduct (*see* § 5.05[2]); and
- § 21C of the Exchange Act and § 8A of the Securities Act, as amended by § 1105 of the Sarbanes-Oxley Act, which authorize the SEC, in connection

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with a cease-and-desist proceeding, to issue an order barring any person who has violated § 10(b) of the Exchange Act or § 17(a)(1) of the Securities Act, as applicable, from acting as a director or officer of any issuer "if the conduct of that person demonstrates unfitness to serve as an officer or director" (*see* § 5.05[3]).

Footnotes

3 *See* Chapter 5.

U.S. Regulation of the International Securities and Derivatives Markets, § 6.03, DISCLOSURE IN ISSUER'S FILINGS OF INFORMATION REGARDING DIRECTORS, OFFICERS AND SIGNIFICANT SHAREHOLDERS

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 § 6.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Disclosure in Issuer's Filings of Information Regarding Directors and Officers

A foreign private issuer that is subject to the reporting requirements of the Exchange Act is required to make disclosures relating to the share ownership of its directors and officers and certain compensation matters, including:

- information as to share ownership in the issuer (including ownership of options over shares in the issuer) by the directors and members of its administrative, supervisory or management bodies (*see* § 4.07[9]);
- information concerning the compensation of directors and officers (*see* § 4.07[9]); and
- information regarding related party transactions (*see* § 4.07[10]).

[2] Disclosure in Issuer's Filings of Shareholders That Beneficially Own 5% or More of the Issuer's Shares or Control the Issuer

An issuer registering a public offering under the Securities Act [4] or registering or filing an annual report under the Exchange Act [5] (for example, in connection with a U.S. exchange listing) is required to name each owner known to it of 5% or more of its voting securities [6] and persons controlling the issuer, together with certain other information related to control. [7]

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Rule 12b-2 under the Exchange Act defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise." [8]

As this definition suggests, the determination of whether "control" of one person or company by another exists is essentially factual in nature, rather than legal. The analysis looks to the dynamics and functional realities of each situation, rather than to formal legal structures or arrangements. It is clear that majority share ownership is not required for control. There are cases where, for one purpose or another, control has been found to exist at relatively low share ownership levels, although generally not below 10%. [9]

Share ownership is not the only consideration in determining whether control exists. Other relevant factors, which might militate for or against a finding of control, include:

- whether the shareholder is, or has the right to be, represented on the issuer's board of directors as well as any key committees of the issuer's board;
- whether any officers of the issuer are designees of the shareholder or have been selected by, or with the concurrence of, the shareholder, and, if so, which officers;
- whether any major policy decisions by the issuer are, as a practical matter, ever precleared by or discussed in advance with the shareholder;

- the nature and volume of any ongoing business and contractual relationships between the shareholder and the issuer;
- whether there are regulatory restrictions on the shareholder's ability to exercise control;
- whether the shareholder could be found to control, or have an ability to influence, the day-to-day activities of the issuer;
- the background of, reasons for and method by which the shareholder obtained its share ownership in the issuer;

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- whether there are other shareholders with a comparable ownership position and, if so, the nature of the relationship among such shareholders; and
- corporate structure, for example, whether there are one or more boards that manage the company, as in Germany.

Footnotes

4 *See* Chapter 3, particularly § 3.02.

5 *See* §§ 3.03[1] and 4.02.

6 *By contrast*, § 13(d) of the Exchange Act applies to beneficial owners of more than 5% of the class.

7 Form 20-F, Item 7. In 1999, the SEC replaced almost all the existing Form 20-F requirements with international disclosure standards adopted by IOSCO in 1998. *See* SEC Release No. 33-7745 (Sept. 28, 1999). The SEC reduced the threshold for disclosure of beneficial ownership from 10% to 5% of each class of the registrant's voting stock and now requires disclosure of significant changes in beneficial ownership by such shareholders over the last three years.

8 Rule 12b-2 under the Exchange Act.

9 *Cf*. Rule 10A-3(e)(1) under the Exchange Act (providing that those persons who are not executive officers or shareholders beneficially owning more than 10% of a class of voting equity securities of an issuer are deemed not to control such entity for purposes of rules implementing § 301 of the Sarbanes-Oxley Act; this safe harbor does not create a presumption that persons outside the safe harbor control an entity, or are affiliates, for which a facts-and-circumstances analysis is appropriate). *See* § 5.02[1][b].

U.S. Regulation of the International Securities and Derivatives Markets, § 6.04, REPORTING AND OTHER REQUIREMENTS APPLICABLE TO SIGNIFICANT BENEFICIAL OWNERS OF SHARES

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 § 6.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

[1] Section 13 Reporting Requirements

[a] Scope

Sections 13(d) and 13(g) of the Exchange Act are intended to provide the investing public (and issuers) with information about beneficial ownership of significant blocks of voting securities. [10] Under these provisions, persons who are directly or indirectly beneficial owners of more than 5% of any class of voting equity securities registered under § 12 of the Exchange Act are required to file reports with the SEC. [11] A person is the beneficial owner of a security if he or she has or shares the power to vote or the power to sell the security, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise. [12] Furthermore, a person is deemed the beneficial owner of any shares that he or she has the right to acquire (such as pursuant to the exercise of an option

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or a conversion right) if the right is exercisable within 60 days or was acquired with the purpose or effect of changing or influencing control of the issuer. [13] Accordingly, more than one person can be deemed to beneficially own the same shares.

The beneficial ownership reporting requirements of § 13 of the Exchange Act apply to both U.S. and foreign entities that hold Exchange Act-registered voting equity securities regardless of (i) the issuer's home country, (ii) whether the securities were purchased outside the United States, (iii) whether U.S. jurisdictional means were used in connection with the purchase and (iv) any position reporting obligations that may be incurred in other jurisdictions. For example, a German person or entity that acquires in France more than 5% of the outstanding stock of a French company whose shares are registered under § 12 of the Exchange Act must file, whether or not reporting is also required under French law. In this regard, the U.S. beneficial ownership reporting system is similar to the position reporting systems adopted by many other jurisdictions. [14]

[b] Qualification for Schedule 13G

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Regulation 13D-G under the Exchange Act generally requires each person (or group of persons acting together) [15] acquiring any voting "equity securities" registered under the Exchange Act as a result of which such person or group beneficially owns [16] more than 5% of such securities to file with the SEC, within ten days after the 5% threshold is crossed, a report on Schedule 13D. [17] However, under certain circumstances, investors that have acquired the securities without the purpose or effect of changing or influencing control of the issuer [18] may qualify to file a short-form report on Schedule 13G instead of a Schedule 13D. Utilization of Schedule 13G is available for such passive investments only if such investor (i) has acquired the securities in the ordinary course of its business and is (A) one of the types of entities enumerated in Rule 13d-1(b) under the Exchange Act, which include U.S. banks as defined in § 3(a)(6) of the Exchange Act, registered investment companies and other specified types of U.S. institutional investors, or (B) is a foreign institution that is functionally equivalent to

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one of the specified types of U.S. institutional investors and is subject to a substantially comparable regulatory scheme [19] ((A) and (B) together, a "qualified institutional investor"), or (ii) beneficially owns less than 20% of the outstanding voting equity securities (a "nonqualified passive investor"). [20]

Qualified institutional investors generally need not file their Schedule 13G until 45 days after the end of the calendar year in which the acquisition occurred, and only if they remain above the 5% threshold at the end of the calendar year. [21] Nonqualified passive investors must file their Schedule 13G within the same period as a Schedule 13D would be due, *i.e.*, within ten calendar days of crossing the 5% threshold. [22]

Section 13(d) requires a person to make a filing only if it *acquires* more than 5% of a class of voting equity securities that is already *registered* under the

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Exchange Act. Thus, a person already owning more than 5% of a company at the time the shares are initially registered under the Exchange Act is "grandfathered" and is not required to file a Schedule 13D unless and until such person acquires beneficial ownership of an additional 2% of the outstanding stock in any 12-month period. [23] Any such person beneficially owning more than 5% of a registered class of securities as of the end of a calendar year is, however, required to file a Schedule 13G within 45 days of the end of that year. This right to file a Schedule 13G instead of a Schedule 13D does not require the investor to be passive.

[c] Groups

When two or more persons agree to act together "for the purpose of acquiring, holding, voting or disposing of equity securities," a group will be considered to have been formed and will be considered to own beneficially all the equity securities owned by each member. [24] The touchstone of a group within the meaning of § 13(d) "is that the members combined in furtherance of a common objective." [25] The agreement to act together does not need to be in writing, and the SEC or a court may infer an agreement exists by reason of parallel action, an inquiry that is highly fact-specific. [26] Financial institutions and their subsidiaries

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and affiliates are usually thought to be a group for purposes of filing because of common control. Thus, the holdings of all these entities must be monitored. [27]

[d] Schedule 13D Disclosure Requirements and Amendments

Regulation 13D-G under the Exchange Act generally requires each person (or group of persons acting together) acquiring any voting equity securities registered under the Exchange Act as a result of which such person or group beneficially owns more than 5% of such securities to file with the SEC, within ten days after the 5% threshold is crossed, a report on Schedule 13D. [28] (An acquiror may continue to purchase target securities after the 5% threshold is crossed and

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thus hold significantly in excess of 5% of the target securities by the time it files its report on Schedule 13D.)

Schedule 13D requires, among other things, disclosure of:

- the identity of the acquiror (or each member of the group), including its management, directors and controlling entities;
- the source and amount of funds used to acquire the securities; [29]
- the purpose of the acquisition, including any plans or proposals the acquiror may have for future

purchases or sales of target stock or for any changes in the target management or board of directors or any major corporate transaction affecting control of the target, such as a tender offer or business combination;

- the amount and percentage of target securities held by the acquiror and details about transactions in such securities during the 60 days prior to filing of the Schedule 13D (or, if shorter, for the period since the most recent Schedule 13D filing); and
- the nature of any arrangements to which the acquiror is a party relating to the target's securities.

Documents relating to, among other matters, the financing of the acquisition, any contemplated extraordinary transaction involving the issuer and the transfer or voting of the securities must be filed as exhibits to the Schedule 13D. In practice, the filing prepared in response to these requirements is usually quite long and complex and must be put together carefully. If the issuer of the securities is or becomes the target of a hostile bid by the person filing the Schedule 13D or otherwise, litigation may be instituted by the issuer, another shareholder (in some circumstances) or the SEC challenging the accuracy of the filing, especially the accuracy of statements describing the acquiror's purpose and plans. [30] As a consequence, persons or entities obligated to file often try to preserve as

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much flexibility as possible by describing a wide variety of options. [31] A report on Schedule 13D must be amended "promptly" (which can mean almost "immediately" in some circumstances) in the event of a material change in the information disclosed in the schedule, including a change in or, in the view of the SEC, the selection of one particular purpose from, the previously disclosed options. [32] Any acquisition or disposition of 1% or more of the relevant class of securities is deemed material for this purpose, while a lesser change in percentage holding, or a change in holdings that does not occur as a result of an

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acquisition or disposition (*e.g.*, as a result of issuances or repurchases of shares by the issuer), [33] may be material, depending upon the circumstances. [34]

[e] Schedule 13G Disclosure Requirements and Amendments

Schedule 13G requires much more limited information than Schedule 13D. The principal disclosures required by Schedule 13G include:

- the identity of the holder;
- the basis for its eligibility to use Schedule 13G;
- the amount and percentage of target securities that it holds; and
- the identity of the persons on whose behalf it owns the securities or who compose an acquiring group.

A Schedule 13G filer must amend its Schedule 13G filing within 45 days of the end of each calendar year to reflect any changes, as of that year end, in the information filed in its previous report on Schedule 13G. [35]

In addition, an amendment to a qualified institutional investor's report on Schedule 13G must also be filed within ten days after the end of the first month in which the qualified institutional investor's direct or indirect beneficial ownership interest exceeds 10% of the class of outstanding shares, and thereafter within ten days after the end of any month in which such person's interest, computed at the end of the month, increases or decreases by more than 5% of that class. [36]

In contrast, an amendment to a nonqualified passive investor's report on Schedule 13G must be filed "promptly" if at any time the nonqualified passive investor acquires beneficial ownership of more than 10% of the subject class of securities. [37] After a nonqualified passive investor exceeds the 10% threshold and

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so long as its percentage of beneficial ownership remains below 20%, an additional amendment to the nonqualified passive investor's report on Schedule 13G must also be filed "promptly" to reflect any increase or decrease in beneficial ownership of more than 5% of the class of subject securities. [38]

If a nonqualified passive investor increases its ownership above 20%, it must file a Schedule 13D within ten days and is prohibited from purchasing any additional shares or voting the securities subject to the Schedule 13D filing until ten days after the filing. [39] Similarly, both a qualified institutional investor and a nonqualified passive investor must convert to a Schedule 13D within ten days after their intentions are no longer passive and are prohibited from purchasing any additional shares or voting the securities subject to the Schedule 13D filing until ten days after the filing. [40]

Grandfathered investors reporting on Schedule 13G as a result of their ownership of shares before the class was registered under § 12 of the Exchange Act must convert from reporting on a Schedule 13G to reporting on a Schedule 13D within ten days after they have acquired beneficial ownership of additional shares totaling 2% or more of the outstanding class of securities in any 12-month period, [41] but they do not need to amend their Schedule 13G or file a Schedule 13D merely by reason of a change in their intent or plans.

[f] Electronic Filing Required

The SEC rules mandate electronic filing for foreign private issuers through the SEC's Electronic Data Gathering, Analysis and Retrieval System (known as EDGAR). [42] Accordingly, persons (including non-U.S. persons) required to make filings on Schedule 13D or 13G by virtue of acquisitions or ownership of shares of foreign private issuers may not make such filings on paper, absent a hardship exemption. It should be noted that a person filing a Schedule 13D or 13G must have its own EDGAR codes, which can be obtained by electronically filing a Form ID with the SEC. [43] The SEC will generally provide the codes within two business days of receiving the form.

[2] Section 16 Reporting and Other Requirements Not Applicable to Shareholders of Foreign Private Issuers

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Section 16 of the Exchange Act requires "insiders" of certain issuers that are not foreign private issuers [44] to report their transactions in the issuer's equity securities and to pay or disgorge to the issuer profits (or deemed profits) resulting from "short-swing" trading in the issuer's equity securities. [45] Section 16 is intended to provide "bright-line" rules that do not depend on an insider's possession of material nonpublic information or on the insider's intent. In practice, these bright-line rules present many potential pitfalls.

In general, insiders of issuers that have a class of equity security (whether or not entitled to vote) registered under § 12 of the Exchange Act and that are not foreign private issuers are subject to the requirements of § 16. Non-U.S. persons who are insiders are subject to the same rules as domestic persons who are insiders. Insiders are defined for purposes of § 16 to include officers [46] and directors [47] of an issuer and persons who are "beneficial owners" of more than 10% of a registered class of voting equity securities of an issuer. [48]

Insiders generally must file reports regarding their ownership of, and transactions in, equity securities of the issuer. [49] They are also subject to "short-swing profit recapture" provisions designed to recapture for the benefit of the issuer profits realized on purchases and sales of equity securities within any six-month

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period. [50] Additionally, Section 16(c) prohibits insiders from selling equity securities of a § 12 issuer that the seller does not own (*i.e.*, certain types of short sales). [51]

[a] Section 16(a)

Section 16(a) requires insiders to file reports on Forms 3, 4 or 5, depending upon the nature of the transaction involved. These filings must be made with the SEC and with the issuer. [52]

Within ten days of becoming an insider (or on the effective date of the Exchange Act registration statement for an issuer registering securities under § 12 for the first time— *e.g.*, pursuant to a Form 8-A in an initial public offering), the insider is required to file a report on Form 3 stating the insider's aggregate position in (i) the class of equity securities of the issuer giving rise to its status as an insider and (ii) all other equity securities (whether voting or nonvoting and whether or not registered under the Exchange Act, including derivative securities and rights, contracts or arrangements treated as derivative securities) [53] of that issuer, in each case, as to which such insider has a direct or indirect pecuniary interest. [54]

Subsequent to the initial filing on Form 3, an insider is required to report changes in beneficial ownership of equity securities as to which it has a direct or indirect pecuniary interest on Form 4 or Form 5, depending on the circumstances. [55] Insiders are required to report virtually all of their transactions in an

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issuer's equity securities on a Form 4 before the end of the second business day following the day on which the transaction is executed, [56] although a very limited number may be reported on Form 5 within 45 days following the end of the issuer's fiscal year.

In addition, all Form 3, Form 4 and Form 5 reports must be filed electronically, and issuers that maintain corporate websites must provide the reports electronically to the public not later than the end of the business day following filing. [57] The SEC's rules additionally require, among other things, that issuers with corporate websites make the forms available free of charge, that the forms not be burdensome to access and that they be available for at least 12 months. [58]

An issuer subject to § 16 is required to publicly disclose, generally in its annual proxy statement to shareholders, any failures of an insider to file on a timely basis any reports required under § 16(a) of the Exchange Act. [59] Such disclosure must include the insider's name, the number of transactions either reported late or not reported at all and certain other information.

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In addition, the SEC is empowered, in connection with any reporting failure, to seek civil penalties against an insider, [60] to issue a permanent cease-and-desist order against an insider and to require an accounting of affected transactions and disgorgement of profits to the issuer. [61]

[b] Section 16(b): Short-Swing Profit Recovery Rules

Section 16(b) of the Exchange Act requires insiders to disgorge to an issuer profits realized from purchases and sales of equity securities of the issuer within any six-month period. (As noted above, this section is not applicable to foreign private issuers.) The transactions can occur in any order, *i.e.*, a purchase followed by a sale at a higher price or a sale followed by a purchase at a lower price. In addition, transactions in the actual equity security can be "matched" for these purposes with transactions in derivative securities relating to that equity security. Section 16(b) imposes strict liability on an insider, and an insider's good faith is irrelevant to any determination of liability. Nonetheless, purchases and sales resulting in a duty to disgorge profits are not illegal and do not result in criminal liability or SEC penalties or sanctions. Most § 16(b) claims are initiated by plaintiffs' attorneys who specialize in pursuing such claims.

In calculating "profit" under § 16(b), courts will match the lowest purchase price paid by the insider against the highest sales price received by the insider in any six-month period. As a result, even though an insider may have suffered a net economic loss with respect to a series of transactions effected in issuer securities during a six-month period, the insider may be treated for purposes of § 16(b) as having realized a "profit" recoverable by the issuer. For example, an insider who during any six-month period buys 100 shares of stock at $10, buys another 100 shares at $20 and sells 200 shares at $12 will have a recoverable "profit" as a result of those transactions of

$200 (100 shares sold at $12 less 100 shares bought at $10) notwithstanding that the actual overall economic effect of the insider's transactions during the six-month period was a $600 loss.

[c] Exempt Transactions

There are a small number of transactions that are exempt from § 16(a) reporting and a somewhat larger number of transactions that are exempt from the short-swing profit recovery rules of § 16(b). Many transactions, such as exercises of employee stock options, that are exempt from § 16(b) are nonetheless reportable under § 16(a). Transactions exempt from § 16(b) are not taken into

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account when determining whether a matchable purchase and sale have occurred during any six-month period. As a result, an insider may effect an exempt purchase and a nonexempt sale (or *vice versa*) in a six-month period without incurring liability under § 16(b).

For example, Rule 16b-3 under the Exchange Act generally provides an exemption from § 16(b) for grants, awards or acquisitions of equity securities from the issuer, or dispositions of equity securities to the issuer, provided that the transaction is approved by the board of directors of the issuer or by holders of a majority of the voting securities of the issuer. Rule 16b-6 under the Exchange Act provides an exemption generally for exercises of derivative securities such as options, warrants or convertible securities with exercise or conversion privileges at a fixed price related to an equity security.

For persons who are not officers or directors (including by deputization), but become subject to § 16 because they acquire more than 10% of a class of registered voting equity securities, the transaction that initially takes them over 10% cannot be matched with any sales. Thus, if such an investor does not purchase any additional shares after the transaction that takes it over 10% ownership (which can be a block purchase that takes it significantly over 10%), subsequent sales within six months will not be subject to § 16(b). [62]

Footnotes

10 Sections 13(d) and 13(g) of the Exchange Act apply only to classes of voting equity securities registered under the Exchange Act. They do not apply to equity securities of issuers that must file periodic reports only by reason of § 15(d) of the Exchange Act as a result of having made a U.S. public offering or to foreign companies that furnish information to the SEC pursuant to Rule 12g3-2(b) under the Exchange Act. Moreover, if an issuer has two classes of equity securities, one registered and one not (or one voting and one not), the sections only apply with respect to the registered, voting class. However, if the unregistered (or nonvoting) class is immediately (or within 60 days) convertible into a registered voting class, filing will be required with respect to the securities owned of the unregistered (or nonvoting) class if such securities would, if converted, represent more than 5% of the registered, voting class. *See* Rule 13d-3(d) under the Exchange Act.

11 ADRs are not a separate class of voting equity securities for purposes of § 13(d) or § 13(g) of the Exchange Act. SEC Release No. 33-6894 (May 23, 1991). Thus, a person owning ADRs will be required to file reports under § 13(d) and § 13(g) of the Exchange Act only if the voting equity securities represented by his or her ADRs plus any underlying securities that he or she beneficially owns outside the ADR facility constitute more than 5% of the underlying securities (including those represented by ADRs).

An ADR holder's standing directions to a depositary to vote shares underlying the ADRs in the manner set forth in a deposit agreement do not confer voting power on the depositary. Consequently, the depositary would not be considered the beneficial owner of such shares and no reporting obligations would arise in connection therewith. *See Second National Bank of Warren* (avail. Aug. 15, 1988).

12 The definition of beneficial ownership generally was not interpreted historically to cover most swaps relating to voting equity securities. With the passage of the Dodd-Frank Act, however, §§ 13(d), 13(f) and 13(g) of the Exchange Act expressly include the purchase or sale of security-based swaps, to the extent defined by

rule by the SEC, as one type of beneficial ownership, thereby giving the SEC the authority to adopt rules that would include security-based swaps within the definition of beneficial ownership. *See* § 766 of the Dodd-Frank Act. The SEC has not utilized this authority other than to readopt existing Rules 13d-3 and 16a-1 under the Exchange Act to ensure that persons who purchase or sell security-based swaps after July 16, 2011 remain within the scope of the beneficial ownership rules to the same extent they were covered prior to July 16, 2011. SEC Release No. 34-64628 (June 8, 2011).

The language in Title VII of the Dodd-Frank Act was preceded by case law finding that a holder of derivative instruments could be regarded as a beneficial owner of shares held for hedging purposes by their counterparties where there is a course of conduct regarding the voting or disposition of such shares. *See CSX Corp. v. TCI Fund Management (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd in part*, *vacated in part*, 654 F.3d 276 (2d Cir. 2011), which discusses in *dicta* whether the 5% beneficial ownership threshold was met and concomitant § 13(d) reporting requirements were triggered due to the holding of equity swaps, in addition to actual shares, by two hedge funds, which each owned less than 5% of CSX outright, but held equity swap positions with an economic interest equivalent to 8% to 12% of CSX. The court found that the hedge funds were required to file a Schedule 13D because they were a "group," but further noted that the holding of swaps could be considered beneficial ownership because the swap holder could influence the counterparty's voting decisions due to the nature of the equity swap market. The SEC's Division of Corporation Finance wrote an *amicus* letter arguing that beneficial ownership would not arise from holding equity swaps, and that economic incentives and influence were insufficient to provide "voting power" to the holders of the swaps. On appeal, the Second Circuit did not address the question whether a long holder of equity swaps may be deemed to beneficially own the shares purchased by the short party as a hedge; however, one member of the panel addressed in a concurrence the reasons that the long party should not be deemed to beneficially own the shares, because it does not, through the swap, obtain investment or voting power over the shares.

13 Rule 13d-3 under the Exchange Act.

14 For example, both U.K. and non-U.K. persons are required to report large holdings in certain companies pursuant to the U.K. Vote Holder and Issuer Notification Rules set out in Chapter 5 of the Disclosure and Transparency Rules of the U.K. Financial Conduct Authority Handbook of Rules and Guidance. The U.K. system requires reporting of such holdings in U.K. companies whose shares are admitted to trading on an EEA-regulated market or on a U.K.-prescribed market (*e.g.*, AIM) and in other companies incorporated in an European Economic Area state (an "EEA state"), with shares admitted to trading on a regulated market, where the United Kingdom is their home state. A non-EEA company with shares admitted to trading on an EEA-regulated market for which the United Kingdom is its home member state is also subject to these requirements unless its domestic regime is deemed equivalent (presently, the United States, Japan, Israel and Switzerland). Similar requirements arise in other EEA states as a result of implementation of the European Union's Directive of the European Parliament and of the Council on Transparency Obligations of December 15, 2004 (Directive 2004/109/EC), as amended by Directive 2010/73/EU and Directive 2013/50/EU.

15 For a further discussion of groups, *see* § 6.04[1][c].

16 *See* § 6.04[1][a].

17 The *Hart-Scott-Rodino Antitrust Improvements Act* ("HSR Act"), as well as other statutes, may, however, delay purchases above certain levels that, depending on the stock price, may be below or above 5%. *See* § 9.06. Similarly, specific ownership thresholds may be relevant in other contexts, such as in regulated industries (e.g., telecommunications, gaming and energy); pursuant to business combination statutes (*e.g.*, DGCL § 203, which generally prohibits, unless a company has in its charter expressly opted out of the provision, an "interested stockholder"—generally a person beneficially owning 15% or more of a corporation's voting stock or an affiliate or associate of that person—from engaging in a "business combination" for three years following the date on which the person became an interested stockholder); and in connection with review by the Committee on Foreign Investment in the United States ("CFIUS"), which has the authority to review transactions in which a foreign person acquires direct or indirect "control" over a

U.S. company to determine whether national security issues may exist, but generally does not review passive acquisitions of voting securities representing less than 10% of outstanding voting securities (*see* § 9.07).

18 A determination of whether securities were acquired without the purpose or effect of changing or influencing control of the issuer is highly dependent on the attendant facts and circumstances. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 103.11 (July 14, 2016).

19 *See* Rule 13d-1(b)(1)(ii)(J) under the Exchange Act. A foreign institution relying on this rule must certify on Schedule 13G that it is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to its U.S. counterparts and undertake to provide to the SEC information that would otherwise be required if the institution filed on Schedule 13D. This rule is a codification of the pre-2008 practice of the SEC of issuing no-action letters permitting Schedule 13G to be used by certain foreign institutional investors that, except for their nationality, qualified for the form in their capacity as qualified institutional investors. The requirements applicable to qualified institutional investors are less onerous than those applicable to nonqualified passive investors, and qualified institutional investors may file a Schedule 13G (and not convert to filing on Schedule 13D) even if their ownership interest exceeds 20%. *See*, *e.g.*, *National Consumer Cooperative Bank* (avail. Jan. 3, 2011); *Morgan Stanley Smith Barney LLC* (avail. May 29, 2009); *Goldman, Sachs & Co.* (avail. Dec. 30, 2008); *Auction Rate Securities* (avail. Sept. 22, 2008); *Orbis Group* (avail. July 16, 2008); *DnB NOR ASA* (avail. Jan. 9, 2008); *Natixis S.A*. (avail. Oct. 9, 2007); *Mellon Financial Corp*. (avail. Nov. 16, 2006); *Mitsubishi UFJ Financial Group, Inc.* (avail. Jan. 23, 2006); *Citigroup Inc*. (avail. May 27, 2004); *Stichting Pensioenfonds ABP* (avail. May 7, 2004); *CGNU PLC* (avail. Mar. 19, 2002); *Cater Allen International Limited* (avail. Mar. 7, 2001); *Swiss Bank Corp*. (avail. Jan. 17, 1997); *Deutsche Bank AG* (avail. Apr. 9, 1996); *Union Bank of Switzerland* (avail. Nov. 23, 1992); *Ontario Teachers' Pension Plan Board* (avail. May 6, 1992); *Royal Bank of Canada* (avail. Dec. 10, 1990); *B.A.T. Industries plc* (avail. Nov. 26, 1990). Certain foreign governments have also used Schedule 13G as qualified institutional investors. *See*, *e.g.*, *Her Majesty's Government* (avail. Dec. 10, 2008).

20 Rule 13d-1(c) under the Exchange Act.

21 Rules 13d-1(b)(2) and 13d-1(d) under the Exchange Act. Section 13(d) requires a person to make a filing only if it *acquires* more than 5% of a class of equity securities that is already *registered* under the Exchange Act. Similarly, where any holding is increased to more than 5% solely due to the issuer's repurchase of its shares, the holder has not made an acquisition within the meaning of § 13(d) and there is no Schedule 13D filing obligation, although a Schedule 13G is required to be filed within 45 days after the year end. *See Drico Industrial Corp.* (avail. June 25, 1976). This exception from the obligation to file a Schedule 13D is not available to persons who influence or control the change in the aggregate number of outstanding securities, including, but not limited to, officers and directors of the issuer. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 103.08 (Sept. 14, 2009).

22 Rule 13d-1(c) under the Exchange Act.

23 § 13(d)(6)(B) of the Exchange Act. The SEC staff has indicated that the 2% calculation should be based on the number of shares outstanding at the beginning of the 12-month period. *See Refreshment Machinery, Inc.* (avail. June 16, 1975). The SEC staff has provided relief from filing a Schedule 13D where a person purchases shares above the 2% threshold to maintain an existing percentage interest in an issuer, where the purchases were contemporaneous with new issuances and sales to other parties. *See Exxon Corporation* (avail. Dec. 13, 1989); *Coca-Cola Co.* (avail. Dec. 12, 1991).

24 § 13(d)(3) of the Exchange Act; Rule 13d-5(b) under the Exchange Act.

25 *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983); *see also Roth v. Jennings*, 489 F.3d 499 (2d Cir. 2007).

26 *See*, *e.g.*, *SEC v. Savoy Industries, Inc.*, 587 F.2d 1149 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *CSX Corp. v. TCI Fund Management (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd in part*, *vacated*

in part, 654 F.3d 276 (2d Cir. July 18, 2011) (the district court found that a group was formed based on concerted investment action in a highly fact-specific analysis; the Second Circuit remanded the question of group formation for further review); *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) (finding a group may be formed without any accompanying agreement to acquire additional securities); *Dreiling v. America Online, Inc.*, 578 F.3d 995 (9th Cir. 2009) (finding no group existed where there was no probative evidence suggesting that there ever was an agreement by the parties to act together to acquire, hold, vote or dispose of the subject stock). Evidence of a pre-existing relationship is inadequate by itself to prove the formation of a group. *See*, *e.g*., *Bayly Corp. v. Marantette*, Fed. Sec. L. Rep. (CCH) ¶98,834 (D.D.C. Oct. 19, 1982). Moreover, action with respect to particular securities must proceed beyond preliminary discussions to actual agreement to act in concert. *See*, *e.g.*, *Lane Bryant, Inc. v. Hatleigh Corp.*, Fed. Sec. L. Rep. (CCH) ¶97,529 (S.D.N.Y. June 9, 1980). *See also Morales v. Quintel Entertainment, Inc*., 249 F.3d 115 (2d Cir. 2001), in which the Second Circuit held that it was a triable issue of fact whether an individual owner, Richard Morales, of less than 2.5% of the common stock of a publicly traded corporation, Quintel, was the "beneficial owner" of more than 10% of such stock by reason of the existence of a "group" of three shareholders for purposes of § 13(d), and therefore had liability under § 16(b). In vacating the district court's decision in part and remanding the case to it, the Second Circuit found, as evidence of the existence of such a group, that the three shareholders had entered into a sales agreement to sell their interest in a closely held corporation in exchange for the issuance of Quintel common stock (though not necessarily for the purpose of acquiring control of Quintel); that such agreement contained lock-up provisions governing the holding and disposal of Quintel common stock; that all three shareholders had deposited their holdings in identical trusts naming the same person as trustee; and that Quintel had redeemed the holdings of all three shareholders together on the same day. In addition, the Second Circuit noted that, although they had disclaimed beneficial ownership of the others' shares in such filing (but not in filings made by Morales on Forms 4 and 5), the three had jointly filed a single Schedule 13D. *But see Lowinger v. Morgan Stanley & Co. LLC*, 841 F.3d 122 (2d. Cir. 2016) (finding an ordinary course lock-up agreement between shareholders and underwriters in connection with Facebook, Inc.’s initial public offering did not result in the formation of a group); *see also Chechele v. Scheetz*, 819 F. Supp. 2d 342 (S.D.N.Y. 2011), *aff'd*, 466 F. App'x 39 (2d Cir. 2012).

27 The SEC has clarified that in cases where appropriate information barriers are in place between business units, divisions or subsidiaries within a group, thereby allowing for the independent exercise of voting and investment powers by the party holding the securities, the attribution of beneficial ownership from the holding party to parties on the other side of the barrier may not be required. The determination as to the independent exercise of voting and investment powers is based on facts and circumstances, but the SEC has indicated that written policies and procedures reasonably designed to prevent the flow of information relating to voting and investment between the relevant parties should be maintained and enforced. These policies and procedures should also be subject to an annual, independent assessment as to their effectiveness. In addition, the separation of the parties must not be "artificial"— *e.g.*, the parties should not participate in a common compensation pool that may result in the alignment of voting and investment decisions between them. Finally, the parties on the other side of the barrier should not have any officers, directors or employees involved in the exercise of the holding party's voting and investment powers. In this regard, the SEC has stated that the existence of an independent investment committee would be evidence of an effective separation between the parties. *See* SEC Release No. 34-39538 (Jan. 12, 1998); *Goldman Sachs Group, Inc.* (avail. Mar. 30, 2001).

28 Title IX of the Dodd-Frank Act gives the SEC rulemaking discretion to shorten the current ten-day reporting time period under Schedule 13D, which it has not elected to exercise to date. In addition, the Dodd-Frank Act amended § 13(d) of the Exchange Act such that the filer is no longer required to mail copies of the filings to the issuer or relevant national securities exchange.

29 In the case of funds loaned in the ordinary course of business by a bank operating under the laws and supervision of bank regulators of the United States or any state, the name of the bank will not be made available to the public if the acquiror at the time of filing of the Schedule 13D so requests in writing and files

such request, naming such bank, with the SEC. Schedule 13D, Item 3; § 3(a)(6) of the Exchange Act; *see also* Item 1007(d) of Regulation M-A under the Securities Act, which allows for the same relief in the business combination context. An acquiror must, however, disclose the identity of any foreign bank providing funds used to acquire the securities.

30 *See* Schedule 13D, Item 4; *see also* Item 1006(c) of Regulation M-A under the Securities Act, which contains substantially similar provisions in the business combination context. The failure to accurately amend a report to describe new intent on Schedule 13D could also lead to violations of state law. *See NACCO Industries*, *Inc. v. Applica Inc.*, 997 A.2d 1 (Del. Ch. 2009) (allowing a fraud claim under state law where an investor filed a Schedule 13D including an allegedly misleading statement on a change in the intent of the investment, stating that its intent was for investment, while accumulating a large stake in anticipation of a takeover bid). The U.S. Court of Appeals for the Seventh Circuit has found a private right of action relating to a Schedule 13D exists in favor of shareholders only in the context of a tender offer or aggregation of shares for the purpose of controlling the issuer. *See Edelson v. Ch'ien*, 405 F.3d 620 (7th Cir. 2005); *see also Motient Corp. v. Dondero*, 529 F.3d 532 (5th Cir. 2008); *E.On AG v. Acciona, SA*, 468 F. Supp. 2d 537 (S.D.N.Y. 2006).

31 For example, investors might disclose their intention as follows: to review their investment in the issuer on a continuing basis, and increase or decrease their investment in the issuer depending upon the price and availability of the securities, subsequent developments affecting the issuer, the issuer's business and prospects, other investment and business opportunities available to the investors, general stock market and economic conditions, tax considerations and other factors. The SEC staff has indicated that generic disclosure must be amended when the security holder has formulated a specific intention with respect to one of the matters enumerated in Item 4(a)-(j). *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 110.06 (Sept. 14, 2009).

32 The SEC has taken enforcement action that illustrates its construction of the requirement to amend "promptly" reports on Schedule 13D. *See SEC v. Edelman*, SEC Litigation Release No. 12835 (Apr. 11, 1991). For example, on Sunday, September 10, 1989, Asher Edelman established a plan to buy additional stock of Datapoint Corporation. He purchased shares on the following Monday and Tuesday and amended his Schedule 13D the next day. Subsequent comments by the SEC staff suggested that Mr. Edelman may have been obligated to amend his outstanding Schedule 13D (which stated that he would review his holdings in Datapoint from time to time) as early as the morning following his formulation of a plan to purchase more Datapoint shares. Kevin G. Salwen, *Edelman Named In SEC Action On 1989 Plan*, WALL ST. J., Apr. 12, 1991; *see also In the Matter of Cooper Laboratories Inc.*, SEC Release No. 34-22171 (June 26, 1985).

A change in intent triggers an obligation to amend Schedule 13D. A "plan or proposal," as those terms are used in Item 4 of Schedule 13D, arises upon formulation of a specific intention, not only once a formal agreement has been signed or a tender offer launched. *See In the Matter of Tracinda Corp.*, SEC Release No. 34-58451 (Sept. 3, 2008). Tracinda Corporation proposed selling 28 million shares of General Motors Corporation to a broker-dealer on November 20, 2006, but only sold 14 million shares because the bid offered by the broker-dealer for the full 28 million shares represented a deeper discount than Tracinda was willing to accept. On November 22, 2006, Tracinda amended its 13D reporting the sale of 14 million shares, but omitted to disclose its plan and proposal to sell the 28 million shares. On November 28, 2006, Tracinda sold an additional 14 million shares of GM stock. This sale reduced its holdings in GM to 4.95%. On November 30, 2006, Tracinda sold its remaining shares of GM stock. The SEC found violations of § 13(d)(2) of the Exchange Act and Rules 12b-20 and 13d-2(a) thereunder and Tracinda was ordered to cease and desist from committing or causing any violations, and any future violations, of such provisions and rules.

33 *See Darco Asso. Calny Food Services, Inc.* (avail. May 6, 1979).

34 Rule 13d-2(a) under the Exchange Act. The requirement to amend "promptly" reports on Schedule 13D creates problems for filers disposing of a material block of the class of subject securities. In such cases, difficulty may arise because of the tension between the requirement of the seller to file an amendment

promptly and the desire of the block positioner to delay the filing until the sale is completed. *See supra* Note 33.

35 Rule 13d-2(b) under the Exchange Act. An amended Schedule 13G must only be filed if there are changes as of the end of the calendar year, and no amendment is required if there is a change in the percent of the class outstanding previously reported if the change results solely from a change in the aggregate number of securities outstanding.

36 Rule 13d-2(c) under the Exchange Act.

37 Rule 13d-2(d) under the Exchange Act. The requirement to file "promptly" is the same standard that applies to amendments to reports on Schedule 13D.

38 Rule 13d-2(d) under the Exchange Act.

39 Rule 13d-1(f) under the Exchange Act.

40 Rule 13d-1(e) under the Exchange Act.

41 § 13(d)(6)(B) of the Exchange Act. The SEC staff has indicated that the 2% calculation should be based on the number of shares outstanding at the beginning of the 12-month period. *See Refreshment Machinery, Inc.* (avail. June 16, 1975); *Exxon Corporation* (avail. Dec. 13, 1989); *Coca-Cola Co.* (avail. Dec. 12, 1991); *Stolt Tankers and Terminals (Holdings) S.A.* (avail. Mar. 12, 1992).

42 *See* SEC Release No. 33-8099 (May 14, 2002) and § 4.02[3][b][i], for a further discussion of EDGAR.

43 *See generally* Regulation S-T under the Securities Act. The Form ID must be filed by completing an online form *available at* https://www.filermanagement.edgarfiling.sec.gov. The SEC does not accept submissions of Form ID by mail.

44 *See* Rule 3a12-3 under the Exchange Act.

45 *See* Peter J. Romeo & Alan L. Dye, SECTION 16 TREATISE AND REPORTING GUIDE (4th ed. 2012) for a comprehensive treatment of § 16 of the Exchange Act.

46 For purposes of § 16, an "officer" is defined to include the president of an issuer, its principal financial and accounting officers or controllers, any other individual who is a vice president in charge of a principal business unit, division or function of the issuer and any other individual who performs a policy-making function for the issuer. *See* Rule 16a-1(f) under the Exchange Act. A person may be an officer for these purposes without regard to that person's title or formal position.

47 A "director" is, in general, any director of a corporation. § 3(a)(7) of the Exchange Act. However, an "honorary director" or "director emeritus" may be deemed to be a director for purposes of § 16 of the Exchange Act, depending on the person's authority, responsibility and access to inside information. *See* SEC Release No. 34-28869 (Feb. 8, 1991); SEC Release No. 34-26333 (Dec. 2, 1988); SEC Release No. 34-18114 (Sept. 24, 1981). A shareholder of an issuer may be deemed to be a director of the issuer if the corporation "deputizes" a representative to occupy the shareholder's position on the board of directors of the issuer, *i.e.*, designates one of its representatives to be a director of the issuer. The shareholder is subject to disgorgement under § 16(b) if it trades, even if the director it designated has not engaged in any trading. *See Blau v. Lehman*, 368 U.S. 403 (1962); *Feder v. Martin Marietta Corp.*, 406 F. 2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

48 The determination of whether a person is a 10% beneficial owner of an issuer is based on the beneficial ownership provisions of § 13(d) of the Exchange Act discussed above. *See* Rule 16a-1(a)(1) under the Exchange Act; § 6.04[1][a].

49 § 16(a) of the Exchange Act.

50 § 16(b) of the Exchange Act.

51 *But see* Rule 16c-4 under the Exchange Act, which exempts certain short positions that are fully covered through ownership of the underlying equity positions. §§ 16(d), 16(e), 16(f) and 16(g) describe the application of §§ 16(a), 16(b) and 16(c) to certain types of transactions.

52 Rule 16a-3 under the Exchange Act.

53 In general, the term "equity security" is defined very broadly for most purposes of § 16, and includes instruments that may not be considered securities for other purposes of the Exchange Act. In addition to common stock, the term "equity securities" includes derivative securities, such as options to acquire stock and debt convertible into stock, as well as other contracts, rights or arrangements the value of which is based on the value of equity securities, including equity swap contracts and certain rights that are typically awarded in connection with executive compensation arrangements.

54 The term "pecuniary interest" means, generally, an economic interest. A pecuniary interest may arise from a direct holding of an equity security, from an indirect interest in a security through a corporation, partnership or trust (of which the insider is a trustee, a settlor or a beneficiary), from equity securities held by certain family members or from equity securities held by an investment partnership from which the insider is entitled to a performance-related management fee. Rule 16a-1(a)(2)(i) under the Exchange Act.

55 The Sarbanes-Oxley Act shortened the period for the reporting of most insider transactions from ten days following the end of the month in which they transpire to within two business days following their occurrence. *See* § 6.04[2]. The Sarbanes-Oxley Act did not amend the ten-day reporting rule applicable to insiders initially becoming subject to § 16 reporting obligations. *See* § 16(a)(2) of the Exchange Act; Form 3. However, Title IX of the Dodd-Frank Act gives the SEC rulemaking discretion to shorten the current ten-day reporting time period for initial reporting.

56 The SEC has established two limited exceptions to the two-day rule to cover circumstances where the insider does not select the date of the execution of the transaction. The first exception covers transactions pursuant to a contract, instruction or written plan for the purchase or sale of issuer securities that satisfies the conditions of Rule 10b5-1(c) under the Exchange Act. These conditions set out an affirmative defense to insider trading liability under Rule 10b-5 where an insider enters into a written plan to engage in nondiscretionary securities transactions before becoming aware of relevant material nonpublic information. *See* § 11.05[2][a][i]. The second exception covers "discretionary transactions" (as defined by Rule 16b-3(b)(1) under the Exchange Act) involving an employee benefit plan, whether or not exempted by Rule 16b-3 under the Exchange Act (which exempts certain transactions from § 16(b) liability). In these cases, the date of execution (triggering the two-day filing deadline) is deemed to be the date the executing broker, dealer or plan administrator notifies the insider of the execution, except that if the notification occurs later than the third business day following the actual trade date of the transaction, then the deemed date of execution is that third business day. The SEC has noted that it expects insiders to make arrangements with executing entities to provide such notification as quickly as feasible and has urged executing entities to provide such information either electronically or by telephone and not to rely on mailed confirmations. *See* SEC Release No. 34-46421 (Aug. 27, 2002).

57 § 16(a)(4) of the Exchange Act.

58 *See* Rule 16a-3(k) under the Exchange Act; SEC Release No. 33-8230 (May 7, 2003). In order to facilitate the easy filing of Forms 3, 4 and 5 by individuals, the SEC established a separate website, https://www.onlineforms.edgarfiling.sec.gov, dedicated exclusively to the on-line creation and submission of the forms. It also adopted a rule providing that direct transmission of the forms through the website on or before 10:00 P.M. Eastern time on a business day will result in the forms being deemed filed on that day. The forms may not be filed via the traditional means of EDGARLink. *See* SEC Release No. 33-8224 (Apr. 30, 2003); SEC Release No. 33-8230 (May 7, 2003).

59 Item 405 of Regulation S-K under the Securities Act.

60 § 32 of the Exchange Act.

61 § 21C of the Exchange Act.

62 *See* Rule 16a-2 under the Exchange Act; *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232 (1976).

U.S. Regulation of the International Securities and Derivatives Markets, § 6.05, POTENTIAL LIABILITY FOR MATERIAL MISSTATEMENTS OR OMISSIONS AND INSIDER TRADING

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 § 6.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Directors, certain executive officers and controlling shareholders, as well as any selling shareholders, may be liable for materially deficient disclosure, including disclosure contained in registration statements filed under the Securities Act and the Exchange Act and offering documents used in private placements. [63]

In addition to potential liability for material misstatements or omissions in disclosure, U.S. securities laws—specifically § 10(b) of the Exchange Act and Rule 10b-5 and the extensive case law thereunder—prohibit trading by certain persons while knowingly in possession of material nonpublic (*i.e.*, "inside") information in connection with the purchase or sale of securities. [64]

Footnotes

63 *See* § 11.03.

64 *See* § 11.05[2][a]. Issuers commonly adopt insider trading policies that impose "black-out periods," during which trading in issuer securities by directors, officers and other employees is prohibited, to prevent such persons from trading while they may be in possession of material nonpublic information.

U.S. Regulation of the International Securities and Derivatives Markets, § 6.06, RESTRICTIONS ON RESALES BY DIRECTORS, OFFICERS AND SIGNIFICANT SHAREHOLDERS OF THE ISSUER

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 § 6.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

[1] Resales of Securities by Affiliates

U.S. law, and contractual arrangements entered into in connection with U.S. public offerings, can restrict the resale of an issuer's securities by its directors, executive officers and significant shareholders.

Resales of securities by "affiliates" of the issuer are restricted under the U.S. securities laws, even when the issuer is public in the United States and has listed securities there. A person is an "affiliate" of an issuer if it directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the issuer. Rule 405 under the Securities Act defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise." [65] An issuer's directors, executive officers and significant shareholders (*e.g.*, those holding at least 10% of the outstanding equity securities) are generally considered to be its affiliates.

Offers and sales of an issuer's securities by an affiliate of the issuer may not be made in the United States unless: (i) prior to their offer and sale, the securities have been registered with the SEC under the Securities Act or (ii) the affiliate's offers and sales of the securities are made pursuant to an exemption from these registration requirements. As a practical matter, the most frequently used exemptions involve sales of limited numbers of shares through transactions under Rule 144 under the Securities Act, [66] resales under Rule 144A under the Securities Act [67] and private placements. [68]

As indicated in Chapter 3, the issuer itself must register any of its securities that are to be sold in the United States pursuant to a registration statement filed with the SEC, even resales by shareholders. Because shareholders may not always be able to cause an issuer to register their securities under the Securities Act for resale purposes, even where they are deemed to "control" the issuer for purposes of determining whether they are affiliates for U.S. securities law purposes, substantial shareholders sometimes negotiate with issuers in order to obtain specific contractual rights with respect to registration of the shareholders' securities in order to permit their public sale. Such registration rights generally

take the form of the issuer's commitment to (i) prepare a "shelf registration statement" registering the sale of the shares, (ii) register the sale of the shares within a specified period, upon demand (generally referred to as "demand rights"), or (iii) include the shareholder's shares as one portion of any contemplated sale involving the filing of a registration statement within a specified period. The third category is usually referred to as "piggyback rights" because the shareholder's offering is, in a sense, carried along as part of the primary offering contemplated by the issuer or a secondary offering by another shareholder. [69]

Affiliates also may sell securities of the issuer in a transaction that takes place outside the United States and complies with Regulation S under the Securities Act. [70]

[2] Lock-Ups in Connection with Offerings of Shares by the Issuer

In connection with securities offerings, directors, officers and shareholders are often required to enter into lock-up agreements with the underwriters of the offering in order to facilitate an orderly trading market following the completion of the offering. [71] In an initial public offering, all or nearly all of the existing shareholders typically will be required to enter into lock-up agreements with the representative(s) for the underwriters. In a follow-on offering, typically only the selling shareholders or those with a separate contractual obligation to do so (*e.g.*, pursuant to a shareholders' agreement) enter into lock-up agreements. Shareholders' agreements and registration rights agreements often include a commitment by the shareholders to enter into lock-up agreements in connection with securities offerings.

[3] Prohibition of Insider Trades During Certain Plan Blackout Periods

Section 306(a) of the Sarbanes-Oxley Act, and Regulation Blackout Trading Restriction ("Regulation BTR") adopted by the SEC to clarify the operation of § 306(a), prohibit directors and executive officers of an issuer from, directly or indirectly, purchasing, selling or otherwise acquiring or transferring any equity security of an issuer that was acquired in connection with the director's or

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executive officer's service or employment in such capacity [72] during a pension plan blackout period that prevents plan participants or beneficiaries from engaging in issuer equity securities transactions. [73] Although not the exclusive remedy, any profit realized by a director or executive officer from any transaction in equity securities of an issuer in violation of § 306(a) is recoverable by the issuer, regardless of the intention of the director or executive officer. [74] In addition, § 306(a) and Regulation BTR require issuers to provide notice of blackout periods to affected officers and directors, as well as to the SEC, and specify the content and timing of that notice. [75]

[a] Applicability to Foreign Private Issuers

Regulation BTR provides that § 306(a) of the Sarbanes-Oxley Act applies to equity securities transactions by directors and executive officers of a foreign private issuer only if (i) 50% or more of the participants or beneficiaries in individual account plans [76] maintained by the issuer [77] who are located in the United States are subject to a blackout period and (ii) either (a) the affected employees

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located in the United States represent more than 15% of the total number of employees of the foreign private issuer and its consolidated subsidiaries worldwide or (b) more than 50,000 participants or beneficiaries located in the United States are affected.

[b] Definition of Blackout Period and Exceptions

A blackout period is any period of more than three consecutive business days during which the ability of not fewer than 50% of the participants or beneficiaries located in the United States under all individual account plans maintained by an issuer (and certain 80% or more commonly controlled entities) to purchase, sell or otherwise acquire or transfer an interest in any equity security of such issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan. [78] Section 306(a)(4)(B) of the Sarbanes-Oxley Act and Rule 102 of Regulation BTR expressly exclude from the definition of "blackout period" (i) certain regularly scheduled blackout periods and (ii) any suspension imposed solely in connection with the commencement or termination of participation in an individual account plan by reason of a corporate merger, acquisition, divestiture or similar transaction involving the plan or the plan sponsor.

[c] Persons Subject to the Trading Prohibition

With respect to foreign private issuers, the term "director" is defined as any director who is a "management employee" of the foreign private issuer, thus excluding outside directors and non-management employee directors. [79] The term "executive officer" is defined, with respect to foreign private issuers, as the principal executive officer or officers, the principal financial officer or officers and the principal accounting officer or officers. [80]

[d] Securities Subject to the Trading Prohibition

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Section 306(a) applies to any equity securities of an issuer other than an exempt security (as defined in § 3(a)(12) of the Exchange Act). Regulation BTR defines "equity security of the issuer" to include any equity security or derivative security relating to an issuer, whether or not issued by that issuer. [81] As a result, § 306(a) applies to options, warrants and exchangeable securities issued by third parties. Regulation BTR defines "derivative security" by reference to Rule 16a-1(c) under the Exchange Act. [82]

[e] Exempt Transactions

Rule 101(c) of Regulation BTR exempts from the trading prohibition certain categories of transactions that occur automatically, are made pursuant to an advance election or are otherwise outside the control of the director or executive officer, including, among others, (i) acquisitions of equity securities under certain dividend or interest reinvestment plans, (ii) purchases or sales of equity securities under so-called "10b5-1 plans" [83] in certain circumstances, (iii) purchases or sales of equity securities made under certain tax-qualified employee benefit plans (other than discretionary transactions), (iv) compensatory grants and awards of equity securities pursuant to programs under which grants occur automatically, (v) exercises, conversions or terminations of certain derivative securities which, by their terms, occur only on a fixed date or are exercised, converted or terminated by a counterparty not subject to influence by the director or executive officer and (vi) increases or decreases in equity securities holdings resulting from a stock split, stock dividend or *pro rata* rights distribution.

Footnotes

65 Rule 405 of Regulation C under the Securities Act.

66 *See* § 7.04[2].

67 *See* § 7.04[1]. A resale under Rule 144A would not be available, however, for shares of the same class as shares listed on a U.S. securities exchange unless the resale shares were issued prior to the listing. § 7.02[3][b].

68 *See* § 7.04[3].

69 *See generally* § 7.05 for a discussion of private offerings with registration rights.

70 *See* Chapter 8. This option may be much more limited in the case of a U.S. issuer, as the requirements of Regulation S applicable to offshore sales of securities of U.S. issuers generally are much more restrictive than the requirements applicable to offshore sales of securities of foreign private issuers.

71 *See* § 3.02[5][d]. Such lock-up agreements are generally not deemed to create a "group" for purposes of § 13(d) of the Exchange Act. *See Lowinger v. Morgan Stanley & Co. LLC*, 841 F.3d 1224 (2d. Cir. 2016).

72 Equity securities sold or otherwise transferred during a blackout period by a director or executive officer of an issuer will be considered to have been acquired in connection with service or employment as a director or executive officer to the extent that the director or executive officer owned such securities at the time of the transaction, unless he or she establishes that the equity securities were not so acquired. To establish this defense, a director or executive officer must specifically identify the origin of the equity securities in

question and demonstrate that this identification of the equity securities is consistent for all purposes related to the transaction (such as tax reporting and any applicable disclosure and reporting requirements). Rule 101(b) of Regulation BTR under the Exchange Act; SEC Release No. 34-47225 (Jan. 22, 2003).

73 § 306(a)(1) of the Sarbanes-Oxley Act; Rule 101 of Regulation BTR under the Exchange Act. *See* § 5.05[7] for a discussion of issuer-adopted policies restricting directors, officers and certain other employees from trading during specified periods.

74 Rule 103 of Regulation BTR under the Exchange Act.

75 § 306(a)(6) of the Sarbanes-Oxley Act; Rule 104 of Regulation BTR under the Exchange Act. In the case of a foreign private issuer, notice to the SEC will be considered timely if provided as an exhibit to the first annual report on Form 20-F filed after such notice is given to the affected officers and directors or, as encouraged by the SEC, furnished earlier on Form 6-K.

76 The definition of "individual account plan" in Rule 100(j) of Regulation BTR under the Exchange Act is based on § 3(34) of the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, as amended ("ERISA"), and includes retirement plans providing for individual accounts for each participant that provide benefits based solely upon amounts contributed to the account and any earnings and losses (and would include 401(k) plans, profit sharing plans and stock bonus plans). It does not include one-participant plans or plans in which only directors may participate.

77 The SEC has clarified that, for purposes of calculating the 50% threshold, individual account plans "maintained by the issuer" include individual account plans in which participants or beneficiaries held or could hold equity securities of the issuer, and would include account plans that (i) permit participants to invest their plan contributions in equity securities of the issuer, (ii) provide for an "open brokerage window" that permits participants to invest in the equity securities of any publicly traded company, including the issuer, (iii) match employee contributions with equity securities of the issuer or (iv) reallocate forfeitures that included equity securities of the issuer to remaining plan participants, whether or not the plan actually contains equity securities of the issuer at the time of the calculation. SEC Release No. 34-47225 (Jan. 22, 2003).

78 Rule 100(b)(3)(ii) of Regulation BTR under the Exchange Act excludes individual account plans maintained outside the United States primarily for the benefit of nonresident aliens.

79 Rule 100(c)(2) of Regulation BTR under the Exchange Act.

80 Rule 100(h)(2) of Regulation BTR under the Exchange Act. This definition and the definition of "director" in Rule 100(c)(2) are intended to assist foreign private issuers in identifying the individuals who are subject to § 306(a) and ensure that § 306(a) does not apply to lower-level employee representatives or nonemployee directors who may be on the boards of directors of foreign private issuers. SEC Release No. 34-46778 (Nov. 6, 2002).

81 Rule 100(f) of Regulation BTR under the Exchange Act. Rule 100(e) of Regulation BTR refers to the definition of "equity security" set out in § 3(a)(11) of the Exchange Act and Rule 3a11-1 thereunder. In the case of foreign private issuers, this includes American Depositary Shares ("ADSs") evidenced by ADRs.

82 Rule 100(d) of Regulation BTR under the Exchange Act.

83 *See* § 11.05[2][a] for a discussion of 10b5-1 plans.

U.S. Regulation of the International Securities and Derivatives Markets, § 7.01, 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 § 7.01 (11th and 12th Editions 2014-2017)
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Cross-border securities offerings are regularly conducted without registration under the Securities Act, in reliance on exemptions for private offerings and for transactions conducted outside the United States—and often in reliance on both exemptions at once. This chapter discusses the exemption for private offerings, while Chapter 8 discusses the exemption for transactions conducted outside the United States.

Offerings by issuers are exempt from registration under § 4(a)(2) of the Securities Act if they are "[t]ransactions by an issuer not involving any public offering." These are usually referred to as "private placements" or "private offerings." Over more than half a century, a substantial body of case law and SEC regulatory practice has developed concerning private placements by U.S. issuers and the resale of privately placed securities. [1] Standardized procedures and documentation have also evolved to allow private placements to proceed with assurance that the exemption from registration under § 4(a)(2) is available.

Private offerings have come to represent a significant portion of total U.S. financing activity, particularly since the SEC adopted Rule 144A under the Securities Act in 1990. [2] Many U.S. issuers rely on the private offering exemption to sell specialized securities that are tailored for the investing institutions. In such cases, the ability to resell the securities in a liquid market is not a primary consideration. Where liquidity is important to investors, however, the price the issuer receives in a private offering has historically been lower than in a public transaction, and investors often require the issuer to provide "registration rights"—a prompt avenue to resell in the public market *via* either a subsequent resale registration statement or a subsequent registered A/B exchange offer—as a condition to purchase. While Rule 144 now provides most purchasers of securities in a private placement the ability to resell publicly one year (or, in the case of reporting companies, six months) after purchase, registration rights are still for a number of reasons not uncommon in Rule 144A offerings. [3]

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Foreign issuers, on the other hand, often seek to place privately in the U.S. institutional market the same kinds of securities that they sell in their domestic markets or in international markets. They also seek the same pricing as they receive in those markets. The market for such private offerings by foreign issuers is well established and includes a broad range of U.S. institutional investors, reflecting the growing liquidity in overseas public markets and the growth of cross-border investing generally.

The principal reasons for the complexities of the private offering process, and for the lack of liquidity in the U.S. private offering market, are legal and regulatory. There have been two main areas of legal and regulatory focus to facilitate private offerings: providing issuers and participating financial institutions with certainty that an offering is exempt from registration under § 4(a)(2) of the Securities Act; and providing investors with flexibility to resell securities purchased in a private offering to increase liquidity. While these developments affect private offerings generally, they are particularly relevant to foreign issuers considering the U.S. private offering market.

With respect to providing certainty regarding the § 4(a)(2) exemption, since 1974, the SEC has provided safe harbor rules, now included in Regulation D under the Securities Act, for private offerings by issuers. While most U.S. private offerings to institutions by foreign issuers are made in reliance on § 4(a)(2) itself rather than Regulation D, [4] the safe harbor procedures provide important guidance on how to conduct U.S. private offerings.

Securities purchased in U.S. private offerings are viewed as "restricted" under SEC rules and thus may not be immediately resold publicly in the U.S. secondary market. [5] Since 1972, the SEC has provided a safe harbor under Rule 144 that permits unlimited resales of restricted securities in the public market by

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non-affiliates of the issuer after an initial holding period, which is currently six months for securities of an SEC-reporting issuer (provided the issuer has filed its required periodic reports under § 13 or 15(d) of the Exchange Act), [6] and one year for securities of other issuers. [7]

U.S. investors can immediately resell restricted securities into markets outside the United States and to qualified private placement investors in the United States, provided they satisfy certain conditions. Resales outside the United States of restricted securities of a foreign issuer were first approved by the SEC in a series of no-action letters beginning in the late 1980s, [8] and since 1990, they have been permitted by Regulation s under the Securities Act. [9] This is important for equity securities of foreign issuers because the home market generally has more depth, and the securities can in effect be sold in the "regular way" in that market.

Before the adoption of Rule 144A, resales of restricted securities to qualified U.S. investors had long been conducted under a legal analysis developed by the U.S. private bar and referred to as the "Section 4(1 ½) exemption." [10] In 1990, the SEC adopted Rule 144A, a safe harbor permitting resales to large institutional investors. The growing reliance on Rule 144A for U.S. institutional resales has led to the development of standardized practices for "Rule 144A offerings." Rule 144A offering practices differ from those in traditional § 4(a)(2) private

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placements, which prevailed before the advent of Rule 144A and are still sometimes conducted today. Rule 144A offerings are typically conducted on an underwritten basis, with terms and conditions substantially identical to those applicable to public offerings. In the case of debt securities, the investment banks that act as initial purchasers and resell in reliance on Rule 144A negotiate the terms of the securities to be offered, while a traditional private placement may involve direct and often protracted negotiations between the issuer and the ultimate investors.

A consensus has also developed within the private securities bar as to appropriate documentation with respect to Rule 144A offerings. [11] In connection with traditional private placements, the private bar has generally required letters from each purchaser (often referred to as nondistribution letters or investment letters) to negate the presence of a distribution subject to Securities Act registration, but these are not required from purchasers under Rule 144A. [12] Other similar requirements developed by the private bar, such as large minimum denominations, the use of legended physical securities and stop-transfer procedures, are also not necessary in connection with an offering made exclusively to "qualified institutional buyers," or "QIBs," under Rule 144A. [13] Regulation M under the Exchange Act specifically exempts Rule 144A offerings from limitations on trading during a distribution, [14] and securities sold in Rule 144A offerings are eligible for clearing at The Depository Trust Company ("DTC"), the principal U.S. clearing organization, which further facilitates trading under Rule 144A. Aftermarket trading in Rule 144A debt securities is also required to be reported to the Financial Industry Regulatory Authority, Inc. ("FINRA"), through the Trade Reporting and Compliance Engine ("TRACE"). [15]

Some concerns about the U.S. private placement market remain for non-U.S. issuers. Some foreign issuers are reluctant to submit to customary market practices incidental to a U.S. private offering, which even if limited to institutional investors and carried out under Rule 144A can involve procedures that

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foreign issuers find intrusive, including extensive "due diligence" inquiries and the need for accountants' and lawyers' negative assurances as to the quality of disclosure provided to initial investors. The requirement under Rule 144A that a nonreporting issuer covenant to provide certain information to purchasers and prospective purchasers in secondary market transactions has also sometimes raised questions for foreign issuers. Notwithstanding these concerns, offerings under Rule 144A by foreign issuers have been a popular approach to the U.S. markets since the Rule's adoption.

Footnotes

1 *See* § 7.02 for a discussion of certain of the principal precedents and SEC rules regarding private placements.

2 According to a published summary of capital markets activity in the United States, in 2015, there were 535 private placements of debt and equity in the U.S. market that raised a total of U.S.$137.0 billion. By comparison in 2015, there were 4,000 SEC-registered public offerings of debt and equity in the U.S. market that raised a total of approximately U.S.$2.1 trillion. Securities Industry and Financial Markets Association ("SIFMA"), 2016 Fact Book.

3 *See* § 7.05 for a discussion of registration rights.

4 *See* § 7.02[2].

5 Rule 144(a)(3) under the Securities Act defines "restricted securities" as, *inter alia*,

> (i) securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering, (ii) securities acquired from the issuer that are subject to the resale limitations of Rule 502(d) under Regulation D or Rule 701(c), (iii) securities acquired in a transaction or chain of transactions meeting the requirements of Rule 144A, (iv) securities acquired from the issuer in a transaction subject to the conditions of Regulation CE, and (v) equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of Rule 901 or Rule 903 under Regulation s.

Securities (other than equity securities of domestic issuers) offered in offshore offerings pursuant to Regulation s are not regarded as "restricted securities." For a discussion of resale restrictions applicable to securities originally sold under Regulation s under the Securities Act, *see* § 8.02.

6 Rule 144(c) under the Securities Act. Timely filing of current reports on Form 8-K (for domestic issuers) or reports on Form 6-K (for foreign private issuers) is not a requirement for this purpose.

7 Rule 144(d) under the Securities Act. The current holding period has been in effect since 2008. *See* SEC Release No. 33-8869 (Dec. 6, 2007). The holding period was originally three years and in 1997 was reduced to one year (subject to conditions relating to current public information, volume of sales, manner of sale and filing of Form 144) or two years (after which these conditions ceased to apply).

8 *See, e.g.*, *French Privatization Program* (avail. Apr. 17, 1987); *College Ret. Equities Fund* (avail. Feb. 18, 1987).

9 Rule 904 of Regulation s under the Securities Act. Resales under Regulation s are discussed in § 7.04[5].

10 *See* § 7.04[3]. *See generally Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*, 66 BUS. LAW, 85 (2010) (a Report by the Committee on Federal Regulation of Securities, ABA Section of Business Law); *The Section 4(1 ½) Phenomenon: Private Resales of "Restricted" Securities*, 34 BUS. LAW, 1961 (1979) (a Report to the Committee on Federal Regulation of Securities from the Study Group on Section 4(1 ½) of the Subcommittee on 1933 Act) ("*The Section 4(1 ½) Phenomenon*"); SEC Release No. 33-6806 (Oct. 25, 1988).

Resales of restricted securities may now also be effected under § 4(a)(7) of the Securities Act, added to the

Securities Act in December 2015. Although subject to certain limitations not thought by the private bar to be applicable to § 4(1 ½) resales, the non-exclusive safe harbor provided by § 4(a)(7) should be particularly useful in resales of restricted securities to accredited investors that are natural persons rather than institutional investors.

11 *See* § 7.04.

12 *See* § 7.02[3].

13 *See* text accompanying *infra* Note 80.

14 Rule 102(b)(7) under Regulation M. Prior to the adoption of Regulation M in 1996, Rule 10b-6 under the Exchange Act imposed limitations on trading by distribution participants in private placements that were considered distributions for purposes of Rule 10b-6. *See* SEC Release No. 34-38067 (Dec. 20, 1996); § 7.10.

15 FINRA Rule 6750 requires that information about aftermarket Rule 144A transactions be publicly disseminated immediately upon FINRA's receipt of the transaction report. *See* SEC Release No. 34-70345 (Sept. 6, 2013).

U.S. Regulation of the International Securities and Derivatives Markets, § 7.02, INSTITUTIONAL PRIVATE PLACEMENTS

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 § 7.02 (11th and 12th Editions 2014-2017)
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[1] Securities Act § 4(a)(2)

The legal basis for private placements and for subsequent resales among institutions and dealers derives from the exemptions from registration found in §§ 4(a)(1), 4(a)(2) and 4(a)(3) of the Securities Act. Section 4(a)(1) exempts from the registration requirements of the Securities Act "[t]ransactions by any person other than an issuer, underwriter or dealer"; § 4(a)(2) exempts "[t]ransactions by an issuer not involving any public offering"; and § 4(a)(3) exempts transactions by a dealer not acting as an underwriter. [16] The Securities Act defines an underwriter to include "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking." [17] One key to these exemptions lies in the twin concepts of a "public offering" and a "distribution" of securities: if there is no public offering, there is no distribution within the meaning of the Securities Act; and, if there is no distribution, there can be no underwriter, so that if there is no public offering, the issuer can find an exemption for its offers and sales under § 4(a)(2), the dealer under § 4(a)(3) and all others under § 4(a)(1) of the Securities Act.

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Whether a public offering has occurred may depend not only on the nature of the issuer's initial offer and sale of securities to a purchaser but also on the nature of subsequent reoffers and resales. If a purchaser from an issuer (or under prevailing SEC positions, any purchaser in a chain of sales from the issuer) resells in such a manner that the securities are distributed to the public, the selling party may be an underwriter and thus not be entitled to an exemption under § 4(a)(1) (or § 4(a)(3) in the case of dealers) and the issuer may not be entitled to an exemption under § 4(a)(2). [18]

What constitutes a "public offering" and, therefore, a distribution for purposes of the securities laws has been the subject of intense discussion. Starting immediately after the adoption of the Securities Act, requests for guidance concerning the § 4(a)(2) exemption were sufficiently numerous to prompt the General Counsel of the SEC to attempt a clarification of the "public offering" concept in 1935. The General Counsel's opinion established that 25 offerees were generally permissible in a private offering, and also enumerated four factors that the SEC would take into account in determining the existence or absence of a public offering. Those factors were (i) the number of offerees and their relationship to each other and to the issuer, (ii) the number of units offered, (iii) the size of the offering and (iv) the manner of the offering. [19]

After a number of conflicting lower court decisions, in 1953 the U.S. Supreme Court in *SEC v. Ralston Purina Co.* [20] attempted to clarify the scope of the private offering exemption by declaring that a public offering was one in which the investors required the protections applicable to public offerings; private offerings were those in which such protections were not needed: "[T]he applicability of [§ 4(a)(2)] should turn on whether the particular class of persons affected needs the protection of the [Securities] Act. An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’" [21]

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The Court in *Ralston Purina* determined that "[§ 5] would seem to apply to a 'public offering' whether to few or many." [22] Consequently, the Court did not fix a maximum number of offerees that would ensure the absence of a public offering. [23] Although *Ralston Purina* continues to be the seminal judicial pronouncement concerning private offerings, its effect was as much to increase the number of potential factual considerations appropriate to a § 4(a)(2) analysis as to focus the inquiry on the nature of prospective investors. [24]

The concept of investors "able to fend for themselves" was not as obvious as it seemed at first blush. The courts ruled that sophistication alone was not necessarily sufficient to ensure availability of the exemption; [25] a prospective investor's relationship with the issuer, based on factors such as employment, family or economic bargaining power, could be sufficient. [26] In addition, the burden to prove the availability of the exemption is placed on the person seeking to take advantage of it [27] and failure to satisfy the burden results in strict liability for the "seller." [28]

Notwithstanding the uncertainties regarding the private offering exemption under § 4(a)(2), the securities bar developed procedures and documentation for offerings before and after *Ralston Purina* that sought to take advantage of the

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exemption. The focus of these procedures was on the factors highlighted, albeit not consistently or uniformly, by the SEC and the courts, including the manner of offering, the number, wherewithal and sophistication of offerees and the relationship between the offerees and the issuer.

Even though the private offering market continued to operate, the SEC was pressured by market participants and the private bar, in light of the unease produced by the case law under § 4(a)(2) and the draconian liability that could result if the exemption were not available—rescission by all purchasers—to provide certainty as to the availability of the exemption. In response, the SEC in 1974 adopted a nonexclusive "safe harbor" rule for private offerings. [29] Eight years later, the SEC adopted Regulation D under the Securities Act, a more comprehensive, but still nonexclusive, safe harbor rule. [30]

[2] Regulation D

Rule 506 under Regulation D provides a safe harbor from registration for offers and sales by issuers. Prior to the SEC's implementation of § 201(a) of the Jumpstart Our Business Startups Act (the "JOBS Act") in 2013, one of the conditions for reliance on the safe harbor was that neither the issuer nor any person acting on its behalf could offer or sell securities under Regulation D by any form of general solicitation or general advertising. Section 201(a) of the JOBS Act directed the SEC to amend Rule 506 to permit general solicitation or general advertising in offerings under the Rule, subject to certain additional conditions. As a result, the SEC adopted changes to Rule 506 that left the existing safe harbor unchanged, but redesignated it as Rule 506(b), and added a new safe harbor in Rule 506(c), under which a private offering may make use of general solicitation and general advertising. [31] These safe harbors cannot be used for transactions other than offers and sales by an issuer. [32] Securities acquired in an offering

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made under Regulation D are "restricted" for purposes of the Securities Act registration requirements. [33]

[a] General Requirements

To qualify for the safe harbor under Rule 506(b), all of the following conditions must be met:

- Neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of general solicitation or general advertising. [34]
- Sales may only be made to "accredited investors" plus up to 35 persons who are not accredited investors. There is no limitation on the number of "accredited investors" to which sales may be made. [35]

- If any purchaser is not an accredited investor, then (i) the issuer must "reasonably believe" that each such purchaser "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment" [36] and (ii) each such purchaser must receive prior to sale certain information specified by the regulation,

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which is broadly similar to that required to be provided in an SEC-registered offering. [37]

- The issuer must exercise "reasonable care" to ensure that the purchasers of the securities are not underwriters within the meaning of § 2(a)(11) of the Securities Act (also referred to as "statutory underwriters")—that is, that they are not taking with a view to, or offering or selling for the issuer in connection with, a distribution of the securities. [38]
- The issuer must file a notice of the offering on Form D [39] with the SEC no later than 15 days after the first sale of securities in the offering. [40]

The safe harbor under Rule 506(c) differs from the safe harbor under Rule 506(b) in five respects:

- The requirement that there be no general solicitation or general advertising does not apply. [41]

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- Sales may only be made to accredited investors. [42]
- The issuer must check a box on Form D to indicate whether it is relying on either Rule 506(b) or Rule 506(c). [43] Some comments on the proposed rule suggested that an issuer might check both boxes—for example, if general solicitation is contemplated but might not be used, or to protect against losing the exemption as a result of inadvertent solicitation. [44] The adopting release specifies that the issuer must check one box or the other. [45] It would appear, however, that an issuer can amend a Form D for an offering to select 506(b) after having selected 506(c) in a prior Form D filing for that offering or vice versa, assuming all other conditions are met.
- The requirement that certain information concerning the issuer be furnished to any investor other than accredited investors [46] does not apply, because only accredited investors may participate. [47]
- The issuer must take "reasonable steps to verify" that the purchasers are accredited investors. [48] This is an independent procedural requirement, and it must be met even if in fact all offerees happen to be accredited investors.

[b] Required Reasonable Steps to Verify Accredited Investors in Rule 506(c) Offerings

The "reasonable steps to verify" that an issuer must take in a Rule 506(c) offering was the subject of extensive comment and is discussed at length in the adopting release. The release explains that it is a "principles-based" requirement, resting on "an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction." [49] Issuers should consider a number of factors, and the

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release discusses three examples: the nature of the purchaser, the information the issuer has about the purchaser, and the nature and terms of the offering. [50]

The final rule includes a safe harbor specifying acceptable, but nonexclusive, methods to verify the accredited investor status of natural persons. [51] The addition of the safe harbor was widely sought in the comment process following the proposed rule and is consistent with the SEC's decades-long practice of providing safe harbors from § 5 violations in light of the draconian consequences (in particular, a strict liability rescission right for purchasers) for those violations.

Specifically, Rule 506(c) provides a nonexclusive list of methods to verify accredited investor status for natural persons that will be deemed to satisfy the verification requirement. These are (a) review of specified documentation showing that a person meets the income test in the definition of accredited investor, [52] (b) review of specified documentation showing that a person meets the net worth test, [53] (c) reliance on written confirmation from a third party that it has verified the person's accredited investor status [54] and (d) reliance on certification from an existing investor who previously invested in a Rule 506(b) offering by the issuer. [55] The issuer may not rely on the Rule 506(c) safe harbor if it or its agent has knowledge that the purchaser is not an accredited investor. [56]

In addition to the new Rule 506(c), the SEC simultaneously adopted Rule 506(d) (pursuant to § 926 of the Dodd-Frank Act), which removes the protection of the Rule 506 safe harbor from offerings in which a "bad actor" participates. [57]

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Rule 506(d) applies if certain categories of persons are subject to certain disqualifying events.

The categories of persons are:

- the issuer, any predecessor, any affiliated issuer and any promoter;
- any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer;
- any beneficial owner of 20% or more of the issuer's outstanding voting equity securities;
- with respect to an issuer that is a pooled investment fund, any investment manager of the issuer;
- any person paid (directly or indirectly) to solicit purchasers in connection with sales in the offering (*e.g.*, a placement agent); and
- with respect to any such investment manager or solicitor, (i) any general partner or managing member and (ii) any director, executive officer or other officer participating in the offering of the investment manager, the solicitor or a general partner or managing member of the investment manager or solicitor. [58]

Disqualifying events include:

- criminal convictions in connection with purchases or sales of a security, making false filings with the SEC or that arise from conducting business as an underwriter, broker-dealer, investment adviser or paid solicitor;
- injunctions and court orders related to engaging in or continuing conduct or practices relating to such activities;
- final orders of certain federal and state regulators that either bar a person from engaging in securities, insurance, banking or similar activities (or from association with an entity regulated by the regulator issuing the order), or that

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  are based on a violation of any law or regulation prohibiting fraudulent, manipulative or deceptive conduct;
- SEC cease-and-desist orders arising from a violation of § 5 of the Securities Act or *scienter*-based antifraud provisions of the federal securities laws;
- certain other SEC orders (including suspension, revocation of registration or limitations on activities as a broker-dealer or investment adviser);

- suspension, expulsion or being barred from association with a national securities exchange or association for improper conduct;
- filing or being named as an underwriter in a registration statement as to which a stop or suspension order was issued, or being the subject of an investigation to determine whether such an order should be issued; or
- U.S. Postal Service false representation orders and certain temporary restraining orders or injunctions. [59]

The time periods for disqualification generally address conduct arising from between five and ten years prior to the date of the Rule 506 sale, although in certain cases an event will only be disqualifying if the injunction, order, investigation or similar event is in effect and continuing at the time of the Rule 506 sale.

Rule 506(d) limits disqualification to triggering events that occur after effectiveness of the Rule (September 23, 2013), although the issuer will still be required to disclose past events that would be disqualifying if they had occurred after the effective date to purchasers in advance of sales under Rule 506 (unless the issuer can establish that it did not know and reasonably could not have known of the existence of those past disqualifying events). Although this will still require issuers to determine whether any pre-adoption disqualifying events exist for purposes of disclosure, the change has helped to address at least some of the concerns raised by commenters as to market participants who may have voluntarily entered into consent decrees or who would otherwise be disqualified based on prior conduct, but who were not in a position to know of the consequences under revised Rule 506.

Rule 506(d) also includes a waiver provision, under which a waiver of disqualification may be granted by the SEC upon a showing of good cause. [60]

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Rule 506(d) sets out a "reasonable care" exception, under which an issuer will not lose the benefit of the Rule 506 safe harbor, despite the existence of a disqualifying event, if it can show that it did not know and, in the exercise of reasonable care, could not have known of the disqualification. The adopting release indicates the issuer will be expected to conduct a factual inquiry to rely on this exception and makes clear that the steps an issuer must take to be deemed to have exercised "reasonable care" will vary according to the particular facts and circumstances. [61] The release notes issuers will likely have in-depth knowledge of their own directors and officers, and that additional inquiry "by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement." [62] The release also notes the SEC's expectation that market participants, such as placement agents and broker-dealers, will develop procedures to assist issuers in gathering the necessary information. Finally, for continuous, delayed or long-lived offerings, the release notes that the requirement to exercise reasonable care will include updating the factual inquiry on a "reasonable" basis, but that, in appropriate cases, periodic updating should suffice. [63]

Regulation D is a safe harbor: compliance with its requirements assures the availability of the private placement exemption. Because it is a nonexclusive safe harbor, however, failure to comply with its requirements does not preclude reliance on § 4(a)(2) to conduct a good private offering. In fact, issuers and their legal advisers generally follow the guidelines of Regulation D as to the manner of conducting a private offering while not attempting formal compliance with the regulation itself. [64] In particular, foreign issuers, like many U.S. issuers, are

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reluctant to publicly disclose the information required by Form D, including the compensation paid to dealers. [65]

Many of the requirements built into Regulation D mirrored prior practice, and their adoption by the SEC provided such practice with new support, even if not all of the technical requirements of the regulation are followed. Other aspects of Regulation D were new developments. [66] Similarly, many of the procedures and practices that developed to ensure compliance with Regulation D were derived from offering practices that predated the regulation. However, the promulgation of the regulation, due to the specificity of its standards as compared to the vague case law under § 4(a)(2), has created greater consistency in the practices followed in private offerings of securities, whether reliance is placed on Regulation D or on § 4(a)(2) itself.

The guidance provided by Regulation D concerning the types of activities that may constitute general solicitation or general advertising has become standard, and still relevant for issuers that seek to offer or sell securities pursuant to Rule 506(b) or the statutory exemption in § 4(a)(2) of the Securities Act. [67] Although Rule 502(c) nonexclusively identifies certain activities that constitute a general solicitation, [68] many issuers have sought no-action advice from the SEC staff concerning particular situations. The general rule that has emerged from staff positions is that no general solicitation will be found to have occurred if there is a pre-existing relationship between the offeror (or its agent) and offeree,

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sufficient to permit the offeror to evaluate the financial sophistication of the offeree. [69]

Rule 502(d) of Regulation D specifies that the issuer must "exercise reasonable care to assure that the purchasers of the securities are not underwriters"—in other words, that purchasers are not taking securities with a view to distribution. The Rule identifies certain steps that an issuer should consider implementing: (i) reasonable inquiry as to whether the purchaser is acquiring the securities for its own account or the account of another person, (ii) notice to purchasers that the securities in question have not been registered under the Securities Act and cannot be resold unless registered or pursuant to an exemption from registration and (iii) the use of an appropriate legend on the securities. The Rule states, however, that these steps are not the exclusive means of complying with the "reasonable care" test.

The private securities bar has developed a fairly consistent series of procedural steps intended to meet the requirements of Regulation D and also the less certain statutory standard of § 4(a)(2) itself. First, letters, commonly called "investment letters" or "nondistribution letters," are generally required of each buyer. In such a letter, the buyer generally (i) is notified and acknowledges that the securities in question were not registered under the Securities Act, (ii) certifies that it is a sophisticated investor and has received all information it has requested about the investment [70] and (iii) acknowledges that it is not purchasing the securities in question with a view to distribution (within the meaning of the Securities Act). Such letters often also include an agreement by the buyer that in the absence of registration or, in certain cases, a clearly available exemption, [71]

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resales of the securities will only be permitted if accompanied by a legal opinion that the resale in question is exempt or if the resale complies with specified restrictions designed to provide sufficient assurances that an exemption from registration is available. Second, the securities are often either denominated, or offered and sold, in large amounts (in the hundreds of thousands or even millions of dollars) that are usual for institutional private transactions but not characteristic of public offerings to retail investors. Third, the number of offerees, generally other than institutional accredited investors, is often limited. Fourth, if the securities are in physical form, the certificates contain restrictive legends and are often subject to stop-transfer instructions to prevent unapproved resales. Such instructions are a mechanism to apply to subsequent purchasers the transfer restrictions imposed on the original purchasers through investment or nondistribution letters. If the securities are not in physical form, either because they are represented by interests in a global security or because they are part of a paperless, book-entry system, other mechanisms may be used for the same purpose. [72]

Despite an overall fairly standard pattern, the exact combination of procedures used in a particular offering may depend on the circumstances. Not all of these procedures are employed in all § 4(a)(2) offerings. For example, in private offerings of commercial paper, with its short maturities and relative lack of trading, the procedures are usually somewhat curtailed. Most important, if the securities to be offered are Rule 144A-eligible and are offered and sold only to "qualified institutional buyers," or QIBs, as defined in Rule 144A, typically the procedures implemented are quite limited, investment letters are not required and no policing of resales is considered necessary. [73] Even if the securities are not Rule 144A-eligible (because, when issued, they were fungible with securities listed on a U.S. exchange), procedures can also remain relatively limited if the securities are offered and sold only to QIBs and there is a *bona fide* market for these securities outside the United States. [74] The procedures in these cases generally would include a notice that the securities may only be resold outside the United States, investor letters confirming each purchaser's status as a QIB and an agreement by each purchaser to resell shares only outside the United States under Regulation s and not to conduct any hedging activities that would be in

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violation of the Securities Act, as well as procedures designed to restrict deposit of securities acquired during the offering into any American Deposit Receipt ("ADR") facility for a period of 40 days after commencement of the offering.

[3] Rule 144A Private Placements

Rule 144A under the Securities Act, adopted in 1990, provides a nonexclusive safe harbor from registration for resales to institutions reasonably believed by the seller [75] to be QIBs. The securities may not be "of the same class" as, or fungible with, securities listed on a national securities exchange or traded on a U.S. automated inter-dealer quotation system. [76] The Rule imposes only two procedural requirements: (1) the seller must take reasonable steps to ensure that purchasers are aware that the seller may be relying on the Rule and (2) in the case of issuers (other than foreign governmental issuers) that do not report or furnish information to the SEC under the Exchange Act, purchasers must have a right to obtain prior to sale certain information concerning the issuer of the securities.

Although Rule 144A is a safe harbor only for *resales*, it provides a way for an issuer to conduct a private placement to large institutional investors without the cumbersome measures to police resales that otherwise apply under § 4(a)(2) of the Securities Act or Regulation D thereunder. [77] The Rule provides that an investor or a dealer that reoffers or resells securities in compliance with the Rule is not engaged in a distribution and is not an underwriter. Rule 144A is premised on the theory that QIBs can "fend for themselves" and therefore do not need the protections of the registration requirements of the Securities Act; accordingly, sales made only to QIBs are not considered to be distributions. Moreover, because QIBs are considered to be familiar with resale restrictions, sales to them are thought to pose little risk that they could lead to a subsequent distribution. Because resales to QIBs under the Rule are not themselves distributions, and pose little risk of leading to subsequent distributions, they are not public

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offerings, and an investor or dealer taking restricted securities purchased from an issuer and reselling them to QIBs is not an underwriter. Thus, the § 4(a)(1) exemption is available for investors (other than dealers) selling in compliance with the Rule, and the § 4(a)(3) exemption is available for dealers. [78] Finally, since the resales are not public offerings, they are consistent with the requirement that an issuer's reliance on § 4(a)(2) or Regulation D be supported by reasonable care to assure that the purchasers of the securities are not underwriters. [79]

Consequently, Rule 144A, although it technically applies only to resales and not to offers and sales by issuers, effectively permits a simplified form of private offering by an issuer. It codifies a form of resale of privately placed securities in a manner that permits the use of simplified procedures both upon an issuer's initial sale and upon such resales. The procedures described above in connection with § 4(a)(2) and Regulation D private placements, including investment letters, limitations on the number of potential offerees (at least outside the safe harbor of Regulation D) and the use of legends, stop-transfer and other procedures that affect pricing and liquidity, are generally not required—either for the initial issuance if the securities are to be resold only under Rule 144A, or for any subsequent resales relying on the Rule. [80] A key effect of this simplification is the enhanced marketability on original issuance of securities that may be resold in reliance on Rule 144A.

One of the objectives of Rule 144A was to make primary offerings of foreign securities available to U.S. institutions in the U.S. market through intermediaries (rather than forcing such investors to go to overseas markets) by making the private offering market in the United States more attractive to foreign issuers. [81] The absence of significant procedural limitations on trading under Rule 144A has increased the willingness of foreign issuers to offer their securities in the United States, both in separate offerings and in conjunction with larger, global offerings. Indeed, a firm commitment offering targeted to QIBs in the United States under Rule 144A is conducted very much like an underwritten public offering except that purchasers are restricted to large institutional investors. [82] Preliminary offering memoranda are often circulated, standard documentation is used, and road shows are conducted to give eligible investors the chance to hear from and question management.

[a] Qualified Institutional Buyer

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The criteria for eligibility as a QIB depend on the type of institution involved. [83]

(i) Any institution in one of the following categories is a QIB if it owns, or invests on a discretionary basis, at least $100 million in securities:

a) a corporation (other than a U.S. or foreign bank or thrift), [84] a partnership, [84.1] a not-for-profit organization qualified under U.S. federal tax law, [85] or a "Massachusetts or similar business trust"; [86]

b) an insurance company; [87]

c) a public or private employee benefit plan or a trust fund for the benefit of such plans; [88] or

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d) an entity registered under applicable U.S. federal statutes as an investment adviser, an investment company, a small business investment company, a business development company or a small business development company. [89]

(ii) A securities dealer registered under the Exchange Act is a QIB if it owns, or invests on a discretionary basis, at least $10 million in securities. Even if it does not meet this threshold, it is a QIB when it acts in a "riskless principal transaction" for a QIB—where it buys a security and makes a simultaneous offsetting sale of such security to a QIB. [90]

(iii) A registered investment company is a QIB if it is part of a "family" of registered investment companies that in the aggregate owns, or invests on a discretionary basis, at least $100 million in securities. This alternative is available to an investment company that does not meet the investment threshold on its own, as described in paragraph (i)(d) above. Under the Rule, a family of investment companies means any two or more investment companies registered under the Investment Company Act (other than a unit investment trust investing solely in shares of other registered investment companies) that have the same investment adviser, or depositor in the case of unit investment trusts. [90.1] Advisers or depositors that are majority-owned subsidiaries of the same parent or of one another will be considered to be the "same" adviser or depositor. [91]

(iv) A U.S. or foreign bank, thrift or equivalent institution is a QIB if it owns, or invests on a discretionary basis, at least $100 million in securities and it also has net worth of at least $25 million. [92] The SEC imposed the net worth test on the grounds that U.S. banks and thrifts, because they are federally insured, "effectively are able to purchase securities using public funds." [93] It extended the net worth

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test to foreign banks and thrifts and equivalent institutions for competitive reasons. [94]

(v) Any entity is a QIB if all of its equity owners are QIBs. [95]

The SEC has clarified that a purchase under the Rule by an insurance company on behalf of one or more of its separate accounts that are not registered, or required to be registered, under the Investment Company Act will be deemed to be a purchase by the insurance company. [96] It is not sufficient, in the case of a sale to an investment adviser or other fiduciary acting with discretion on behalf of another institution, that the adviser or fiduciary be a QIB—both the adviser or other fiduciary and the underlying account must meet the Rule's requirements.

The Rule generally requires that securities holdings be valued at cost, unless the institution reports its holdings on the basis of market value and no current information regarding the cost of the securities has been published (in which case the securities may be valued at market). The Rule also specifies that the securities holdings of an entity's consolidated subsidiaries may be included in the calculation only if they are managed by the entity and that the securities may not be included at all if the entity is itself a majority-owned subsidiary included in the consolidated financial statements of another entity, unless the entity is an Exchange Act-reporting company.

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Securities issued or guaranteed by the United States and its instrumentalities, [97] securities held on margin and securities loaned out to borrowers [97.1] are permitted to be included in calculating the amount of securities investments by an institution, whereas bank deposit notes and certificates of deposit, loan participations, [98] repurchase agreements, securities subject to repurchase agreements, borrowed securities and short positions in securities [98.1] as well as currency, interest rate and commodity swaps may not be so included. [98.2] A broker-dealer may not include allotment securities in its calculation. [98.3]

Rule 144A specifies that sellers can rely on certain means identified in the Rule to establish that a prospective purchaser satisfies the securities ownership requirement. [99] The most widely used method among U.S. broker-dealers to establish that a prospective purchaser is a QIB is to rely on a "QIB list" maintained by a commercial service. [100]

[b] Nonfungible Securities

A security's eligibility for resale under Rule 144A is determined when the security is issued. A security is not eligible for resale under Rule 144A if when

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issued it is "of the same class" as securities listed on a U.S. national securities exchange or quoted in a U.S. automated inter-dealer quotation system. The fungibility test of Rule 144A is intended to prevent the creation of "side-by-side" public and private markets in the same security, which could divert resales of the securities away from the public market with possible adverse implications for the public market's liquidity and volatility. [101] Securities of a particular class that are issued prior to the listing of that class (such as securities held by significant shareholders of an issuer at the time of its IPO, often referred to as "founder shares") are eligible for resale under Rule 144A if they can be specifically identified.

Rule 144A is not available with respect to the securities of any open-end investment company, unit investment trust or face-amount certificate company that is or is required to be registered under § 8 of the Investment Company Act. [102]

Convertible and exchangeable securities present specific issues under the nonfungibility requirement. In general, securities that are convertible into or exchangeable for securities that are listed on a U.S. national securities exchange or quoted on a U.S. automated interdealer quotation system are not considered to be fungible with such listed or quoted securities if such convertible or exchangeable securities had an effective conversion premium of 10% or more when issued. [103] In addition, warrants to purchase such U.S. listed or quoted securities are not considered fungible with such securities if the warrants are exercisable for at least three years after issuance and had an effective exercise premium of 10% or more when issued. [104] Listed or quoted ADRs are considered fungible with the class of securities that underlies them. [105] Mandatorily exchangeable

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securities, which involve the issuance by issuer A of a debt security mandatorily exchangeable at its maturity into a security, generally common stock, of issuer B (or, at A's election, its cash equivalent), raise additional issues under Rule 144A, particularly relating to the nonfungibility requirement. [106] The SEC has retained authority to designate other securities as not fungible with listed or quoted securities, [107] but to date has not exercised its authority. Because not many debt or preferred stock issues are listed on a U.S. securities exchange, the question of fungibility arises less often than for common stock.

Whether a new issue of equity securities will be considered to be part of the "same class" as outstanding securities listed or quoted for purposes of Rule 144A depends on whether they are of substantially similar character and whether the holders have substantially similar rights and privileges. Although used for many years and for a variety of purposes in the U.S. federal securities laws, [108] this standard has not been elaborated in SEC no-action letters. A difference in designation alone will not be sufficient to create distinct classes. [109] In general, if equity securities differ as to preference or voting rights, they will not be considered to be of the same class. [110] On the other hand, if equity securities have identical terms with respect to dividend, liquidation and voting rights, but differ as to terms such as redemption or convertibility, they nevertheless may be deemed to constitute a single class. [111]

In the case of preferred stock and debt securities, the SEC stated in the release adopting Rule 144A that issues "commonly viewed as different series will generally be viewed as different, nonfungible classes of securities for purposes of Rule 144A." [112] The SEC stated, however, that preferred stock issues

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will be considered to be of the same class "if their terms relating to dividend rate, cumulation, participation, liquidation preference, voting rights, convertibility, call, redemption and other similar material matters are substantially identical." [113] Debt securities will be considered fungible if there is substantial identity in terms relating to coupon rate, maturity, subordination, security, convertibility, call, redemption and any other material terms. [114]

[c] Information Delivery

If the issuer of the securities is a reporting company under the Exchange Act, or if it is exempt from reporting under Rule 12g3-2(b) thereunder, [115] Rule 144A does not impose any requirement concerning available public information as a condition for resale under the Rule. There is also no information requirement if the issuer is a foreign government or government agency eligible to register securities under Schedule B to the Securities Act. [116]

Otherwise, however, Rule 144A provides that, as a condition to an exempt resale, the holder and the prospective purchaser must "have the right to obtain from the issuer" certain reasonably current information concerning the issuer. Documentation for Rule 144A offerings typically addresses this requirement by including an undertaking by the issuer to provide any information required by Rule 144A(d)(4) in connection with a future resale, unless it is reporting or exempt at that time. The existence of a reporting obligation in the issuer's home jurisdiction does not suffice. In the case of guaranteed securities, the SEC has stated that the information furnishing requirement does not apply if the guarantor is a reporting company under the Exchange Act or exempt pursuant to Rule 12g3-2(b) thereunder; alternatively, the information furnishing requirement may

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be satisfied in the case of guaranteed securities by looking to information furnished under Rule 144A(d)(4)(i) by the guarantor. [117] The Rule permits the seller or any of its agents, in addition to the issuer and its agents, to deliver the information to the prospective purchaser.

The information required by Rule 144A is a brief description of the issuer's business and the products and services it offers, its most recent balance sheet, profit and loss and retained earnings statements, and similar financial statements for that portion of the two preceding fiscal years during which the issuer has been in operation. [118] The financial statements should be audited "to the extent reasonably available," and the information must be "reasonably current" in relation to the date of resale pursuant to the Rule. The Rule specifies that information will be deemed to be "reasonably current," in the case of a foreign private issuer, if it meets the timing requirements of the issuer's home country or principal trading markets. [119]

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It has been suggested that the requirement to supply information could create additional liability for issuers under the U.S. securities laws, including in particular civil liability under § 10(b) of the Exchange Act and Rule 10b-5 thereunder. [120] This potential liability could also exist for any broker-dealer or other seller that provides the information to a prospective purchaser under Rule 144A. Rule 10b-5 imposes liability for material misstatements or omissions made in connection with the sale of a security. To sustain a claim under Rule 10b-5, a plaintiff must prove both that the defendant acted with *scienter* (*i.e.*, intentionally or recklessly) and that the plaintiff relied on the misstatement or omission in making its purchase. Issuers (and broker-dealers) providing information pursuant to Rule 144A(d)(4) may also be subject to liability for such information under state securities laws and the common law. [121] A particular issue with respect to liability is whether the information delivery requirement of Rule 144A(d)(4) includes a duty of the issuer to update the information with material developments affecting the issuer's financial condition and results of operations [122]—in effect, to maintain an "evergreen" disclosure document—to avoid liability to purchasers who request the information.

Although these risks may be remote, a nonreporting foreign issuer should consider whether to avoid the Rule 144A information requirement by complying with the conditions for the Rule 12g3-2(b) exemption from reporting, especially if a high volume of Rule 144A resales can be expected. [123] There is then no

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requirement to supply information as a condition to Rule 144A resales and no duty to keep information current or updated other than to continue complying with the conditions for the Rule 12g3-2(b) exemption. [124] Complying with the Rule 12g3-2(b) exemption would, however, also permit the establishment of a public ADR program for the issuer's securities without the issuer's consent, and this could be a disadvantage for an issuer that otherwise prefers to prevent the establishment of unsponsored ADR programs. [125]

[d] Notice

Rule 144A requires that a seller and any person acting on its behalf "take reasonable steps to ensure that the purchaser is aware that the seller may rely on [Rule 144A]." [126] This requirement will not in most cases present any difficulties. If the sale is by an investment bank in connection with a purchase from an issuer in a private placement, the offering document will indicate that the bank and other members of the syndicate may rely upon the Rule. If no offering document is prepared, such as where a block trade is being conducted on an "undocumented" basis, [127] notice may be provided in confirmations of sale. [128]

[4] Publicity and Marketing Consistent with Restrictions on General Solicitation and General Advertising

Although the SEC has eliminated the prohibitions on general solicitation and general advertising applicable to Rule 506(c) offerings and Rule 144A offerings, the prohibition on general solicitation and general advertising continues to apply to offerings made under Rule 506(b) and the statutory exemption under § 4(a)(2). [129] A press announcement in or directed into the United States regarding a private offering, which is made prior to completion of the offering, may constitute a general solicitation or general advertisement of the offer and could

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jeopardize the availability of these private placement exemptions. [130] There are, however, two rules that provide "safe harbor" protection by specifying that communications meeting specified conditions are not deemed to be offers.

Rule 135c under the Securities Act provides a safe harbor for certain public announcements of unregistered offerings by the issuer. It is similar to Rule 135, a safe harbor for announcements of registered public offerings made prior to the filing of a registration statement, but unlike Rule 135 it is available only to the issuer and not to a selling securityholder. To rely on the Rule 135c safe harbor, the issuer must be either subject to the reporting requirements of § 13 or § 15(d) of the Exchange Act or exempt from Exchange Act reporting requirements pursuant to Rule 12g3-2(b) thereunder. [131] Rule 135c(b) provides that an issuer may announce an offering in the form of a news release, written communication to securityholders or employees, or other published statements. The announcement may include (i) the name of the issuer, (ii) the title, amount and basic terms of the securities offered, (iii) the amount sold by any selling securityholders, (iv) the time of the offering and (v) a brief statement of the manner and purpose of the offering without naming the participating financial institutions. [132] The announcement must also include a legend to the effect that the securities have not been registered under the Securities Act and may not be offered or sold in the United States absent registration or an applicable exemption. Rule 135c specifies that it is not available if the announcement is made to condition the market for the offered securities. A foreign private issuer subject to Exchange Act reporting requirements must furnish a copy of any Rule 135c announcement to the SEC on Form 6-K. An issuer subject to the domestic reporting forms would instead file the announcement on Form 8-K. [133]

Rule 135e under the Securities Act provides a safe harbor for certain press-related activities outside the United States. It was adopted in 1997 to encourage issuers to grant the U.S. press equal access to offshore press activities in connection with offshore offerings. [134] Under Rule 135e, a foreign private issuer, foreign government issuer, or selling securityholder may give U.S. journalists access to offshore press activities relating to an offering of securities without being deemed to have made an offer for the sale of a security within the meaning

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of § 5 of the Securities Act, engaged in "general solicitation" within the meaning of Regulation D or engaged in "directed selling efforts" within the meaning of Regulation s —provided that it respects certain conditions. These conditions are (i) at least part of the offering is conducted outside the United States, (ii) access is provided to both U.S. and foreign journalists and (iii) any written materials released to journalists bear a specified legend and meet certain other conditions. Issuers conducting side-by-side offshore offerings and U.S. private offerings may rely on Rule 135e in conducting offshore press activities, so long as there is "an intent to make a *bona fide* offering offshore." [135]

The elimination of the prohibitions on general solicitation and offers to non-QIBs in Rule 506(c) and Rule 144A offerings, respectively, permits issuers and their agents to communicate with prospective investors in Rule 144A and Rule 506(c) offerings with no limit on the method of communication or the number or type of investors reached. Issuers may use, among other methods, cold calls, blast e-mails, advertisements, articles and other communications published in newspapers, magazines, on the Internet or in television or radio broadcasts. The liberalization also allows communications about these kinds of offerings at conferences, promotional seminars or other meetings. Regardless of the prospective investors reached by these communications, the ultimate sales must be made to investors reasonably believed to be QIBs (in Rule 144A offerings) or accredited investors (in Rule 506(c) offerings).

Issuers and their agents should be aware that any communications made to prospective investors are, of course, still subject to the antifraud provisions of the securities laws and, in particular, § 10(b) of the Exchange Act and Rule 10b-5 thereunder. In addition to liability concerns related to the purchasers in the offering itself, use of general solicitation may also expand the scope of potential liability for information contained in these communications to secondary market participants, either with respect to the security being sold or other securities of the issuer. Furthermore, many foreign jurisdictions have their own rules and restrictions regarding publicity in connection with offerings [136] that will require careful analysis and consultation with local counsel. As a result, issuers and their agents should carefully consider the content, form and distribution of general solicitation communications. To date, offering participants do not appear to be

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making any dramatic changes to offering practices to take advantage of the added flexibility.

Nevertheless, some changes in practice with respect to press releases and other publicity about or at the time of an offering pursuant to Rule 144A or Rule 506(c) seem likely over time. These press releases and other communications no longer need to comply with the strict requirements of Rule 135c under the Securities Act or other similar safe harbors. For example, participating financial institutions may now wish to include their names on press releases. In light of liability concerns, however, it would still be prudent to limit the content and ensure it is consistent with the offering circular. The timing of offering press releases is unlikely to change—they are unlikely to be published prior to launch both to avoid liability concerns associated with making statements prior to finalizing the content of the offering circular and also to preserve flexibility for the offering participants about whether and when to launch the offering. [137]

In light of these liability concerns, issuers and participating financial institutions may also want to limit discussion of Rule 144A and Rule 506(c) offerings at conferences or other public speaking engagements to completed transactions [138] and, after an offering has launched, to information consistent with the offering circular. [139]

Finally, the ability to use general solicitation permits issuers and their agents to expand the pool of potential investors and contact investors with which they had no pre-existing relationship. Over time, paid referral agencies and other similar services may develop to facilitate this process. [140]

The publication of a research report on an issuer by a financial institution participating in a distribution of securities of that issuer may be viewed as general solicitation, which would be inconsistent with the exemptions under Rule

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506(b) or § 4(a)(2). Accordingly, a financial institution that is participating in a U.S. private placement will ordinarily cease publishing research on the issuer in the United States unless the research qualifies for a safe harbor under Rule 138 or Rule 139 under the Securities Act. These safe harbors were originally developed to permit continuation of research coverage during a registered offering, but the SEC and the private bar understood them to be available also to permit publication of research during a Rule 144A offering, and the rules were amended in 2005 to codify that view. [141] In light of the adoption of Rule 506(c) and the change to Rule 144A, financial institutions are no longer restricted from publishing research reports on an issuer conducting a Rule 506(c) or a Rule 144A offering. However, given the liability concerns under Rule 10b-5, financial institutions participating in these offerings are not likely to take advantage of this flexibility to publish research other than in the ordinary course or that refers to a pending offering.

Rule 138 permits the publication of a research report about a qualifying issuer if the report relates to securities other than the type of securities being offered. Rule 139 permits issuer-specific research to continue if it meets certain conditions and the issuer is eligible. Eligible issuers include seasoned Exchange Act-reporting companies and nonreporting foreign private issuers that meet certain quantitative criteria for public float and trading markets. Rule 139 also permits the inclusion of an issuer in an industry report under specified circumstances. [142] The safe harbors typically are not available where the offering is a debut offering in the issuer's home market.

If a foreign private issuer is offering securities outside the United States, the participating financial institutions may propose to publish research reports in advance of the offering—often referred to as "pre-deal" research—based on customary practices in the home jurisdiction or other markets where the securities will be offered; this is particularly common in debut offerings. [143] For pre-deal research distribution in the United States, the participating financial institutions

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may rely on Rule 144A, which includes no prohibition on general solicitation and general advertising. They must also, however, consider limitations on the distribution of research in the United States that arise from the Global Research Settlement and FINRA rules limiting interaction between investment banking and research personnel. [144] Among other things, the settlement strictly limits communications between investment bankers and research analysts at the investment banking firms that are party to it, while the FINRA rules prohibit investment bankers at member firms from directing [145] a research analyst to engage in sales or marketing efforts related to an offering or to engage in any communication with an investor about an offering. Compliance with these restrictions, as well as concern over 10b-5 liability, led investment banking firms to refrain from distributing pre-deal research in the United States even to eligible investors in Rule 144A offerings and traditional private placements.

The practice of holding meetings between research analysts and prospective investors to discuss an issuer and its securities prior to the commencement of marketing—often referred to as "investor education"—also presents issues

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under the Global Research Settlement and FINRA rules. It is common in some markets outside the United States for meetings of this kind to occur in connection with a debut offering after the first public filing or other public disclosure. When the offering will include a Rule 144A component, research analysts at the banks involved may wish to conduct investor education with investors in the United States. Considering the potential liability for communications with investors during these meetings, analysts have generally only met with a limited number of QIBs despite the greater flexibility to engage with investors afforded by amendments to Rule 144A introduced by the JOBS Act. Investment banking personnel and representatives of the issuer may not participate in the meetings, and they must be organized and scheduled in compliance with the prohibition under the FINRA rules on investment banking personnel directing research analysts to engage in sales and marketing efforts or to communicate with investors concerning an offering. The information concerning the issuer that is used in investor education should be consistent as to factual matters with what will be included in the preliminary offering circular, though it often includes the analyst's (but not the issuer's) projections. Written presentations used in the meetings generally are not delivered in a manner that allows investors to retain them.

There is also a wide range of pre-launch investor contacts that do not include research personnel, and a range of terminology to describe them. One common form is sometimes called "pilot fishing," "pre-sounding" or "testing the waters"—contacts between the issuer and potential investors arranged by the investment bankers with a view to, for example, gauging investor interest, deciding whether to proceed with an offering, identifying issuers considered comparable, or developing an approach to valuation and the price range for launch. In private offerings by foreign private issuers, pilot fishing may occur in a variety of circumstances, such as a Rule 144A offering that is part of a home-country IPO, or a proposed debt offering in difficult market circumstances. Similarly, in some Rule 144A offerings, the launch of marketing is preceded by investor meetings at which the issuer and the investment bankers make a road show style presentation but do not typically market a specific offering (sometimes referred to as a "nondeal road show"); whether the launch then occurs depends on investor receptivity and market conditions.

In these pre-launch marketing activities, as with investor education, the issuer information is consistent with what will be included in the offering circular, investors do not retain written presentations, and the meetings are limited to QIBs. Some bank policies impose limits on the number of investors that may be contacted in some forms of pre-launch marketing, and the laws of the home country or other markets may require further limitations. Sometimes difficult negotiations arise concerning whether the issuer's indemnification, under the purchase agreement for the offering, should cover materials used in pilot fishing,

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pre-launch investor meetings or even investor education. Marketing to prospective "cornerstone" or "anchor" investors can raise some of the same issues. [146]

[5] Use of the Internet for Private Placements

As is the case with public offerings, the Internet provides an additional forum for private placements of securities, whether in the United States in reliance on § 4(a)(2) of the Securities Act or Regulation D thereunder or pursuant to Rule 144A or outside the United States in reliance on Regulation s. Because of the widespread public access to the Internet, conducting a private offering through the Internet in a manner that complies with the requirements for a valid private offering—in particular limiting, in the case of § 4(a)(2), the number and type of offerees and (with respect to Rule 506(b) offerings under Regulation D as well) the prohibition on the use of general solicitation or general advertising [147]—poses particular challenges.

[a] Material Available on Unrestricted Websites

Despite the existence of appropriate, restricted access procedures for offering-related information on a website, issuers in private placements made pursuant to § 4(a)(2) or Rule 506(b), in which general solicitation is not allowed, are advised to refrain from including on their unrestricted websites information that can reasonably be expected to encourage directly or indirectly interest in the offering or that could be deemed to have been released primarily for the purpose of directly or indirectly encouraging interest in the offering. This includes all information about any aspect of the offering (other than what is permitted by Rule 135c). [148] It can also encompass information about the operations, financial position or prospects of the company, statements with respect to the level of dividend payout, any predictions, projections, forecasts or opinions regarding the

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value of the company, any "corporate image" or other advertising not in the ordinary course of the company's business or inconsistent with its past practice and any information released through arranged press coverage about the company. Information that relates solely to the company's products or services and the publication of which is consistent with the company's past practice generally may be kept on an unrestricted website. As a rule, issuers in private offerings pursuant to § 4(a)(2) or Rule 506(b) should not establish or expand unrestricted websites until after completion of the offering. [149]

[b] Electronic Road Shows

One component of private offerings for which issuers have made frequent use of the Internet is the road show. As in the case of public offerings, [150] the SEC has approved the use of the Internet to conduct road shows for private offerings in the United States. [151] In order to comply with § 4(a)(2) of the Securities Act, no-action guidance has sought to ensure that the electronic road show is transmitted on behalf of a seller solely to persons reasonably believed to be QIBs (or accredited investors in Regulation D or traditional private placements). [152] Other protective measures arising from no-action relief or traditionally advocated by counsel include measures similar to those in the context of road shows for public offerings. These include presenting the entire unedited live road show, [153] except for corrections of misstatements and deletions of dead air, making the offering circular available on the website, accessible only through a password-protected "button" on the site; restrictions on downloading, videotaping or other copying and distribution of the road show's content, and consistency between the road show and the offering circular. The limited no-action relief granted in the context of private offerings so far suggests that unlimited viewings of a road show may be permitted until the offering is concluded.

[c] Non-U.S. Offerings

Special concerns arise when an issuer conducts through the Internet a private placement in the United States concurrently with an offshore offering to

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non-U.S. persons under Regulation s. In such cases, the SEC staff has suggested some measures that could be taken in order to comply with § 4(a)(2) and Rule 506(b) of Regulation D, as the case may be, but has expressly indicated that other types of measures may be sufficient to prevent offshore Internet offerings from being used to solicit investors in a private placement in the United States. [154] Consistent with the staff's suggestions, persons responding to the non-U.S. Internet offering should be prohibited from participating in the concurrent private placement in the United States, even if they would otherwise be qualified to do so. In addition, access to the offering materials posted on the Internet for the Regulation s offering should generally be limited to those viewers who first provide residence information (and who do not provide other information that would otherwise indicate that they are U.S. persons). [155] Finally, unless password protections are put in place, the posted offering information should generally be limited to information about the non-U.S. offering, except for information about the U.S. offering required by applicable non-U.S. law to be provided to investors participating in the non-U.S. offering.

[d] Electronic Document Distribution

Just as the SEC has expressly permitted the Internet to be used for the dissemination of mandatory disclosure documents in a U.S.-registered offering, [156] the Internet may also be used to distribute disclosure documents in a Regulation D private placement, a Rule 144A transaction or a traditional private placement, provided that the relevant requirements applicable to these types of offerings are satisfied. [157] The same considerations applying to hyperlinks in the context of

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public offerings apply in private offerings as well. [158] In addition, many market participants now distribute disclosure documents in Rule 144A transactions or other private offerings by e-mail; prior to the changes, to Rule 144A permitting general solicitation, such e-mails typically included a legend as to the possible reliance upon an exemption from the registration requirements under the Securities Act and the restrictions on redistribution of such disclosure documents. Although broad-reaching redistribution is no longer restricted by Rule 144A, the inclusion of legends on such e-mails is unlikely to change given the 10b-5 liability concerns discussed above. [159]

[6] Integration Concerns and Mixed Private/Public Offerings

All sales that are part of "the same Regulation D offering" must meet all the requirements for the exemption. This "integration" doctrine was developed to prevent a public offering from being divided into multiple "private" offerings to avoid registration. Regulation D provides a safe harbor from this "integration" doctrine with respect to offers and sales made more than six months before or after the transaction under consideration. [160]

The ability to use general solicitation in Rule 506(c) offerings raised integration questions in the context of proximate private offerings. If a Rule 506(c) offering that uses general solicitation is integrated with a Rule 506(b) offering, the general solicitation will result in the loss of the Rule 506(b) exemption and any sales to nonaccredited investors will be a violation of § 5. [161]

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If an issuer conducts a private offering of securities in close temporal proximity to a registered public offering, it could be argued that the two offerings should be integrated and viewed as a single distribution of securities. [162] If the private offerings are conducted under Rule 506(b) or § 4(a)(2), the resulting integrated offering would be illegal because the private offering exemption would be unavailable due to the general solicitation involved in the public offering. The offers and sales in the prior private offering (including private offerings under Rule 506(c) or Rule 144A) might also constitute an illegal public offer in connection with the registered public offering (so-called "gun jumping") in violation of § 5 of the Securities Act. The SEC has, however, provided some relief in this area through Rules 152 and 155 under the Securities Act, as well as no-action positions and interpretive guidance.

Rule 152 provides generally that a transaction that qualifies for the § 4(a)(2) exemption will continue to be exempt even if the issuer subsequently decides to make a public offering of the securities or files a registration statement. The SEC staff has clarified this Rule by taking the position that the filing of a registration statement following an offering otherwise exempt under § 4(a)(2) for the same securities does not vitiate the exemption, so long as the private offering is completed prior to the filing of the registration statement. [163] In *Black Box Inc.*, the staff indicated that the execution of binding purchase agreements for a private offering that were not subject to conditions within the control of the purchasers could constitute "completion" for these purposes even though the closing of the private offering had not occurred prior to the filing of the registration statement. [164] In *Privatization of the United States Enrichment Corp.*, the SEC staff indicated that abandonment of a private offering could also constitute completion for purposes of Rule 152. [165]

In *Squadron, Ellenoff, Pleasant & Lehrer*, the SEC staff confirmed that it intended Black Box to represent a policy position not to integrate a private placement to QIBs under Rule 144A (along with a private placement to up to three large institutional accredited investors that were not QIBs) with a concurrently registered public offering of the same class of securities. [166] The staff noted in *Squadron*, however, that the mere filing of a registration statement will generally be considered as a general solicitation, even where the issuer does not circulate a "red herring" prospectus or make any press announcement concerning the proposed offering. [167]

In its 2007 proposal to revise Regulation D, the SEC provided further guidance regarding the integration of concurrent public and private offerings, reiterating and elaborating on its position set out in *Black Box* and *Squadron*. The SEC clarified that, while there are many situations in which the filing of a registration statement could serve as general solicitation or general advertising for a concurrent private offering, the filing of a registration statement does not *per se* eliminate a company's ability to conduct a concurrent private offering. The determination as to whether the filing of the registration statement should be considered to be general solicitation or general advertising that would affect the

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availability of the § 4(a)(2) exemption for such a concurrent unregistered offering should be based on a consideration of whether the investors in the private placement were solicited by the registration statement, or instead through some other means that would otherwise not foreclose the availability of the § 4(a)(2) exemption, such as through a substantive, pre-existing relationship with the company or direct contact by the company or its agents unrelated to the registration statement or the public offering effort. [168]

Rule 155 under the Securities Act provides a safe harbor for a registered offering following an abandoned private offering and for a private offering following an abandoned registered offering. Rule 155 facilitates a switch from a private offering to a registered public offering and *vice versa* in response to changing securities markets; it does not, however, modify or rescind the five-factor test for assessing integration in Regulation D, Rule 152 or the SEC guidance described above. [169]

Under Rule 155(b), an issuer that begins a private offering may subsequently commence a registered offering [170] without the risk that both offerings will be integrated if the following conditions are met:

- no securities were sold in the private offering;
- the issuer and any person acting on its behalf terminate all offering activity in the private offering before the issuer files the registration statement for the registered offering;
- any prospectus filed as part of the registration statement discloses information about the abandoned private offering, including the size and nature of the private offering, the date on which the issuer terminated all offering activity in the private offering, that any offers to buy or indications of interest in the private offering were rejected or otherwise not accepted and that the prospectus delivered in the registered offering supersedes any selling material used in the private offering; and

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- the issuer does not file the registration statement until at least 30 calendar days after termination of all offering activity in the private offering, except that the 30-day delay does not apply if the issuer and any person acting on its behalf offered securities in the private offering only to persons who were (or who the issuer reasonably believes were) accredited investors or who satisfy the knowledge and experience standard of Rule 506(b)(2)(ii) under the Securities Act.

Under Rule 155(c), an issuer that begins a registered offering may subsequently commence a private offering without the risk that both offerings will be integrated if the following conditions are met:

- no securities were sold in the registered offering;
- the issuer withdraws the registration statement for the registered offering; [171]
- the issuer and any person acting on its behalf do not commence the private offering earlier than 30 calendar days after the effective date of withdrawal of the registration statement;
- the issuer notifies each offeree in the private offering that the offering is not registered under the Securities Act, the securities offered will be "restricted securities" as defined in Rule 144 under the Securities Act and cannot be resold without registration unless an exemption is available, purchasers do not have the protection of § 11 of the Securities Act and a registration statement for the abandoned offering was filed and withdrawn, specifying the effective date of the withdrawal; and
- any disclosure document used in the private offering discloses any changes in the issuer's business or financial condition that occurred after the issuer filed the registration statement that are material to the investment decision in the private offering.

Each of the specific conditions must be satisfied in order to take advantage of the Rule 155 safe harbor; however, it is not available for transactions that are

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part of a plan or scheme to avoid registration even if the issuer technically complies with the requirements of the Rule. [172]

Footnotes

16 Section 4(a)(3) of the Securities Act is not available (i) for sales of securities by a dealer taking place prior to the expiration of 40 days after the first date on which any of such securities were "*bona fide* offered to the public by the issuer or by or through an underwriter" or (ii) at any time with respect to an underwriter's unsold allotment securities. In a private placement that is part of a larger, non-U.S. public offering of securities, the 40-day § 4(a)(3) restriction on dealer sales is applicable commencing on the initial offering date of the non-U.S. offering, which is generally the date on which the offering price of the securities is determined.

17 § 2(a)(11) of the Securities Act.

18 *See, e.g.*, *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959). In proposing amendments to Rule 144 in 1997, the SEC stated that:

> [i]ndividual investors who are not professionals in the securities business may be "underwriters" [and taking "with a view to … distribution"] within the meaning of that term as used in the [Securities] Act if they act as links in a chain of transactions through which securities move from an issuer to the public.

SEC Release No. 33-7391 (Feb. 20, 1997), 62 Fed. Reg. 9246, 9256 (Feb. 28, 1997).

19 Op. Gen. Counsel, SEC Release No. 33-285 (Jan. 24, 1935).

20 *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

21 *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). *Ralston Purina* actually refers to § 4(1), because what is now § 4(2) of the Securities Act was included in a second clause of § 4(1) until 1964.

22 *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). Footnote 11 to the quoted text cites *Nash v. Lynde*, [1929] A.C. 158, 169 (H.L.) (U.K.): "[t]he 'public'… is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve; perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole." *SEC v. Ralston Purina Co.,* 346 U.S. 119, 125 n.11 (1953).

23 *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953).

24 *See*, *e.g.*, SEC v. Continental Tobacco Company of South Carolina, Inc., 463 F.2d 137, 158 (5th Cir. 1972); *Henderson v. Hayden, Stone Inc.*, 461 F.2d 1069, 1071–72 (5th Cir. 1972); *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 687–89 (5th Cir. 1971); *SEC v. Murphy*, 626 F.2d 633, 645–47 (9th Cir. 1980).

25 *See, e.g.*, *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 902–03 (5th Cir. 1977), *aff'd*, 576 F.2d 91 (5th Cir. 1978), and cases cited therein; *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 690–91 (5th Cir. 1971).

26 *See*, *e.g.*, SEC v. Continental Tobacco Company of South Carolina, Inc., 463 F.2d 137, 159 (5th Cir. 1972); *Western Federal Corp. v. Erickson*, 739 F.2d 1439, 1443 (9th Cir. 1984).

27 *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953); *see also Mark v. FSC Securities Corp.*, 870 F.2d 331, 333 (6th Cir. 1989).

28 *See* § 11.02[2][b] for a discussion of liability for the offer or sale of unregistered securities under § 12(a)(1) of the Securities Act. Some courts have even indicated that if the person claiming a private placement exemption cannot show that each offeree was sufficiently sophisticated to participate in a private offering, all buyers could rescind even if the nonqualifying offerees did not actually purchase any securities. *Lively v. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971); *see also SEC v. Murphy*, 626 F.2d 633 (9th Cir. 1980); *Eriksson v. Galvin*, 484 F. Supp. 1108 (S.D.N.Y. 1980).

29 SEC Release No. 33-5487 (Apr. 23, 1974). This safe harbor, Rule 146 under the Securities Act, was rescinded on adoption of Regulation D.

30 SEC Release No. 33-6389 (Mar. 8, 1982).

31 Regulation D under the Securities Act includes four safe harbors from registration. Two of the four, set forth in Rule 506 of the Regulation, arise under § 4(a)(2) of the Securities Act. The other two safe harbors, set out in Rules 504 and 505, are promulgated under the exemption for small offerings in § 3(b) of the Securities Act. Only the Rule 506 safe harbors are discussed here.

32 Preliminary Note 4 to Regulation D under the Securities Act. Regulation D may be relied upon for a sale by an issuer to one or more investors that involves an intermediary acting as *agent* for the issuer. However, Regulation D may not be relied upon for a sale to one or more investors by a dealer that purchases from an issuer as *principal*. In the second case, the sale by the issuer to the dealer may qualify for the Regulation D safe harbor and the sale by the dealer to the investors may qualify for the Rule 144A safe harbor. Thus, in private offerings structured on the model of public underwritten offerings (*i.e.*, an issuer sale to a dealer, acting as principal, followed by the dealer's separate sales to investors), the Regulation D safe harbor could cover the issuer's sale to the dealer, but not the dealer's resales.

33 Rules 502(d) and 144(a)(3) under the Securities Act.

34 Rule 502(c) under the Securities Act.

35 Rules 506(b)(2)(i) and 501(e)(1)(iv) under the Securities Act. Regulation D defines "accredited investor" to include most institutions, as well as directors and specified management officials of the issuer and certain

wealthy individuals. Rule 501(a) under the Securities Act. The SEC solicited comments on the definition of "accredited investor" for natural persons (SEC Release No. 33-9416 (July 10, 2013)) and published a report summarizing its review of the definition in December 2015 (SEC, REPORT ON THE REVIEW OF THE DEFINITION OF "Accredited Investor" (Dec. 18, 2015)). In the report, the staff recommended that the SEC consider several revisions to the definition, including (i) revising the financial thresholds above which a natural person may qualify as an accredited investor and (ii) permitting natural persons to qualify as accredited investors based on indicators other than financial thresholds, including a minimum investment amount or certain professional credentials. To date, the SEC has not adopted any changes to the definition of accredited investor.

36 Rule 506(b)(2)(ii) under the Securities Act. Like its predecessor (Rule 146), Rule 506 permits a prospective investor to be represented by one or more other persons having the appropriate degree of knowledge and sophistication. Rule 501(h) under the Securities Act.

37 Rule 502(b)(2)(i)(C) under the Securities Act. In 2010, the SEC proposed broad changes in disclosure requirements for asset-backed securities, including private placements. SEC Release No. 33-9117 (Apr. 7, 2010). Under these proposals, it would have been a condition to the exemptions under Rule 506 and Rule 144A for asset-backed securities that there be an undertaking to provide specified information to investors on a continuous basis throughout the life of the securities. This would have been a substantial departure from existing law, since there are currently no specific information requirements for sales to accredited investors under Rule 506 and only a limited requirement to provide continuous information for resales under Rule 144A. After requesting additional comments (SEC Release No. 33-9244 (July 26, 2011)), the SEC ultimately declined to adopt the proposed changes to the rules governing private placements. SEC Release No. 33-9638 (Sept. 4, 2014).

38 Rule 502(d) under the Securities Act.

39 Rule 503 under the Securities Act. Form D requires, among other things, information on the issuer (including its directors and officers, industry group, revenues and assets), the offering (including the number of accredited and nonaccredited investors, minimum investment size and the jurisdictions in which solicitation occurred) and the broker-dealers involved (including names and compensation).

40 Compliance with Rule 503 is not a condition to the availability of the exemption under Rule 506. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 257.07 (Jan. 26, 2009). Rule 507 under the Securities Act expressly provides that the Regulation D exemptions are unavailable to an issuer that has previously been enjoined for failure to comply with Rule 503, but apparently no such injunction has ever been issued. *See* SEC Release No. 33-8891 (Feb. 6, 2008); SEC Office of Inspector General, Regulation D Exemption Practice 10 (Mar. 31, 2009). A 2009 report of the SEC's Office of Inspector General noted that noncompliance with Rule 503 is common and that there is no effective enforcement of the Rule. The report recommended that the SEC develop an enforcement program and consider making filing a Form D a required element of the Regulation D exemptions. SEC Office of Inspector General, Regulation D Exemption Practice (Mar. 31, 2009). In July 2013, the SEC stated that some issuers do not make Form D filings in Regulation D offerings because the filing of the form is not a condition to reliance on the Regulation D rules. SEC Release No. 33-9416 (July 10, 2013).

41 *See* Rule 506(c) under the Securities Act.

42 Rule 506(c)(2)(i) under the Securities Act.

43 Rule 503 under the Securities Act. The SEC has proposed to revise Form D to require certain additional disclosure items, some of which would apply to all Regulation D offerings and some of which would apply only to Rule 506(c) offerings. The most notable of the proposed changes would require issuers relying on Rule 506(c) to disclose (a) the methods of general solicitation used, (b) the methods used to verify accredited investor status of the purchasers and (c) the persons directly or indirectly controlling the issuer. SEC Release No. 33-9416 (July 10, 2013). To date, these proposed changes to Form D have not been adopted.

44 SEC Release No. 33-9415 (July 10, 2013).

45 SEC Release No. 33-9415 (July 10, 2013).

46 Rule 506(b) under the Securities Act.

47 *See* Rule 506(c) under the Securities Act.

48 Rule 506(c)(2)(ii) under the Securities Act.

49 SEC Release No. 33-9415 (July 10, 2013), 78 Fed. Reg. 44,771, 44,778 (July 24, 2013).

50 SEC Release No. 33-9415 (July 10, 2013).

51 Rule 506(c)(2)(ii) under the Securities Act.

52 Rule 506(c)(2)(ii)(A) under the Securities Act. The verification requirement is met if the issuer reviews specified IRS forms showing the requisite income level for the two most recent years and obtains a written representation from the potential investor that he or she has a reasonable expectation of reaching the requisite income level during the current year.

53 Rule 506(c)(2)(ii)(B) under the Securities Act. The verification requirement is met if the issuer reviews specified types of documentation of the potential investor's net worth and obtains a written representation from the potential investor that all liabilities necessary to make a determination of net worth have been disclosed.

54 Rule 506(c)(2)(ii)(C) under the Securities Act. The third party may be a broker-dealer, an investment adviser, an attorney or a certified public accountant. On June 23, 2014, SIFMA issued guidance to registered broker-dealers and investment advisers on some verification methods they could use to comply with the requirements of the safe harbor method designated for them with respect to purchasers who are natural persons as well as on some verification methods they could use to determine whether certain legal entities qualify as accredited investors. *See* SIFMA, SIFMA Guidance on Rule 506(c) Verification (June 23, 2014).

55 Rule 506(c)(2)(ii)(D) under the Securities Act. The investor must have invested in the issuer's Rule 506(b) offering prior to September 23, 2013 and continue to hold such securities.

56 Rule 506(c)(2)(ii) under the Securities Act.

57 SEC Release No. 33-9414 (July 10, 2013).

58 Rule 506(d) does not define what it means for an officer to be "participating in the offering." According to the adopting release, however, participation in an offering would be more than transitory or incidental involvement, and could include activities such as participation or involvement in due diligence activities, involvement in the preparation of disclosure documents and communication with the issuer, prospective investors or other offering participants. The SEC also considered, but determined not to make any changes to, the definition or coverage of promoters, noting that promoters represent a broad category of persons that captures all individuals and entities that have relevant relationships with the issuer or to the offering, and that those relationships must be analyzed on a look-through basis. SEC Release No. 33-9414 (July 10, 2013).

59 SEC Release No. 33-9414 (July 10, 2013).

60 The Rule delegates waiver authority to the Director of the Division of Corporation Finance and permits any court or regulatory authority that enters an order, judgment or decree that would cause an actor to be disqualified under the Rule to advise the SEC that, in its view, disqualification under Rule 506 should not arise as a consequence of such order, judgment or decree, and in such circumstances disqualification will not arise. The notice provided by the court or regulatory agency can either be in the relevant order, judgment or decree or in a separate writing to the SEC or its staff. That waiver will be effective even without a separate waiver from the SEC, if it was made before the relevant Rule 506 sale.

61 The adopting release states that issuers "should consider the totality of the offering taking into account the circumstances of the offering, the covered persons involved in the offering and the Rule's requirements, which include specific disqualifying events and covered persons subject to those disqualifying events." This will enable issuers to "determine their own methodology for a factual inquiry," which helps to promote efficiency because it enables the issuer "to tailor its own inquiry without adherence to uniform standards that

may not be applicable or appropriate in the context of a particular issuer or particular offering." SEC Release No. 33-9414 (July 10, 2013), 78 Fed. Reg. 44,730, 44,765 (July 24, 2013).

62 SEC Release No. 33-9414 (July 10, 2013), 78 Fed. Reg. 44,730, 44,747 (July 24, 2013).

63 SEC Release No. 33-9414 (July 10, 2013).

64 As an attempt to make the Regulation D safe harbors more "user friendly," the SEC adopted Rule 508, which permits issuers to deviate in part from Regulation D without losing the benefits of the safe harbor. SEC Release No. 33-6825 (Mar. 14, 1989).

65 *See supra* Note 39.

66 For example, the Rule 506 exemption turns on the nature and number of purchasers, not offerees, which is a departure from the generally accepted, and still prevailing, judicial interpretation of the § 4(a)(2) exemption. Moreover, it does not limit the number of accredited investors that can participate in any offering. The view that an exempt private placement can be made to an unlimited number of large institutional investors is also supported by the SEC's adoption of Rule 144A, as discussed at § 7.02[3].

67 SEC Release No. 33-9415 (July 10, 2013). The release states that "[a]n 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)." 78 Fed. Reg. 47,771, 44,774 (July 24, 2013).

68 Such activities include any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. Rules 135c and 135e under the Securities Act provide exemptions for certain publicity activities. *See* §§ 7.02[4] and 3.02[4]. In 2007, the SEC proposed a new exemption within Regulation D, which would have permitted certain kinds of advertising in connection with an exempt offering to "large accredited investors." SEC Release No. 33-8828 (Aug. 3, 2007). This proposal was never adopted.

69 *See* SEC Release No. 33-8828 (Aug. 3, 2007), Part II.C (interest in a private placement through a "substantial, pre-existing relationship" could mean that a prior registration statement did not constitute general solicitation); *Robert T. Willis, Jr., P.C.* (avail. Jan. 18, 1988); *Mineral Lands Research & Marketing Corp.* (avail. Dec. 4, 1985); *E. F. Hutton & Co.* (avail. Dec. 3, 1985); *Woodtrails-Seattle, Ltd.* (avail. Aug. 9, 1982). *But see Agristar Global Networks, Ltd.* (avail. Feb. 9, 2004) ("Agristar") (refusing to confirm that no general solicitation would occur although a pre-existing relationship existed between the proposed offeror and the proposed offeree when the offeror proposed to send generic investor qualification questionnaires to certain principals in the offeror's database who appeared likely to be accredited investors).

70 This is to establish that, based on the *Ralston Purina* interpretation of § 4(a)(2) described above, the investor does not require the protection of the registration provisions of the Securities Act. Courts interpreting the § 4(a)(2) exemption have emphasized the importance of prospective purchasers having access to information, but have not imposed an affirmative duty on sellers to provide information to prospective purchasers. *See Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*, 66 B US. LAW, 85, 100 n.82 (2010) (a Report by the Committee on Federal Regulation of Securities, ABA Section of Business Law); *see also Investors Mortgage Group, Inc.* (avail. Feb. 9, 1976).

71 *See, e.g.*, the discussion of the exemption from registration under Rule 144 at § 7.04[2].

72 These arrangements may include, among others, establishing a restricted depositary facility for the securities or requiring an underwriter of the securities or a designated custodian to be the sole custodian through which all such securities may be held. Such measures would facilitate policing of the transfer restrictions.

73 *See* § 7.04[1].

74 Although we are not aware of any SEC gloss on what constitutes a *bona fide* market, we believe 20% of trading volume—the minimum threshold for a substantial U.S. market interest—certainly would suffice.

75 The belief may be held by a bank acting as an underwriter or a placement agent, even if as a contractual matter it does not purchase and resell the securities.

76 Nasdaq was the only such system but became a national securities exchange in 2006. *See* § 3.01, Note 4. The term "automated inter-dealer quotation system" does not include, for example, bid and ask quotations appearing in the "pink sheets" of Pink Sheets LLC (formerly the National Quotation Bureau, Inc.) or the OTC Bulletin Board. *See* SEC Release No. 34-27975 (May 1, 1990).

77 SEC Release No. 33-6806 (Oct. 25, 1988) (proposed rule); SEC Release No. 33-6862 (Apr. 23, 1990) (final rule).

78 For purposes of § 4(a)(3), the resold securities are also not part of an unsold allotment and are deemed not to have been *bona fide* offered to the public.

79 Preliminary Note 7 to Rule 144A under the Securities Act.

80 *See* § 7.04[1] for a more detailed discussion of certain documentation issues.

81 SEC Release No. 33-6862 (Oct. 25, 1988).

82 Indeed, § 201(a) of the JOBS Act required the SEC to amend Rule 144A to permit offers to persons other than QIBs, including by means of general solicitation or general advertising. In response, the SEC amended Rule 144A to eliminate the references to "offers" and "offerees" in the conditions set forth in paragraph (d)(1) of the Rule. Consequently, a seller may rely on Rule 144A even if the securities were offered to non-QIBs and even if there has been general solicitation or general advertising. Sales, however, must still be made only to QIBs. SEC Release No. 33-9415 (July 10, 2013).

83 "Qualified institutional buyer" is defined in Rule 144A(a)(1) under the Securities Act.

84 Rule 144A(a)(1)(i)(H) under the Securities Act. Certain other forms of corporate organization may also be treated as qualified institutional buyers—for example, the SEC staff has advised that limited liability companies meeting the $100 million threshold may be deemed to have QIB status. The SEC staff has also informally expressed the view that municipalities organized as corporations (such as New York City) may be treated as QIBs, while unincorporated states (such as New York State), or municipalities as such, may not. *See also Alaska Permanent Fund* (avail. July 14, 2011) (large sovereign wealth investment fund with unique form of organization may be treated as a QIB).

84.1 A limited partnership will be deemed a QIB if all of its limited partners are QIBs. The general partner need not be a QIB for the limited partnership to be deemed a QIB, unless the general partner is also a limited partner. SEC Division of Corporation Finance Compliance and Disclosure Interpretations Question 138.10 (Dec. 8, 2016).

85 A not-for-profit organization must be registered under § 501(c)(3) of the Internal Revenue Code to be eligible for purposes of Rule 144A(a)(1)(i)(H).

86 Although the SEC has not defined the term "similar business trust" for purposes of Rule 144A or the Securities Act, we consider it reasonable, based on the distinction drawn between institutional investors and individual investors in Rule 144A (both as adopted and amended) and on other factors, to conclude for purposes of Rule 144A that the term "similar business trust" refers to any trust created primarily to aggregate funds of a number of investors to engage in profit-making activity, including investing in securities or other assets, rather than one created primarily to protect and preserve the assets of an individual or one or more related individuals. If a trust is not established as a Massachusetts or similar business trust, in order for the trust to qualify as a QIB, each of its beneficiaries must be a QIB as provided in paragraph (v) below.

87 Rule 144A(a)(1)(i)(A) under the Securities Act.

88 Rule 144A(a)(1)(i)(D), (E) and (F) under the Securities Act. A trust fund may not have individual accounts as participants.

89 Rule 144A(a)(1)(i)(B), (C), (G) and (I) under the Securities Act. It is also reasonable to conclude that an unregistered investment adviser (assuming it is organized as a partnership or corporation and is not a natural person) that is acting for an unregistered investment company that is a qualified institutional buyer may purchase under Rule 144A.

90 Rule 144A(a)(1)(ii) and (iii) under the Securities Act.

90.1 An investment company that is not registered under the Investment Company Act cannot aggregate investments by other funds that are part of its family of funds when determining its status as a QIB. SEC Division of Corporation Finance Compliance and Disclosure Interpretations Question 138.09 (Dec. 8, 2016).

91 Rule 144A(a)(1)(iv) under the Securities Act.

92 Rule 144A(a)(1)(vi) under the Securities Act.

93 SEC Release No. 33-6862 (Apr. 23, 1990), 55 Fed. Reg. 17,933, 17,936 (Apr. 30, 1990).

94 According to the release adopting Rule 144A, "foreign bank" is defined in Rule 6c-9(b)(2) and (3) under the Investment Company Act. As a result of the SEC's rescission of Rule 6c-9 in 1991, the release should be read to refer instead to Rule 3a-6 under the Investment Company Act, which replaced Rule 6c-9. *See* § 15.05[2]. In keeping with the less stringent financial reporting standards applicable to foreign private issuers (Item 8 of Form 20-F), net worth is to be determined as of a date not more than 18 months (as opposed to 16 months) prior to the sale date. A bank's net worth currently includes the bank's perpetual preferred stock, common stock, surplus, undivided profits and capital reserves (less net unrealized loss on marketable equity securities) and cumulative foreign currency translation adjustments. For a U.S. thrift, net worth equals its adjusted core capital stated in its audited balance sheet. In adopting Rule 144A, the SEC requested comment on the appropriateness of the net worth test, including the $25 million threshold, and whether this test is rightly applied to foreign banks. SEC Release No. 33-6862 (Apr. 23, 1990). The test received mixed reviews. On the one hand, the Board of Governors of the Federal Reserve System preliminarily concluded that the test does not appreciably affect the number of insured banks that would qualify to purchase securities under Rule 144A, *see* Letter from Robert S. Plotkin, Division of Banking, Board of Governors of the Federal Reserve System, to Linda C. Quinn, Director, SEC Division of Corporation Finance (Aug. 1, 1990), and the United States League of Savings Institutions expressed support for the test, *see* Letter from Renie Yoshida Grohl, United States League of Savings Institutions, to Jonathan G. Katz, Secretary, SEC (June 12, 1990). On the other hand, private banking associations objected to the test as unfairly discriminating against banks, *see* Letter from Anthony T. Cluff, Association of Reserve City Bankers, to Jonathan G. Katz, Secretary, SEC (June 14, 1990). No commenters addressed the application of the test to foreign banks.

95 Rule 144A(a)(1)(v) under the Securities Act.

96 SEC Release No. 33-6963 (Oct. 22, 1992).

97 SEC Release No. 33-6963 (Oct. 22, 1992).

97.1 SEC Division of Corporation Finance Compliance and Disclosure Interpretations Questions 138.05 and 138.06 (Dec. 8, 2016).

98 The SEC staff has declined to take the position that the only type of arrangement to be excluded as a loan participation is that in which a participating bank is not in privity with the borrower but instead relies on an original lender to underwrite, administer and enforce the loan, although it has confirmed that generally, if an instrument would be subject to registration under the Securities Act, absent an exemption, it may be counted in determining the status of a buyer under the Rule. *Unum Life Insurance Company* (avail. Nov. 21, 1990). The SEC staff has often said that "pass-through" securities will not be deemed to be loan participations.

98.1 SEC Division of Corporation Finance Compliance and Disclosure Interpretations Questions 138.07 and 138.08 (Dec. 8, 2016).

98.2 Rule 144(a)(2) under the Securities Act.

98.3 Rule 144(a)(1)(ii) under the Securities Act.

99 Rule 144A(d)(1) under the Securities Act. Acceptable means are (i) a certificate of the chief financial or other executive officer of the prospective purchaser that specifies the amount of securities that it owned and invested on a discretionary basis on a specific date on or since the close of the prospective purchaser's

most recent fiscal year, (ii) the most recent publicly available financial statements of the prospective purchaser, (iii) the most recent publicly available information appearing in documents filed by the prospective purchaser with the SEC or another U.S. or foreign governmental agency or self-regulatory organization and (iv) the most recent publicly available information appearing in a recognized securities manual, in each case if the information is provided as of a date (16 months or, in the case of a foreign purchaser, 18 months prior to sale under the Rule) otherwise required by the Rule. However, a representation or certificate of a prospective purchaser claiming that it is a qualified institutional buyer, without more, is not sufficient in the view of the SEC staff.

100 *See CommScan, LLC* (avail. Feb. 3, 1999) (sellers may rely on the QIB List maintained by CommScan (now Dealogic)); *Communicator Inc.* (avail. Sept. 20, 2002) (broker-dealers may rely on the QIB List maintained by Communicator in a joint venture with eight leading broker-dealers).

101 SEC Release No. 33-6839 (July 11, 1989) (reproposing Rule 144A for public comment).

102 Rule 144A(d)(3)(ii) under the Securities Act. *See* § 15.06 for a discussion of issues raised in connection with U.S. private placements of securities by companies that are investment companies, including closed-end investment companies, whose securities are technically eligible for Rule144A. Private offerings of investment company securities are subject to restrictions that go beyond those applicable under the Securities Act.

103 Rule 144A(d)(3) under the Securities Act. The staff of the SEC has also confirmed that securities are eligible for resale under Rule 144A if they are received, without any payment by holders, upon conversion of convertible securities that are themselves eligible for resale under the Rule. *Debevoise & Plimpton* (avail. July 23, 1990). Based on a similar analysis, securities of an issuer obtainable upon the cashless exercise of warrants issued by the same issuer should be eligible for resale under Rule 144A, provided that the warrants themselves are eligible for resale under Rule 144A *. Cf.* Rule 144(d)(3)(x); SEC Release No. 33-8869 (Dec. 6, 2007); SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 132.11 (Jan. 26, 2009) (where equity securities of an issuer are acquired upon "cashless" exercise of warrants or options, the holding period for the equity securities may be "tacked" to the holding period of the warrants or options, except in the case of cashless exercise of employee stock options).

104 Rule 144A(d)(3)(i) under the Securities Act.

105 SEC Release No. 33-6839 (July 19, 1989); SEC Release No. 33-6862 (Apr. 23, 1990).

106 *See* § 10.06 for a general discussion of mandatorily exchangeable securities.

107 SEC Release No. 33-6862 (Apr. 23, 1990).

108 *See, e.g.*, §§ 12(g)(5), 15(d) and 16 of the Exchange Act. In the release adopting Rule 144A, the SEC expressed its intention to interpret Rule 144A's "fungibility" requirement in the case of equity securities in a manner consistent with its practice under § 12(g)(5) of the Exchange Act.

109 Louis Loss, FUNDAMENTALS OF SECURITIES REGULATION 642–43 (6th ed. 2011).

110 *See, e.g.*, *Jevic Transportation, Inc.* (avail. Apr. 20, 1999); *Bear, Stearns & Co.* (avail. Aug. 2, 1982); *Cal-West Real Estate Fund* (avail. Oct. 15, 1979); *Cal-American Income Property Fund II* (avail. Sept. 1, 1975); *Motorola, Inc.* (avail. Jan. 31, 1972); *see also Turner Broadcasting System, Inc.* (avail. Feb. 6, 1990) (two classes of common stock that varied as to voting and dividend rights were separate classes for purposes of § 16(a) of the Exchange Act); *Petro-Search, Inc.* (avail. July 28, 1975) (interests in separate partnerships constituted separate classes of securities for purposes of § 15(d) of the Exchange Act).

111 *Amana Society* (avail. Sept. 23, 1974); *Ellerin v. Massachusetts Mutual Life Insurance Co.*, 270 F.2d 259 (2d Cir. 1959).

112 SEC Release No. 33-6862 (Apr. 23, 1990), 55 Fed. Reg. 17,933, 17,935 (Apr. 30, 1990). In this respect, the SEC deviated from the position it has taken from time to time with respect to the broad reach of Exchange Act reporting requirements. *See, e.g.*, *Ellerin v. Massachusetts Mutual Life Insurance Co.*, 270 F.2d 259 (2d Cir. 1959) (where the SEC urged treatment of two series of preferred stock as a single class

of securities for purposes of § 16 of the Exchange Act).

113 SEC Release No. 33-6862 (Apr. 23, 1990), 55 Fed. Reg. 17,933, 17,935 (Apr. 30, 1990).

114 SEC Release No. 33-6862 (Apr. 23, 1990). In view of the aim of the nonfungibility requirement, for purposes of Rule 144A, securities are not of the same class and series if they are expected to trade as different series in the secondary market. In the case of "strips," where the interest and principal payments, or the dividend and capital appreciation components, of a listed security are separated into two securities, a question is raised as to the fungibility of the new instruments with the underlying security. In light of the purpose of the Rule 144A fungibility requirement, the "strips" should not be considered fungible since they can be expected to have substantially different trading patterns from the listed security.

115 The exemption under Rule 12g3-2(b) is discussed in § 4.02[3][a][iv].

116 Schedule B to the Securities Act is available for the registration of securities of a foreign government, as defined in Rule 405 under the Securities Act. The definition includes the government of a foreign country or a political subdivision of a foreign country, and Schedule B is also used to register securities of an agency or instrumentality of a foreign government that are fully and unconditionally guaranteed by that government. *See* § 3.05[1].

117 *See Homestake Mining Company* (avail. Aug. 28, 1998); *British Aerospace Public Limited Company* (avail. May 9, 1990). The SEC has also taken this position where an entity guarantees all of the obligations of its wholly owned subsidiary under warrants issued by the subsidiary and exercisable for securities of the guarantor. *Schering-Plough Corp.* (avail. Nov. 21, 1991). According to informal SEC advice, an agreement between an issuer and, for example, its parent whereby the parent agrees to provide funds or net worth necessary for the issuer to make payment (a so-called "keepwell" or "support" agreement) will not be treated as the functional equivalent of a guarantee for these purposes and, accordingly, a subsidiary benefiting from such an agreement must comply with Rule 144A(d)(4) in connection with its issuance of Rule 144A securities.

118 The SEC did not specify in adopting Rule 144A whether the required information must be provided in English. It ought to be the case, however, that no special translations or English language versions of the information need be provided if not otherwise available. First, the premise of Rule 144A is that qualified institutional buyers have sufficient sophistication and economic clout to fend for themselves—including, presumably, by reviewing disclosure in a foreign language or requiring the issuer to provide English summaries of any information not already in English. Second, in the context of Rule 12g3-2(b) under the Exchange Act (discussed at § 4.02[3][a][iv]), the SEC has expressly addressed the translation issue by specifying cases in which translations or English language summaries or versions are required. The SEC could have, but did not, include a similar requirement in Rule 144A. Thus, it would appear that the Rule's information delivery requirement may be met using foreign language documents. Certainly no more than an English language summary of the documents should be required. The staff of the SEC has in any event stated that it will not respond to inquiries concerning the adequacy of information proposed to be supplied pursuant to Rule 144A(d)(4). SEC Release No. 33-6862 (Apr. 23, 1990). Nevertheless, the SEC staff has stated, in the case of securities issued by a company and its principal subsidiary and guaranteed by two other groups of subsidiaries, that compliance with the Rule 144A(d)(4) requirements regarding financial statement presentation may be satisfied by aggregate presentation of financial results for each of the two groups. *CEMEX, S.A.* (avail. May 7, 1992).

119 Rule 144A(d)(4)(ii)(C) under the Securities Act. For U.S. issuers, by contrast, the balance sheet must be as of a date less than 16 months before the date of resale, and the statements of profit and loss and retained earnings must relate to the 12-month period preceding the date of the balance sheet. If the balance sheet is not as of a date less than six months before the date of resale, it must be accompanied by additional statements of profit and loss and retained earnings for the period from the date of the balance sheet to a date less than six months prior to the resale date. Rule 144A(d)(4)(ii)(A) under the Securities Act. Finally, the description of the issuer's business must be as of a date within 12 months prior to the resale date. Rule 144A(d)(4)(ii)(B) under the Securities Act.

120 *See* Separate Statement of Commissioner Fleischman, SEC Release No. 33-6862 (Apr. 23, 1990); *see also* Preliminary Note 1 to Rule 144A under the Securities Act ("This section relates solely to the application of Section 5 of the [Securities] Act and not to the antifraud or other provisions of the federal securities laws."). When Rule 144A was adopted, it was widely assumed that purchasers in a private placement also had a remedy under § 12(a)(2) of the Securities Act, although *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), later held otherwise. *See* § 11.04[1].

121 *See* § 11.04.

122 Similar questions arise with respect to information presented in a "Management's Discussion and Analysis" section in a registration statement or report, *see* § 4.06, and with respect to communications with financial analysts, *see* § 4.10[4].

123 Under § 12(g) of the Exchange Act, a foreign private issuer that has 2,000 or more holders of record (or 500 or more holders of record who are not accredited investors) of a class of equity securities and more than $10 million in total assets, and 300 or more U.S. resident holders at the end of its most recently completed fiscal year, must register that class under the Exchange Act unless an exemption is available. Exchange Act registration requires a company to comply with SEC reporting requirements and with the Sarbanes-Oxley Act. However, an automatic exemption is available under Rule 12g3-2(b) under the Exchange Act, which exempts a non-U.S. company that has not listed or publicly offered securities in the United States from Exchange Act registration provided such company complies with the criteria under Rule 12g3-2(b). SEC Release No. 33-10075 (May 3, 2016). The criteria for the exemption under Rule 12g3-2(b) are discussed in § 7.02[3].

124 The information made public to meet the conditions for the Rule 12g3-2(b) exemption may still be subject to the antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder.

125 *See* Form F-6, General Instruction I.A; § 3.04[1][b].

126 Rule 144A(d)(2) under the Securities Act. In 2010, the SEC proposed broad changes to the disclosure requirements for asset-backed securities, including private placements. SEC Release No. 33-9117 (Apr. 7, 2010). Under these proposals, an issuer would have been required to file with the SEC a notice of a Rule 144A offering of asset-backed securities providing specified information to investors. Rule 144A has not otherwise required any public notice. After requesting additional comments (SEC Release No. 33-9244 (July 26, 2011)), the SEC ultimately declined to adopt the proposed changes to the rules governing private placements. SEC Release No. 33-9638 (Sept. 4, 2014).

127 For a discussion of undocumented offerings, *see* § 13.06.

128 A sample legend might read "Sale Relying on Rule 144A—Restricted Security."

129 *See supra* Notes 67 and 68. *See also* text accompanying Notes 147–155 for a discussion of general solicitation and general advertising in the context of private offerings through the Internet.

130 A tombstone advertisement issued upon completion of a traditional private placement may also constitute a solicitation if, for example, the offering was part of an ongoing program. *Alma Securities Corp.* (avail. Aug. 2, 1982).

131 Rule 135c(a) under the Securities Act.

132 In the case of rights or exchange offerings, or offerings to the employees of the issuer or its affiliates, certain additional information may be provided. Rule 135c(a)(3) under the Securities Act.

133 Rule 135c(d) also requires an issuer that is exempt under Rule 12g3-2(b) to furnish any Rule 135c notice to the SEC "in accordance with the provisions of that exemptive section," but Rule 12g3-2(b) was amended in 2008 to eliminate the submission of documentation to the SEC. SEC Release No. 34-58465 (Sept. 5, 2008).

134 SEC Release No. 33-7470 (Oct. 10, 1997).

135 Note to paragraph (a)(1) of Rule 135e under the Securities Act. *See* § 4.05[4] for further discussion of Rule 135e.

136 As discussed below in § 7.09, for non-SEC-reporting issuers in Rule 144A offerings, U.S. state "blue sky"

laws also may inhibit the full use of the flexibility provided under the revised rules.

137 The SEC's proposal to require a Form D filing in advance of the first use of general solicitation, if adopted, could affect the timing of these press releases in Rule 506(c) offerings.

138 Issuers subject to Regulation FD will also have to consider the implications of any communications or disclosures of material nonpublic information they make as part of general solicitation materials. *See* § 3.02[3][c] for a discussion of Regulation FD. Form 8-K and Form 6-K filings designed to ensure public dissemination of material nonpublic information included in an offering circular for a Rule 144A or Rule 506(c) offering can now include the offering circular as an exhibit rather than including a summary of the specific material information without referencing the offering, as had been the practice to comply with Regulation FD before the elimination of restrictions on general solicitation and general advertising in connection with these types of offerings. However, liability concerns about expanding the scope of potential liability to secondary market participants for the entire contents of the offering circular may still favor the previous practice.

139 [Reserved.]

140 These kinds of services will need to consider a variety of issues, including whether they will be required to register as a broker-dealer under the Exchange Act.

141 Rules 138(b) and 139(c) under the Securities Act; *see* SEC Release No. 33-8591 (July 19, 2005). The safe harbors are not available for an offering under Regulation D (but are no longer necessary in connection with a Rule 506(c) offering) or § 4(a)(2).

142 *See* § 3.02[2][c] for a full discussion of Rules 138 and 139. *See* § 14.07[5] for a discussion of FINRA rules applicable to broker-dealer research practices.

143 *See* §§ 3.02[2] and 3.02[2][d] for a discussion of research in the context of a registered offering. As discussed in § 3.02[2][d], underwriters' practices concerning pre-deal research are influenced not only by regulatory issues, but also by the prospect that the content of research reports could be a potential source of liability. (Liability for a research report is not covered by indemnification from the issuer in a standard purchase agreement.) Based mainly on this concern, market participants have historically imposed a blackout period on pre-deal research for a limited period prior to the launch of marketing for the offering in order to be in a position to argue that the research reports should be viewed separately from the prospects, and underwriters also often agree to other restrictions such as limiting the scope of projections.

144 *See* § 14.07[5][b] for a discussion of the Global Research Settlement. *See also* FINRA Rules 2241 (for equity research) and 2242 (for debt research), FINRA MANUAL. Some banks avoided the distribution of pre-deal research in the United States for liability reasons even before the settlement. The research practices of international investment banks concerning pre-deal research still vary, based on differing views of the concerns discussed in the text above and in Note 143 *supra*, but in a given offering the underwriters often agree on a set of procedures to avoid divergent approaches. The SEC clarified that the provisions of the JOBS Act liberalizing the publication of research about "emerging growth companies" do not amend or modify the Global Research Settlement. *See* SEC, Division of Trading and Markets, Jumpstart Our Business Startup Act—Frequently Asked Questions [("FAQs")] About Research Analysts and Underwriters (Aug. 22, 2012), SEC Trading and Markets FAQs, FAQ2. Any investment bank currently subject to the Global Research Settlement therefore cannot take advantage of any relevant JOBS Act provision without first seeking amendment or modification of the Global Research Settlement from the court overseeing its application, and the SEC could support or oppose a requested modification. Although the SEC has indicated that the Global Research Settlement may also be modified through an SEC, FINRA or NYSE rule that specifically states an intent to supersede it, there is no evidence that such future rulemaking is likely.

145 The SEC has addressed the difference between investment banking personnel "arranging" for communication between research analysts and investors—conduct permitted by the JOBS Act in connection with an emerging growth company IPO—and "directing" research analysts to communicate with prospective clients or engage in other sales efforts—conduct prohibited by existing FINRA/NASD and NYSE rules. Permissible "arranging" includes an investment banker sending an analyst a list of clients to

contact, provided the analyst retains the discretion to decide whether to do so, and an investment banker arranging a call between an analyst and a client, provided the investment banker does not participate in such call. SEC Trading and Markets FAQs, FAQ 3 (Aug. 22, 2012).

146 In a registered offering, this kind of activity is limited by a number of considerations: the prohibition under § 5(c) of the Securities Act on making offers before a registration statement is filed; the conditions on reliance on the safe harbors from § 5(c) provided by Rule 163 (for a well-known seasoned issuer) and Rule 163A under the Securities Act; and the requirement (in an IPO) under the Instructions to Item 501(b)(3) of Regulation s -K to provide a price range in any preliminary prospectus that is "circulated." *See* §§ 3.02[2][a] and [b].

147 *See* § 7.02[1] and [2] for a discussion of the requirements for valid private offerings conducted in reliance on § 4(a)(2) of the Securities Act or Regulation D thereunder and § 7.02[3] for a discussion of the requirements for valid private offerings conducted pursuant to Rule 144A. As discussed above, the prohibition on general solicitation and general advertising no longer applies in offerings under Rule 506(c) of Regulation D and Rule 144A.

148 *See* § 7.02[4].

149 *Cf.* § 3.02[2][v][A] for a discussion of publicity with respect to the Internet in the context of a public offering.

150 *See* § 3.02[2][v][A]. This approval is relevant only for issuers who are not conducting a Rule 144A or Rule 506(c) offering, for which general solicitation (*via* the Internet or any other medium) is not prohibited.

151 *See Net Roadshow, Inc.* (avail. Jan. 30, 1998); *Net Roadshow, Inc.* (avail. Sept. 8, 1997).

152 *Net Roadshow, Inc.* (avail. Jan. 30, 1998).

153 *See* § 3.02[2][c][iii], therein and the accompanying text for a discussion of standard market practice regarding the taping of live road shows.

154 SEC Release No. 33-7516 (Mar. 23, 1998). The SEC subsequently emphasized the importance of restricting access from the United States or by U.S. persons, as appropriate, to web-posted offshore offering materials for offshore offerings conducted in conjunction with a U.S. private placement.

155 *See* Chapter 3, Note 237 therein for a discussion of the variety of electronic "gateposts" that can be used to restrict access to an Internet website. Where the offering materials posted on the website appear in English, it would be prudent to employ the more restrictive of these gateposts. Even where the posted offering materials are not in English, it may be prudent to employ more restrictive mechanisms, where, for instance, there is reason to believe a large expatriate community resident in the United States may seek to invest in securities issued by a company in their home jurisdiction.

156 *See* § 3.02[3][ix]. Some companies have conducted their own offerings on the Internet. These have tended to be issuers with small capitalizations that have used the Internet to raise fairly small sums, typically without the assistance of established underwriters. However, most issuers and established underwriters do not show signs of moving substantially away from traditional offering practices relying on paper-based disclosure, and most are using the Internet only supplementally.

157 Consideration must also be given to compliance with the broker-dealer registration requirements of the Exchange Act in connection with the use of the Internet to disseminate disclosure documents. *See* § 14.03.

158 *See* § 3.02[3][c][i].

159 *See* § 7.02[4].

160 Rule 502(a) under the Securities Act. In 2007, the SEC proposed to reduce the time frame for the Rule 502(a) integration safe harbor to 90 days, but it has never acted on the proposal. SEC Release No. 33-8828 (Aug. 3, 2007). The Note to Rule 502(a) also describes five factors to be considered in determining whether offers and sales should be integrated: (i) whether the sales are part of a single plan of financing, (ii) whether the sales involve issuance of the same class of securities, (iii) whether the sales have been made at or about the same time, (iv) whether the same type of consideration is being received and (v) whether the sales are made for the same general purpose.

161 Recent guidance from the SEC confirmed that a Rule 506(c) offering can follow a Rule 506(b) offering,

within six months of the Rule 506(b) offering (six months being the Rule 502(a) time-based threshold otherwise applicable to determine that two Regulation D offerings should not be integrated), and notwithstanding the five factors set forth in Rule 502(a) as being indicative of whether two offerings within six months of each other should be integrated. SEC Division of Corporation Finance Compliance and Disclosure Interpretations Question 256.34 (Nov. 17, 2016).In practice, this means an issuer can, for example, raise capital today from a number of investors with whom it has a previously existing relationship, under Rule 506(b) and without the need to take reasonable steps to verify the accredited investor status of those investors (so long as it "reasonably believes" they are accredited investors, as Rule 506(b) requires). Once all sales under that Rule 506(b) offering are completed, the issuer can then immediately do a separate offering under Rule 506(c) to raise additional capital by using general solicitation to find additional investors. The issuer would then have to take reasonable steps to verify accredited investor status of the investors only in the second (Rule 506(c)) offering. Earlier integration guidance from the SEC in 2015 addressed the combinations of Rule 506 offerings with each of Regulation A (SEC Release No. 33-9741 (Mar. 25, 2015)), proposed amendments to Rule 147 under the Securities Act (SEC Release No. 33-9973 (Oct. 30, 2015) (final rule)) and Regulation Crowdfunding (SEC Release No. 33-9974 (Oct. 30, 2015) (final rule)) but did not address the combination of consecutive offerings under Rules 506(b) and 506(c) (or vice versa).

162 The SEC's integration doctrine concerns "the determination as to whether separate sales of securities are part of the same offering (*i.e.*, are considered 'integrated')." SEC Release No. 33-6863 (Apr. 24, 1990), 55 Fed. Reg. 18,306, 18,322 (May 2, 1990). The question of integration originally arose with respect to whether two or more otherwise exempt offerings should be treated as a single offering to determine whether an exemption is available. The SEC has addressed integration of exempt offerings in, *inter alia*: Rule 502(a) under the Securities Act (safe harbor from integration for Regulation D offerings) and Preliminary Note 7 to Regulation s (no integration of private domestic offerings with offshore sales under Regulation s); *see also* § 7.02[2].

163 *Black Box Inc.* (avail. June 26, 1990); *Quad City Holdings, Inc.* (avail. Apr. 8, 1993).

164 *Black Box Inc.* (avail. June 26, 1990) (noting, however, that, if the issuer were to renegotiate the purchase agreements following the filing of the registration statement, the renegotiated placement might constitute a new offering and thus render this "completion" interpretation of the rule inapplicable). Thus, transactions in which investors agree to purchase securities in private offerings but condition closing on the availability of an effective resale registration statement (so-called "PIPE" transactions) are permitted under this *Black Box Inc.* interpretation of Rule 152, so long as the investors' commitments are subject only to conditions beyond their control and there is no renegotiation of the terms of the purchase after the filing of the registration statement. However, if there are any commitments made by investors after such filing to purchase privately the securities to which the registration statement relates, Rule 152 would be unavailable, the private offering could be integrated with the public offering deemed to have commenced with the filing of the registration statement, and the solicitation of the pre-filing commitments could be deemed to constitute an illegal public offer.

165 *Privatization of the United States Enrichment Corp*. (avail. May 13, 1998) (expressing the staff's view that unregistered offers to sell securities in connection with a possible merger or acquisition transaction, if made pursuant to a valid private placement exemption, need not be integrated with a subsequent initial public offering commenced by the filing of a registration statement after such possible merger or acquisition transaction has been abandoned).

166 *Squadron, Ellenoff, Pleasant & Lehrer* (avail. Feb. 28, 1992). Although the SEC staff is understood to have intended the restrictions in the Squadron letter to apply to both offerees and purchasers, we believe applying the restrictions to offerees is unduly restrictive and inconsistent with Regulation D 's focus on purchasers alone.

167 In taking this position, the SEC nevertheless distinguishes between a registration statement filed with respect to a specific issue of securities and a shelf registration statement. In the latter case, because the registration statement covers securities the final terms of which will not be determined until a "takedown" is

effected, no general solicitation occurs upon the mere filing of the registration statement. *See* SEC Release No. 33-7606 (Nov. 3, 1998), *as amended*, SEC Release No. 33-7606A (Nov. 13, 1998). This concern does not apply in the case of a Rule 144A or Rule 506(c) offering, for which general solicitation is not prohibited.

168 SEC Release No. 33-8828 (Aug. 3, 2007); *see also* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, Question No. 139.25 (Nov. 26, 2008). Although the proposal to revise Regulation D was not adopted, the guidance in the release on this topic remains salient. Again, this concern does not apply in the case of a Rule 144A or Rule 506(c) offering, for which general solicitation is not prohibited.

169 SEC Release No. 33-7943 (Jan. 26, 2001); *see also infra* Note 234. Reliance on Rule 155 is unnecessary where an abandoned public offering is followed by a Rule 144A or Rule 506(c) offering, for which general solicitation is not prohibited.

170 The SEC staff has said informally that it will not permit reliance on Rule 155(b) if an issuer with an effective shelf registration statement wishes to distribute, on a private basis and without filing, written material about a proposed new securities offering and, if it is well received, convert that private placement into a shelf takedown.

171 In connection with the adoption of Rule 155, Rule 477 under the Securities Act was amended to provide that an issuer's application to withdraw an entire pre-effective registration statement will become effective automatically upon filing with the SEC unless it objects within 15 days. The SEC also indicated that it would consider promptly applications to withdraw effective registration statements. In addition, Rules 429 and 457 under the Securities Act were amended to permit issuers to offset the filing fees paid in respect of withdrawn registration statements against future filing fees within the five years following their original filing. *See* SEC Release No. 33-7943 (Jan. 26, 2001).

172 *See* SEC Release No. 33-7943 (Jan. 26, 2001). The SEC staff has indicated in an informal meeting with practitioners that the Rule 155(c) safe harbor will not be available if marketing efforts prior to abandoning the registered public offering constitute general solicitation with respect to the subsequent private offering, even if those marketing efforts were part of a good faith effort to complete the public offering and not part of a plan or scheme to avoid registration of the subsequent private offering. Neither the language of the Rule itself nor the discussion of it in the adopting release suggests this additional condition. If indeed the SEC continues to take this view, it could effectively limit the availability of the safe harbor, where there has been more than a quiet filing of the registration statement, to private offerings only to those with whom the issuer or its underwriters have a pre-existing relationship or done in reliance on Rule 506(c) or Rule 144A.

U.S. Regulation of the International Securities and Derivatives Markets, § 7.03, DISCLOSURE AND DUE DILIGENCE PRACTICES IN RULE 144A 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 § 7.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Most offerings by foreign private issuers to U.S. investors are structured as private placements, generally as offerings through financial intermediaries relying on Rule 144A. The principal technical U.S. legal issues in such an offering involve meeting U.S. regulatory requirements: ensuring that the offering is exempt from registration under the Securities Act; determining that the issuer is not an investment company or, if it is, ensuring that the offering is structured to comply with the Investment Company Act; [173] determining that the offering does not have derivative features that present issues under the Commodity Exchange Act; [174] and in the case of debt securities, ensuring that there is no violation of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") rules. [175] In addition to these technical issues, however, Rule 144A offerings are shaped by disclosure and due diligence practices. These practices reflect U.S. liability concerns, and they have evolved to address them, in addition to complying with legal requirements and market practices in the issuer's home jurisdiction or in the primary trading market for its shares. [176]

The disclosure process in a typical Rule 144A offering is similar in its broad outlines to the process in a U.S. public offering. The issuer, assisted by counsel, prepares a formal offering document, [177] which is distributed to investors in preliminary form for use in marketing the offering and then in final form

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after the offering has been priced. [178] The financial institutions conducting the offering, assisted by counsel, conduct a due diligence investigation prior to the commencement of marketing and update it (or "bring it down") before pricing and again at closing. Those institutions, acting as initial purchasers, [179] enter into a purchase agreement with the issuer, in which (among other things) the issuer provides representations relating to the offering circular and to its legal status, business and other matters, the issuer agrees to indemnify the initial purchasers against liabilities arising from the disclosure, and the obligations of the initial purchasers are conditioned on delivery of documentation (*e.g.*, legal opinions and auditors' comfort letters) that supports the due diligence. If there are selling securityholders in an equity offering, they are also parties to the purchase agreement, and the contractual allocation of risk between selling securityholders and the issuer, through representations and indemnities, is negotiable; but the issuer is still responsible for the offering circular. There is typically a road show presentation, distinct from the offering circular but in principle consistent with it. [180]

[1] The Rule 144A Offering Circular—Form

There are many possible formats for an offering circular in a Rule 144A offering, depending on the structure of the offering. For example, many debt

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offerings are placed with U.S. institutional investors under Rule 144A and with non-U.S. investors under local exemptions from registration for institutional placements, so that no regulatory approval is required in any jurisdiction. In such an offering, it is typical to prepare a single, integrated, stand-alone offering circular in English. [181] Many equity offerings, on the other hand, are placed with U.S. institutional investors under Rule 144A and in a concurrent public offering registered under local securities laws in the home jurisdiction, which is the principal or only trading market. [182] In an equity offering of this kind, there would be (i) an offering circular for use in the Rule 144A placement (and for use in the offering elsewhere outside the home market) and (ii) a parallel prospectus for use in the home jurisdiction. The preparation of the parallel offering documents is particularly complex if the home jurisdiction prospectus is not in English. Practices vary widely as to whether the English-language offering circular or the home-language prospectus is prepared first.

If the issuer is a reporting company in the United States, information may be incorporated by reference into a Rule 144A offering circular from material filed with the SEC. This practice was at one time debated, because of the absence of any specific basis for it in the SEC's rules, but it has ceased to be controversial. Rule 144A offering circulars do not typically incorporate by reference material filed with a non-U.S. securities regulator or exchange, although they could presumably do so if the material is readily available, at least if it is in English.

Where the Rule 144A offering is part of a global offering that is primarily conducted outside the United States, the global offering document may include certain disclosure material that relates specifically to the U.S. placement. This disclosure might, for example, cover the aspects of the plan of distribution that are relevant to the U.S. market, restrictions on resale of the privately placed securities, any related ADR program, and tax consequences to U.S. purchasers. Alternative approaches, used less often today than in the past, include (i) a supplement (sometimes known as a "*wrap-around*") attached to the non-U.S. offering documentation and containing only the U.S. market material and (ii) a separate "U.S. version" of the offering circular for use in the United States, differing from the "non-U.S. version" only in including the U.S. market material.

[2] The Rule 144A Offering Circular—Content

The content of a Rule 144A offering circular is determined by a number of different factors. One of the most important is marketing, because the offering

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circular serves to present the securities and the issuer in a manner that is favorable to the success of the offering and that also responds to the expectations of institutional investors. Another is precedent, because investors and initial purchasers tend to compare disclosure in a new offering with disclosure in similar offerings or of similar issuers.

A third factor is existing disclosure. If the issuer is subject to periodic reporting in its home country or principal trading market, it will have existing disclosure that responds to local regulatory requirements and that is already being relied on by existing investors. If, on the other hand, it is conducting an initial public offering in its home jurisdiction concurrently with a Rule 144A offering in the United States, it will prepare disclosure for its home regulator in accordance with that regulator's requirements. In such cases, where the issuer will provide disclosure for home-country purposes at the same time as it provides an offering circular to Rule 144A investors, there is usually consensus that the two disclosure documents should be consistent—because if they diverge, the differences could be used in retrospect to characterize one of them as deficient, and also because regulators in the home jurisdiction may expect that information provided to investors in the international offering will also be provided to investors in the home offering. Divergences do, however, arise. The home country disclosure may include material that is unnecessary or confusing in the context of a Rule 144A offering, or that cannot be verified in the due diligence process, and that is consequently omitted from the Rule 144A offering circular. [183] Conversely, the Rule 144A offering circular may include material that is considered unnecessary under home country practice.

In addition to these factors, practitioners have developed a broad consensus that certain items of disclosure are standard in Rule 144A offerings. This consensus is reflected in the criteria of international financial institutions for their participation in a Rule 144A transaction, and in the criteria of international law firms and auditing firms for their participation and for their delivery of the "negative assurance" letters on disclosure that are customary conditions precedent to closing. Ultimately all these are driven by a combination of liability concerns, reputational concerns, investor expectations and institutionalized best practices. For all these purposes, the touchstone is materiality to investors—the offering

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circular must be free of both material misstatements and omissions of material facts necessary to make the statements made therein not misleading. Practices in SEC-registered offerings often serve as a reference point: if a particular element of disclosure would be sufficient in a U.S.-registered offering, it is presumed to be sufficient in a Rule 144A offering. But other sources, including implementing regulations and practices under the European Prospectus Directive, are important as well, and generally the fact that information would be disclosed in a registered public offering does not in itself require the conclusion that it must also be disclosed in a Rule 144A offering.

Views about the sufficiency of disclosure evolve as market practices change. Following is a list of core elements of disclosure in a Rule 144A offering, without which an offering circular would present challenges for an investment bank, an auditor or a law firm. The list includes only the principal disclosure elements that arise in common situations.

Audited financial statements—Financial statements of the issuer, with full notes and audited by an independent auditor are included. Financial statements in Rule 144A offerings may be presented under various systems of accounting principles—U.S. generally accepted accounting principles ("GAAP"), International Financial Reporting Standards ("IFRS") or another national system. [184] The audited financial statements are generally consolidated. They typically cover three years, based on what would be required under SEC rules and under the European Prospectus Directive and implementing regulations. [185] They are accompanied by explanatory notes, whose scope and content are governed by the applicable accounting and auditing principles. Unless the issuer is an SEC-reporting company, the standards governing the conduct of the audit are usually not the Public Company Accounting Oversight Board ("PCAOB") standards that would apply in an SEC-registered offering, [186] and auditor independence is not

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usually evaluated under Regulation s -X, as it would be in an SEC-registered offering. [187] The audited financial statements are sometimes more than 12 months old by the time the securities are sold—in other words, the offering may be conducted in the early months of a fiscal year without audited financial statements from the most recently completed fiscal year.

If the issuer has not otherwise published interim financial statements, difficult questions occasionally arise as to whether they should be included, depending on the age of the audited financial statements at the time of the offering. [188] When interim financial statements are presented, they are ordinarily not audited, and a limited review report of the auditor is generally not included in the offering circular. [189] An interim income statement is ordinarily accompanied by the income statement for the corresponding period of the previous year.

Potentially challenging issues regarding financial statements arise when the issuer has recently made a material acquisition, or has agreed to make one. In such a situation, financial statements of the target could obviously be valuable for investors to understand the acquisition, but they may not be readily available or reliable. In an SEC-registered offering, detailed rules provide for the inclusion in the registration statement of separate financial statements of the acquired (or target) company and *pro forma* financial information showing the effects of the acquisition, depending on how "significant" the acquisition is under a highly specific measurement rule. [190] In Rule 144A offerings, these rules are of course inapplicable, and many other jurisdictions have either no applicable regulation, or principles of uncertain application, or regulator discretion. Practitioners accordingly often refer to the rules that apply in an SEC-registered offering as a first

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step in determining what financial information should be provided. [191] In some cases, the inability to provide target financial statements or *pro forma* financial information makes it impossible to proceed with an offering.

MD&A or OFR—A discussion of the issuer's financial performance and its financial condition is included, and is similar to the "management's discussion and analysis" ("MD&A") or "operating and financial review" ("OFR") required in offerings and periodic reports under SEC rules, the European Prospectus Directive and many other national disclosure regimes. [192] The guiding principle is to present management's view of the issuer's financial performance and financial condition, supplementing the information provided in the financial statements and notes. The typical elements include: (i) an overview identifying key issues about the financial statements and recent performance, (ii) a discussion of critical accounting policies, generally meaning policies that require significant estimates and judgments, (iii) a detailed discussion comparing results of operations for recent annual and interim periods, with particular attention to trends and uncertainties that will affect future performance and to factors that may affect comparability among periods, and (iv) a discussion of liquidity and capital resources, with particular attention to liquidity, funding requirements, sources of funding, terms of outstanding debt and related matters. Of these four elements, the last two are more nearly universal. Many of the specific elements of the discussion are based on SEC requirements, although some of the specific disclosures required in SEC filings, particularly those introduced after the Sarbanes-Oxley Act of 2002, are not as common in Rule 144A offerings. [193]

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Risk factors—A discussion of the principal risks applicable to the issuer, its business and the particular securities is included. In its breadth, this discussion usually corresponds to practices in the U.S. public markets. The expression "risk factors," borrowed from SEC requirements [194] but now adopted in many other jurisdictions, is perhaps too narrow, as this discussion usually provides an extensive list of challenges facing the issuer and potential disadvantages of investing in its securities. While there may be an argument that a particular issuer or offering does not present significant risks, it is extremely rare for a Rule 144A offering circular to omit risk factors altogether.

Use of proceeds—In a primary offering (where the net proceeds will go to the issuer, as opposed to a selling securityholder), disclosure about how the issuer plans to use the net proceeds of the offering is included.

Description of business—A description of the issuer's business, including strategy, operations, facilities, competitive and regulatory environment and other elements is provided. [195] The extent of this description varies widely, depending on many factors including home-country regulatory requirements, economic sector of the issuer, familiarity with the issuer on the part of the market and investors, and marketing considerations. [196] Some key elements of the business description, such as capital expenditure requirements, major contracts or material legal proceedings, may be described under other or separate headings.

SEC rules provide specific, detailed disclosure regimes for registered offerings by issuers in certain sectors, including banking, mining, oil and gas and insurance. [197] In Rule 144A offerings by foreign private issuers in those sectors, questions often arise as to the degree to which the offering circular should follow the SEC's specific disclosure requirements. If there is a well-developed alternative disclosure regime under home country law that addresses the same issues—as there may be, for example, for disclosure of mineral reserves or oil

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and gas reserves—that can be sufficient. [198] Otherwise, practitioners usually agree on a package of disclosures that addresses the same issues as the SEC's requirements but may do so in a different way or at a lower level of detail.

Management and board of directors—There is a discussion of how the issuer is managed and governed, including the identity of the members of the board of directors (or similar body) and the principal executives. A particularly sensitive issue is arrangements for compensation of directors and especially management. Although regulatory requirements have become far more demanding in domestic markets around the world, and especially in the United States, it remains common in Rule 144A offerings to provide aggregate disclosure at a

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comparatively low level of detail. [199] Additional detail is provided if it is publicly available or it is particularly material, either because of the amounts involved or the potential incentives or contingencies they create, for example, with respect to a potential change of control.

Major shareholders—Any shareholders with a controlling or otherwise significant interest are identified, and there is disclosure of contractual arrangements among them relating to their investment in the issuer. Practices differ concerning the threshold for disclosure of a shareholding interest. [200] In some cases, the identification of direct shareholders of the issuer is simple enough, but if effective control lies with other parties that own their interest through the direct shareholders, more detailed disclosure relating to such other parties would be appropriate. It is sometimes difficult to determine the parties that have effective control, and the issuer or such parties may be reluctant to disclose their identities, but most practitioners believe controlling interests must be disclosed where the information is known or reasonably available to the issuer or selling securityholders. [201]

Related-party transactions—A description of transactions or circumstances that present the possibility of conflict of interest between the issuer and its executives, directors or major shareholders is provided. This topic is fundamentally important, because of the potential that parties in a position to influence the issuer will do so to the detriment of investors in the offering, because of the inherent importance of conflicting interests, and because in rare cases the consequences can be serious for investors and for the initial purchasers. It can be difficult to identify and evaluate related-party transactions, but in close cases the touchstone should be the potential for material effects on investors and it is common to err on the side of caution. [202]

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Description of securities—There is a description of the terms of the securities and their governing instruments. For debt securities, this description is ordinarily very complete and may consist of the actual terms of the securities. For equity securities, it customarily consists of a description of those aspects of the issuer's constitutive documents that bear on the rights of equity holders.

Tax disclosure—A summary of the tax implications of investing in the securities is provided. In Rule 144A offerings, this disclosure typically covers the laws of the United States and the issuer's home jurisdiction.

Plan of distribution—There is disclosure about the contractual arrangements between the initial purchasers and the issuer or selling securityholders, including the terms of initial purchase, the expected terms of sale to investors and other matters. [203]

Transfer restrictions—A summary of the restrictions applicable to any offer, sale or transfer of the securities by a holder after closing, including deemed representations by purchasers in the offering that they acknowledge the securities have not been registered under the Securities Act and may only be offered, resold or transferred in compliance with the Securities Act, is provided.

[3] Due Diligence Practices

The initial purchasers in a Rule 144A offering conduct due diligence for the same reasons as underwriters in a registered public offering—because it assists them in defending against liability and because it reduces the risk of defective disclosure. [204] Defective disclosure is harmful to the initial purchasers even when it does not lead to litigation and liability, because if investors suffer losses they may hold the initial purchasers commercially responsible, which hurts their reputation and may also entail direct costs to compensate investors.

The standard due diligence process includes discussions with the issuer's senior management, often based on a written questionnaire, and often referred to as management or business due diligence. Sometimes these discussions extend to major shareholders or outside parties like important creditors or suppliers. There are also discussions with the issuer's auditors. All these conversations are

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updated ("brought down") by additional conversations shortly prior to pricing and again shortly prior to closing.

The standard due diligence process also includes review of issuer documentation, again often in response to a written list of requests typically prepared by counsel to the initial purchasers. For example, the review may include corporate documentation, major contracts and records of the board of directors and its major committees. In some cases, sensitivities about the confidentiality of documents lead issuers to restrict access to certain documents or impose other conditions on the due diligence process, but counsel need to conclude that any proposed restrictions will not unreasonably interfere with the access they require to provide their negative assurance letters. The review is usually conducted mainly by counsel, often in a team including lawyers from the home jurisdiction who are qualified to review documentation and lawyers with experience in U.S. disclosure practices. [205]

As a supplement to the due diligence process, there is a contractual requirement that the issuer deliver various documents as a condition to the obligations of the initial purchasers to close. These documents typically include, in addition to various certificates, negative assurance letters of counsel (often from more than one law firm) [206] and a comfort letter from the auditor. Under the applicable auditing standards, delivery of a comfort letter in a transaction that is not subject to § 11 of the Securities Act is not permitted unless the recipient of the letter has provided the auditors with a representation letter to the effect that it has conducted a review process, or due diligence inquiry, substantially consistent with that it would conduct in a registered offering. [207] Alternatively, if the recipient chooses not to provide such a letter, the auditors may report on the results of applying certain agreed-upon procedures to specific financial statement line

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items; [208] under these circumstances, the auditors may not, however, provide negative assurance with respect to such items. [209]

Footnotes

173 *See* Chapter 14, Part A.

174 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.03[4].

175 *See* § 8.03[2].

176 The liability regime under U.S. law applicable to Rule 144A and other private placements is discussed in Chapter 11.

177 The Rule 144A offering document is not ordinarily referred to as a "prospectus"—that term being reserved for the analogous document filed with the SEC in an offering registered under the Securities Act and, in many cases, for a disclosure document filed for regulatory purposes in a non-U.S. jurisdiction. The names most often used are offering circular (which is used in this Chapter 7) and offering memorandum.

178 In a Rule 144A offering, the use of preliminary and final versions of the offering document is not required for any regulatory reason (in contrast to the practice in SEC-registered offerings and in many non-U.S. jurisdictions). In a successful Rule 144A offering, the offering is fully sold before the final offering circular is prepared, so the final offering circular is not actually used in the marketing process or as a basis for investment decisions.

179 The financial institutions conducting a Rule 144A offering on behalf of the issuer are not typically referred to as "underwriters," even when they make a firm commitment to purchase the securities just as underwriters do in a registered offering, because pursuant to Rule 144A they are not underwriters for purposes of the statutory definition of the term in § 2(a)(11) of the Securities Act. They are often referred to as "initial purchasers." For the same reason, the agreement is not typically called an "underwriting" agreement. In some markets, the financial institutions conducting the offering do not purchase and resell the securities but rather undertake to procure purchasers, and they agree that if they fail to do so they will purchase the securities themselves. In other markets, the financial institutions conducting the Rule 144A placement do so as agents for the home-country underwriters. Practices of this kind may be to avoid additional stamp duty under applicable local law, or to accommodate local regulatory concerns.

180 Road show presentations may be made in person or accessed *via* the Internet, but in either case the presentation is not usually made available in a format that allows investors to retain it. Transaction participants typically seek to ensure that road show materials are consistent with the offering circular and do not contain material information that is not in the offering circular. Initial purchasers increasingly request that road show materials be covered by company representation and indemnities in the purchase agreement, especially when there is an electronic road show.

181 The offering circular, or a slightly modified version of it, may also serve as a listing prospectus for a listing on an exchange-regulated market like the Euro MTF in Luxembourg or the Global Exchange Market in Ireland.

182 In both the debt and equity examples, the non-U.S. offering is, for U.S. purposes, exempt from registration under Regulation s.

183 Forward-looking information, such as projections or forecasts of future financial performance, presents difficult issues in this respect. In some jurisdictions outside the United States, it is required or customary, particularly for a company or operation that is new or still under development, to include projections that would be unusual in U.S. practice because of the perception that liability risk is high and conducting due diligence is difficult. Unless the information is clearly positive or inconsequential (which will rarely be the case), excluding it from the Rule 144A offering circular might appear to be a material omission, so including it with appropriate cautionary language and due diligence procedures may be preferable. *See* Chapter 11 for a discussion of 10b-5 liability considerations applicable to forward-looking information.

184 In the early years of Rule 144A offerings it was common, where the financial statements were presented under a system other than U.S. GAAP, for the offering circular to include a discussion of significant differences between that system and U.S. GAAP. Such a discussion is no longer considered necessary, at least if the system of accounting principles is reasonably well established. If it is not, the offering participants would want to consider additional due diligence concerning the system of accounting principles as well as disclosure about how it differs from U.S. GAAP or IFRS. Similar considerations might arise in the case of a financial presentation under a variant of IFRS that does not conform fully to IFRS as adopted by the International Accounting Standards Board ("IASB").

185 A balance sheet as of the end of the earliest of the three years is not required under SEC rules, however, if that balance sheet is not required by the registrant's home jurisdiction (or any other jurisdiction whose rules are applicable to the registrant outside the United States). If the issuer were an "emerging growth company," consideration could be given to including only two years of audited financial statements. *See* § 3.02[1][c].

186 *See* Chapter 5 for a discussion of the standards of the U.S. PCAOB. Many non-U.S. jurisdictions require an audit to be performed in accordance with the International Standards on Auditing ("ISAs") promulgated by the International Auditing and Assurance Standards Board ("IAASB"), while others rely on auditing standards adopted by a national auditor oversight body. An auditor's use of unfamiliar auditing standards would be a point for additional due diligence and possibly for cautionary disclosures.

187 *See* Rule 2.01 of Regulation s -X (auditor independence requirements for an SEC registration statement or annual report). There is, however, a general expectation that the auditors qualify as independent under some applicable standard, and they are ordinarily expected to confirm it in their comfort letter to the initial purchasers. If the independence standards are unfamiliar, they would be a topic for due diligence inquiry by the initial purchasers.

188 For an SEC registration statement of a foreign private issuer, interim financial statements are required if the audited financial statements are more than nine months old, and if the issuer has published more recent financial information, that information must be reflected in the registration statement. *See* Form 20-F, Item 8.A.5; § 4.04[4].

189 Depending on how much time has passed since the last audit, limited review may be necessary to support the ability of the auditor to provide, in its comfort letter to the initial purchasers, negative assurance as to changes subsequent to the date of the last financial statements included in the offering circular. *See* AS §

6101.46. Even then, however, the limited review report is not typically included in the offering circular unless it is included in home-country disclosure.

190 *See* § 4.04[10].

191 SEC rules for a registered offering also require the inclusion in the registration statement of financial statements of a major unconsolidated subsidiary or equity-method investee. *See* § 4.05[5][b]. These financial statements are not always considered necessary in a Rule 144A offering.

192 *See* Form 20-F, Item 5 (for an SEC registration statement or annual report of a foreign private issuer); Item 303 of Regulation s -K (for an SEC registration statement or annual report of a domestic issuer); Items 9 and 10 of Annex I to Commission Regulation (EC) 809/2004, as amended (the "Prospectus Regulation") (disclosures on operating and financial review and capital resources applicable to equity offerings). The term "MD&A" derives from the title of the disclosure under SEC rules applicable to domestic issuers; it has not been used since 2000 in the SEC rules governing disclosure by foreign private issuers (Form 20-F requires instead, in Item 5, a discussion of "Operating and Financial Review and Prospects"). Lawyers and auditors often refer to SEC guidance on the content of MD&A, even though for a nonreporting issuer it has no direct bearing on a Rule 144A offering and might be unknown to the issuer's financial reporting personnel. *See* § 4.05.

193 For example, disclosure requirements on off-balance sheet arrangements and on contractual obligations were added to Item 5 of Form 20-F pursuant to the Sarbanes-Oxley Act but are not required by the International Organization of Securities Commissions ("IOSCO") standards on which Form 20-F is otherwise based. These disclosures are often not included in Rule 144A offering circulars, particularly in equity offerings where home country requirements frequently guide the scope of disclosure.

194 *See* Form 20-F, Item 3.D; Item 503 of Regulation s -K; *see also*, *e.g.*, Item 4 of Annex I and Item 2 of Annex III to the Prospectus Regulation (risk factor disclosure requirements for equity offerings).

195 Early Rule 144A offering circulars often also included disclosure about general economic and political conditions in the issuer's country, primarily because information about the country was considered helpful for marketing to U.S. investors that might not be familiar with it. This practice has become rare, as investors have become familiar with a wide range of jurisdictions and have developed other information sources. Initial purchasers may find it challenging to conduct adequate due diligence on country disclosures, unless they are attributable to official sources. In this regard, the liability provisions applicable to a registered offering establish a lower threshold for an initial purchaser's due diligence defense where statements in a registration statement are copied or extracted from a public official document. § 11(b)(3)(D) of the Securities Act.

196 The SEC requirements applicable in registered offerings are in Item 4 of Form 20-F (for a foreign private issuer) and Item 101 (as to business), Item 102 (as to property) and Item 103 (as to legal proceedings) of Regulation s -K (for a domestic issuer). *See also*, *e.g.*, Item 6 of Annex I to the Prospectus Regulation (business disclosure requirements for equity offerings).

197 *See* § 4.08 ; *see also* § 4.02[1][a].

198 Some private placements involve more expansive disclosures than would be required in an SEC-registered offering. For example, some Russian oil companies making Rule 144A offerings have provided more complete disclosure than their U.S.-registered counterparts in the oil and gas context. The offering circular prepared in connection with a Rule 144A private placement by Rosneft in July 2006 contained a variety of reserves and resources data that would not otherwise have been permitted under SEC rules in place at the time. *See* Rosneft, Offering Circular (July 14, 2006). Generally, the SEC had permitted oil and gas companies, in their filings with the SEC, to disclose only proved reserves, *i.e.*, the estimated quantities of crude oil, natural gas and natural gas liquids that geological and engineering data demonstrate with "reasonable certainty" to be recoverable in future years from known reservoirs under existing economic and operating conditions. The SEC now permits additional categories of reserves to be disclosed, but still does not allow the disclosure of resources that are not reserves. *See* § 4.08[1] for a discussion of amendments to the SEC's rules governing disclosures about oil and gas activities that took effect for Securities Act

registration statements filed on or after January 1, 2010. In addition, SEC guidance has indicated that disclosed reserves should generally include only those reserves that can be produced through the license expiration date, unless there is a long and clear track record of license renewal as a matter of course. The Rosneft offering circular contained not only SEC-standard proved reserves data through expiration of licenses, but also SEC-standard proved reserves data through the economic lives of the fields, as well as proved, probable and possible reserves data under the standards set forth by the Society of Petroleum Engineers (the "SPE"), estimates of reserves determined under the Russian reserves methodology and crude oil and gas resources data based on standards set forth by the SPE covering both prospective and contingent resources. *See* Rosneft, Offering Circular (July 14, 2006). The SEC-standard proved reserves data through the economic lives of the fields were included in the offering circular based on the fact that, under relevant Russian law, Rosneft had a right to renew its licenses to the end of the economic lives of the fields so long as it did not violate the conditions of the license, and Rosneft's established history of success in extending various licenses. The other additional reserves and resources data were included in the Rosneft offering circular following consideration, in part, of the customary scope of disclosure in the international market and the issuer's home market. It is our experience that disclosure of proved, probable and possible reserves data under the SPE standards has become quite standard in the international market in connection with a Rule 144A offering. Inclusion of any other resources data in an offering document prepared in connection with a private placement will require a case-by-case analysis of the facts and circumstances concerning the issuer and any particular characteristics of its home market. In June 2016, the SEC proposed new rules intended to align disclosure requirements for mining properties with industry and global regulatory practices and standards. The proposed rules include more expansive disclosure requirements relating to mining operations and mineral reserves, exploration and resources. SEC Release No. 33-10098 (June 16, 2016). *See* § 4.07.

199 Aggregate disclosure is permitted in an SEC registration statement or annual report of a foreign private issuer, provided that individual information is not required in the home jurisdiction or otherwise publicly disclosed. Form 20-F, Item 6.B. This would support the position that the absence of individual disclosures is not *per se* a material omission.

200 The 5% level applicable in an SEC registration statement or annual report may serve as a threshold below which an interest can generally be presumed not to be material. *See* Form 20-F, Item 7.A; Item 403(a) of Regulation s -K.

201 Similarly, in some cases there are arrangements between shareholders that have an important effect on control of the issuer but to which the issuer is not a party, and these should be disclosed if the information is known or reasonably available to the issuer or selling securityholders. *See* Form 20-F, Item 7.A; Item 403(c) of Regulation s -K. In some countries, concern for personal security may be a factor in the discussion whether to identify an individual with a significant interest or to provide individual compensation information. The key issue is whether the information is material to investors, and the materiality concern is strongest where control of the issuer is concerned and may be less strong where compensation is concerned.

202 *See* Form 20-F, Item 7.B; Item 404(a) of Regulation s -K.

203 *See* Form 20-F, Item 9.B; Item 508 of Regulation s -K. Many Rule 144A offering circulars include disclosures derived from those included for regulatory reasons in registered offerings—for example, relating to stabilization transactions. However, they often do not include information about initial purchaser compensation and the allocation of offering expenses that would be required in an SEC-registered offering when that disclosure is determined not to be material to investors.

204 *See* § 11.04 for a discussion of the liability standards applicable to a Rule 144A offering under the securities laws. *See* § 3.02[6] for a discussion of due diligence practices in public offerings.

205 Practices vary widely with respect to the preparation of written reports on due diligence, depending on how initial purchasers and their counsel balance the potential advantages of documenting a rigorous process against the risk that a written report will be damaging evidence in future litigation. In some cases, local

underwriter or listing sponsor requirements will dictate whether due diligence or verification documentation will be preserved.

206 *See Negative Assurance in Securities Offerings* (*2008 Revision*), 64 BUS. LAW. 395 (2009) (report of an American Bar Association ("ABA") committee on law firm negative assurance letters). While there are other approaches, negative assurance is commonly provided by two U.S. firms, one representing the issuer and the other representing the initial purchasers. It is also often provided by law firms in the issuer's home jurisdiction and by in-house counsel for the issuer.

207 U.S. auditor comfort letters are governed by AS § 6101, which codifies Statement of Auditing Standards No. 72 and subsequent amending statements. *See* AS § 6101.04 (providing for a representation letter from the recipient in unregistered offerings). For a general discussion of comfort letters, *see* § 3.02[6], Note 325.

208 Reports of the results of applying agreed-upon procedures are governed by AT § 201 ("Agreed-Upon Procedures Engagements"). AT § 201 is based on Statement on Standards for Attestation Engagements ("SSAE") No. 10 (Attestation Standards: Revision and Recodification), which also withdrew SAS 75 (Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement).

209 *See* § 3.02[6], Note 348, as to the meaning of the term "negative assurance." Although the negative assurance provided through a comfort letter is based essentially on the same procedures reported on in an agreed-procedures letter, the extent to which a court may accord greater weight to a comfort letter in establishing that the initial purchasers did not have the requisite *scienter* for Rule 10b-5 liability remains untested.

U.S. Regulation of the International Securities and Derivatives Markets, § 7.04, RESALES OF PRIVATELY PLACED 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 § 7.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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While § 4(a)(2) of the Securities Act and Regulation D thereunder provide the basis for an issuer's exemption from the registration requirements of the Securities Act, they do not provide an exemption from registration for investors to resell, publicly or privately, securities purchased in a private offering. Securities acquired from an issuer in a private placement are considered "restricted" securities, and purchasers must have their own exemption for resale of those securities. The SEC's concept of "restricted securities" was without direct foundation in the Securities Act and was based on its view that a purchaser in a private offering that subsequently resold the securities in the public market could be viewed as "taking from an issuer with a view to distribution" and thus be an underwriter, in which case it had no statutory exemption from Securities Act registration requirements under § 4(a)(1), or in the case of dealers, § 4(a)(3). Further, as noted above, one of the requirements of Regulation D is that the issuer exercise "reasonable care" to ensure that purchasers are not underwriters of the securities in question, and the procedures used to ensure compliance with either Regulation D or § 4(a)(2) include restrictions on resales of privately sold securities. Regulation D and § 4(a)(2) do not, however, indicate what resales are permissible. One answer, as discussed above, is embodied in the safe harbor for resales to QIBs under Rule 144A. This section also addresses resales under the Rule 144 safe harbor, the § 4(1 ½) doctrine, the § 4(a)(7) safe harbor and the Regulation s safe harbor.

[1] Resale Under Rule 144A

Securities sold in a private placement can be resold pursuant to Rule 144A under the Securities Act, as discussed above.

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Many foreign issuers also provide for the possibility of Rule 144A resales in connection with offerings of their securities under Regulation s under the Securities Act. [210] As discussed below, securities initially sold under Regulation s are effectively subject to a limitation on U.S. sales, generally 40 days from the date the offering commenced, as a result of the prohibition against dealer sales contained in § 4(a)(3)(A) of the Securities Act. [211] In addition, in certain cases resales are also subject to the applicable distribution compliance period (40 days, six months or one year), also referred to as a "seasoning" period, under the safe harbors of Regulation s. [212] After these periods, securities sold in a Regulation s offering are generally unrestricted with two important exceptions: (i) equity securities of U.S. issuers [213] and (ii) securities that are part of an unsold allotment, for which the limitations on U.S. sales of § 4(a)(3)(C) of the Securities Act apply. [214] However, Rule 144A provides a safe harbor for U.S. sales of eligible securities even during these periods. In cases where the underwriting or other selling documentation does not restrict sales of the securities under Rule 144A, and the securities are otherwise eligible for resale under Rule 144A (*i.e.*, the securities are not fungible with U.S. exchange-listed securities and the information requirement is satisfied or does not apply), U.S. broker-dealers may purchase securities sold abroad under Regulation s and resell them to QIBs under the Rule, even during any applicable Regulation s distribution compliance period and the 40-day period of § 4(a)(3)(A). Following Rule 144A sales, the securities in question will be "restricted" even after the expiration of any such seasoning period. [215]

The rationale underpinning the broker-dealer's ability to resell under Rule 144A securities initially sold abroad derives from the nature of the exemption

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provided by Rule 144A. Sales under Rule 144A do not constitute a distribution and are not subject to registration under the Securities Act, even during the distribution compliance period that follows a foreign offering. [216]

Under the philosophy of Rule 144A, issuer-imposed documentation and procedures to police resales by the purchaser should not be necessary. However, since Regulation D requires the issuer to take "reasonable care" to ensure that purchasers are not underwriters—or risk strict liability under § 12(a)(1) of the Securities Act—the question for issuers is to what extent they need to police resales to comply with the reasonable care requirement. Commenters on Rule 144A as originally proposed requested that the SEC amend Regulation D to provide expressly that "reasonable care" could include sales to dealers based solely on contractual restrictions requiring them to resell the securities only pursuant to Rule 144A. The imposition of other restrictions to monitor subsequent resales, such as transfer restrictions, "stop-transfer" procedures, letters from subsequent purchasers and other procedures, would then be unnecessary to establish the issuer's private offering exemption. The SEC did not, however, amend Regulation D, leaving open the question whether contractual restrictions limited to the requirement that the first round of resales be made under Rule 144A are sufficient to constitute "reasonable care."

The SEC adopted Rule 144A on the premise that QIBs can be relied on to know the law, and the law requires them to have an exemption for any resale of a restricted security. The seller under Rule 144A does not police and is not responsible for the resales by the buyer—it must only notify a buyer that the seller may be relying on the Rule. If a seller is not responsible for the acts of its buyer, it would be anomalous to think that the issuer has responsibility for resales after its initial § 4(a)(2) sale; it should therefore be enough that the issuer has by contract required that resales be made only to QIBs in compliance with Rule 144A. Under this analysis, a court should respect an issuer's § 4(a)(2) exemption in a case where a remote purchaser sells in violation of the Rule, and liability should be found under § 12(a)(1) only against the seller that sold without a Securities Act exemption. Moreover, if the SEC did not intend, by the very adoption of Rule 144A, to facilitate liquidity by reducing documentation, it is difficult to imagine a rationale for the SEC initiative in proposing the Rule at all. [217]

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Transaction practices suggest a consensus among issuers and the private securities bar that (i) an issuer has a valid exemption under § 4(a)(2) if it sells securities to investment banks that agree to resell only under Rule 144A and in accordance with its requirements and (ii) there is no need to restrict subsequent resales by investors or take other procedural steps. Under this approach, no investment letters from initial or subsequent investors are required, no transfer restrictions or "stop-transfer" provisions are imposed, and no legends on securities are necessary. Documentation for Rule 144A offerings does generally include disclosure—under the headings "Transfer Restrictions" and/or "Notice to Investors"—stating that investors are (i) deemed to represent and agree as to their sophistication and investigation in respect of the offering and (ii) notified that the offering is exempt from registration under the Securities Act, that they may only resell or otherwise transfer the restricted securities they will hold under a valid exemption from registration (such as resales under Rule 144A, Rule 144 and Regulation s and, in some cases, under § 4(1 ½)), and of other matters. [218] It is also common practice to include a legend on certificated and global securities that describes the limitations on resale. [219]

One area where there is a tendency to obtain letters from investors in Rule 144A offerings, notwithstanding the general practice of not obtaining such letters, involves cautionary letters in cases of issuers, especially in certain emerging markets, where special levels of sophistication and care by investors are required. Such letters have been used for offerings out of certain markets at certain times, such as Russia and parts of Eastern Europe during their transition to market-based economies, where accounting standards, disclosure standards and

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the relative unavailability of information raise special issues, but where there is demand for investment opportunities by sophisticated investors. In such letters, investors generally acknowledge their special sophistication in the market in question and the special accounting and disclosure issues and lack of information involved, state that they have not relied on the financial institution intermediary in making their investment decision, represent that they have performed and relied on their own investigation and make certain other representations and undertakings. These letters are sometimes referred to as "toxic waste" letters.

A consensus among issuers and the private bar has also developed with respect to "side-by-side" offerings in which the participating financial institutions are permitted to resell both to QIBs under Rule 144A and to other investors under § 4(1 ½). The non-QIB investors are usually limited to institutions that are accredited investors as defined in Regulation D. In the immediate wake of Rule 144A's adoption, there was concern that, whatever the SEC's view of the sophistication of QIBs, the introduction of the § 4(1 ½) element requires policing of all resales to ensure that the issuer has taken reasonable care to avoid a distribution. The imposition of such procedures on Rule 144A transactions, even if only using a short form of nondistribution letter, [220] can still lead to reduced market liquidity, and reduced attractiveness of private placements, especially for foreign issuers.

The consensus approach instead applies traditional § 4(1 ½) procedures only to the sales relying on that exemption, thus in effect separating the transaction into two parts and giving the Rule 144A part the full benefit of the Rule on the theory that it is independent of the part proceeding under full § 4(1 ½) procedures. Transfers are permitted not only by the § 4(1 ½) purchasers to QIBs under Rule 144A but also by QIBs to other QIBs or to accredited investors under § 4(1 ½) (with QIBs deciding for themselves what procedures to apply to document their own compliance with the Securities Act in the case of subsequent transfers). In the case of side-by-side placements in which accredited investors purchasing in the initial placement are required by the applicable documentation to resell only to QIBs, thereby subjecting the entire deal to Rule 144A after all accredited investors have completed their first resale, ongoing stop-transfer and other transfer restrictions on the securities are not necessary.

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Putting aside the legal debate as to sufficiency of procedures, the lack of uniform documentation in respect of resale restrictions may raise practical uncertainties for a secondary market purchaser. It can be expected that when an offering document is prepared, the applicable restrictions will be disclosed to the initial investors in detail. An offering document, however, is not generally made available to subsequent investors. Moreover, certificates representing securities held in "street" name or book-entry form (on which contractual transfer restrictions might be stated) are not generally available to investors. Similar factors limit the utility of a "Notice to Investors" in the original offering document outlining contractual resale restrictions that could prohibit exempt transfers outside Rule 144A or impose procedural requirements. As a result, investors considering a resale of restricted securities outside Rule 144A should ascertain the scope of any applicable resale restrictions.

[2] Resale Under Rule 144

Early doctrine suggested that private placement investors were required to purchase with an intent to invest and with no current intention to dispose of the security. [221] This doctrine gave rise to a theory that restricted securities could be sold only upon a "change of circumstances" affecting the investor. [222] There was no clear indication what "change" was sufficient or that passage of time alone was enough to free restricted securities of any applicable resale restrictions.

The SEC expressly rejected the "change of circumstances" doctrine in 1972 when it adopted Rule 144 under the Securities Act. Rule 144 provides a nonexclusive safe harbor from the § 2(a)(11) definition of "underwriter" for resales in the U.S. public market of securities acquired in a private offering, establishing specific criteria for determining that a holder of such securities is not engaged in a distribution. [223] The critical element under the Rule is the passage of time after acquisition of the securities from the issuer, or from an affiliate of the issuer. The other conditions for the Rule 144 safe harbor depend on whether the seller is an affiliate or a nonaffiliate of the issuer.

If the seller is not an affiliate of the issuer (and has not been for the three months preceding the sale), the Rule provides safe harbor protection for a resale

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beginning one year after acquisition of the securities, with no other conditions. [224] Where the issuer is an Exchange Act-reporting company that is current in its reporting obligations, the Rule provides safe harbor protection for resale by a nonaffiliate beginning six months after acquisition of the securities, with no other conditions. To be current for this purpose, the issuer must have been a reporting company for at least 90 days prior to the sale and must have filed all required reports (other than on Form 8-K or Form 6-K) during the 12 months (or such shorter period as it has been a reporting company) preceding the sale. [225]

If the seller is an affiliate of the issuer and acquired the securities in a private offering, [226] the same holding periods apply, and resales are subject to additional conditions relating to current public information, volume of sales, manner of sale and filing of a notice with the SEC. [227] These additional requirements are summarized below:

(i) If the issuer is an Exchange Act-reporting company, it must be current in its reporting obligations, as described above. If it is not an

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Exchange Act-reporting company, certain information concerning the issuer must be publicly available. [228]

(ii) The seller must comply with restrictions limiting the aggregate amount of securities of the issuer sold during the preceding three months pursuant to Rule 144 to:

(a) for equity securities, the greater of:

- 1% of the outstanding shares or other units of the class of securities as shown by the most recent report or statement published by the issuer; and
- the average weekly reported volume of trading in such securities on all national exchanges in the United States and/or reported through an automated quotation system in the United States or on the consolidated tape during the four calendar weeks preceding the date of execution of the sale order or the date of notice in paragraph (iv) below; and

(b) for debt securities, the greater of the two tests described above for equity securities and 10% of the principal amount of the tranche [229] (or class when the securities are nonparticipatory preferred stock) attributable to the securities sold. [230]

(iii) In the case of equity securities only, the securities must be sold in "brokers' transactions" exempt from registration pursuant to § 4(4) of the Securities Act, in transactions directly with a market-maker [231]

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(which is the manner of sale generally relied upon for Rule 144-complying block trades) [232] or in riskless principal transactions, [233] and no solicitations of orders may be made.

(iv) If sales during any three-month period exceed 5,000 shares or other units or $50,000 in sale price, a notice must be filed with the SEC.

Rule 144 includes specific "tacking" rules that address the calculation of the six-month and one-year holding periods in special cases, such as stock dividends and splits, convertible securities and pledges. Acquisition and resale of securities by the issuer or any of its affiliates restarts the holding periods.

Rule 144 also applies to the sale of securities that are not restricted securities when those securities are sold by an affiliate of the issuer (*i.e.*, "control securities"). For example, it provides a safe harbor for resale of securities acquired by the affiliate in the open market, in a registered offering or in an offering of securities (other than equity securities of domestic issuers) exempt from Securities Act registration under Regulation s. For such resales, no holding period is required, but resales must be conducted in accordance with the other requirements described above. The SEC, however, has taken the position that the Rule 144 safe harbor is not available for sales of securities by a wholly owned subsidiary of an issuer. [234] The SEC staff has also rejected the use of the Rule 144

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safe harbor in so-called "gypsy swap" transactions. In such transactions, an issuer would arrange for a nonaffiliated stockholder who either has unrestricted securities or has restricted securities eligible for resale under Rule 144, or an affiliated stockholder who has securities eligible for resale under Rule 144, to sell its securities to end investors. Through pre-arrangement, the issuer would, at or about the same time, sell an equivalent number of unregistered securities to the selling stockholder. The SEC has stated that the shares taken by the end purchasers would be restricted securities within the meaning of Rule 144(a)(3) notwithstanding the purported reliance on the Rule 144 safe harbor, and that the holding period for such securities would begin on the date of the acquisition from the seller. [235]

[a] Hedging Transactions

The SEC has repeatedly expressed concern regarding the effect of hedging activities designed to shift the economic risk of investment away from the holder of restricted securities. If a holder of restricted securities, soon after acquiring them, enters into a derivative transaction that transfers the economic risk of owning the securities to another party, "[i]t becomes more difficult to conclude that the security holder … has held the security for investment purposes and not with a view to distribution." [236]

This concern has led the SEC to question whether Rule 144 adequately deals with hedging activities. One specific proposal has been to provide that hedging suspends (or "tolls") the holding period under Rule 144. Under Rule 144 as it stood prior to 1990, the Rule 144 holding period for restricted securities would be tolled if the securityholder maintained a short position in, or held any put or other option to dispose of, securities equivalent to the restricted securities. This tolling provision was eliminated in 1990 when the Rule was amended to broaden the ability to tack the holding period of a prior holder to the holding period of the current holder. [237] The SEC proposed in 1997 and again in 2007 to reinstitute a version of the tolling provision, but it has not adopted either proposal, in part because of the complexity of applying it to investors with complex

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positions or where holding periods of successive holders are tacked. [238] A number of other proposals to address hedging activities were included in the 1997 proposal but not the 2007 proposal. [239]

On the other hand, industry participants have been concerned about uncertainty whether certain hedging activities could be viewed as distributions violating § 5 of the Securities Act. They have, for example, proposed that the SEC adopt a specific safe harbor for certain hedging activities that would be deemed permissible under Rule 144, and the SEC has declined to do so but has addressed some of these concerns in an interpretive letter. [240] Some hedging activities are widely thought to be permissible despite the absence of any confirmation from the SEC—for example, the widespread practice of a buyer of convertible notes in a Rule 144A private placement engaging in a short sale of equity securities corresponding to the shares into which the notes are convertible. However, where an investor purchases securities in a private placement and then engages in a short sale of a corresponding amount of the same securities, uncertainty remains as to whether the short sale should be considered a distribution. [241]

[3] Resale Under Section 4(1 ½)

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Rule 144 does not address the question whether and under what circumstances a purchaser in a private offering can sell in another private sale without waiting for the expiration of the applicable Rule 144 holding period. However, so long as the subsequent resale also is private, it would be consistent with concluding that the seller—as initial investor in the private placement—had not taken the privately placed, restricted securities from the issuer with a "view to distribution" and therefore was not an underwriter.

While the SEC did not provide any guidance in this area, the private bar and market participants developed mechanisms permitting limited resales from one purchaser in a private offering to another, without requiring any particular holding period, and dubbed the exemption "Section 4(1 ½)." [242] The exemption relies on the interplay of §§ 4(a)(1) (or for dealers, 4(a)(3)) and 4(a)(2), and it proceeds on the theory that if the seller is not an underwriter—that is, the seller did not purchase with a view to distribution and its sale is not being made for the issuer—one of these exemptions should be available. [243]

Thus, if an investor to whom the private sale could originally have been made purchases from another investor a security acquired in a private offering where the new investor will be subject to the same restrictions imposed on the original purchaser, the resale should not be a distribution and should therefore be exempt from registration. Such resales generally are permitted under the § 4(a)(1) exemption only if accompanied by (i) a legal opinion that the transaction in question is exempt or (ii) an investment or nondistribution letter from the purchaser containing essentially the same representations and agreements as those provided by the original purchaser, [244] or both. Restrictive legends on the securities and any stop-transfer instructions ordinarily remain in place. [245]

The continuation of these restrictions through the chain of opinions and letters required by the investment or nondistribution letter obtained from each purchaser by each seller in the chain is intended to keep the requirements of the original private offering in effect. The use by the private bar and market participants of this method of cascading sales restrictions is consistent with the SEC's policy of preventing public offerings or distributions of unregistered securities

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before the end of the periods set out in Rule 144 and, in that respect, does not take advantage of a more aggressive reading of the exemptions provided in the Securities Act. One may ask why an investor, at the end of a chain of resales that are exempt under so-called § 4(1 ½), is not entitled to the § 4(a)(1) exemption on resale, regardless of the manner of sale or the time elapsed since its initial sale. The only argument that § 4(a)(1) is not available is that the selling investor is a so-called "statutory underwriter." But even if the sale in question is a "distribution," the investor at the end of a chain of resales arguably does not meet the other prong of the definition of underwriter—it has not taken from an issuer or sold for an issuer or participated (even indirectly) in any such undertaking within any reasonable meaning of the words. Some insurance companies and other investors in private offerings have, on the basis of this argument, taken the position that when they sell a security, whether purchased in a public or private offering, they are entitled to rely on the § 4(a)(1) exemption. The SEC, however, has never accepted this position, and indeed its entire "restricted security" theory is based on its assertion that any seller, however remote from the issuer, may be an underwriter if the sale is into the public market before the end of the periods set out in Rule 144. While this theory has, as indicated above, no direct basis in the statute, the fact that § 4(1 ½) and the regulatory safe harbors (Rule 144, Rule 144A and Regulation s) have been almost the exclusive means of resale for securities purchased in private offerings attests to the dominance of the SEC's view.

[4] Resale Under § 4(a)(7)

A new nonexclusive safe harbor from registration for resales in the United States came into effect in December 2015 upon the signing into law of the Fixing America's Surface Transportation Act (the "FAST Act"). [246] New § 4(a)(7) of the Securities Act exempts from registration certain resales of securities to accredited investors. We believe § 4(a)(7) was generally intended to codify existing market use of § 4(1 ½). The new exemption, like Regulation D for private placements by issuers, provides sellers, and issuers required to police resales following their private placements, with certainty regarding these subjective elements for private resales, which is particularly important for sales to natural persons.

Section 4(a)(7) includes several significant limitations that will not allow sellers to rely on it as broadly as they have relied on § 4(1 ½) in the past. However, § 4(a)(7) by its terms is a nonexclusive safe harbor, and we believe market

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participants will continue to rely on § 4(1 ½) in many situations, which we discuss below.

The requirements of § 4(a)(7) [247] are as follows:

- All purchasers must be accredited investors. A seller seeking an exemption from registration under § 4(a)(7) should be able to rely on the "reasonable belief" standard with respect to the determination as to whether a purchaser is an accredited investor, but the SEC has not provided guidance as to whether the "reasonable belief" standard applies in the context of § 4(a)(7).
- No general solicitation or general advertising may be used by the seller or anyone acting on the seller's behalf. This prohibition is limited to actions taken by the seller or anyone acting on its behalf and does not capture concurrent actions by the issuer, which provides confirmation that an issuer's conduct should not affect a private resale by an unaffiliated seller not acting in concert with the issuer.
- For resales of securities of an issuer that is not an SEC reporting company or exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, the seller must deliver certain information to prospective purchasers. The required information includes, among other items, "reasonably current" financial information [248] prepared in accordance with U.S. GAAP or IFRS but which need not be audited or reviewed. [249]
- If the seller is an affiliate of the issuer, the seller must include a brief statement regarding the nature of the affiliation and a statement certified by the

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  seller that it has no reasonable grounds to believe the issuer is in violation of the securities laws or regulations. [250]
- The exemption may not be used if the seller or any agent being compensated for its participation in the transaction would be disqualified under the bad actor provisions of Rule 506(d)(1) of Regulation D.
- The exemption may not be used by an issuer or a direct or indirect subsidiary of the issuer.
- The issuer must be engaged in business. The exemption may not be used for resales of securities of an issuer that is in bankruptcy or reorganization, or in formation, or that is a blank check, blind pool or shell company.
- The exemption cannot be used for an unsold allotment held by a broker or dealer as an underwriter.
- The exemption may only be used for securities of a class that has been authorized and outstanding for at least 90 days.

Furthermore, § 4(a)(7) expressly establishes that (i) securities sold under the exemption are "covered securities" within the meaning of § 18 of the Securities Act, and therefore state "blue sky" laws [251] are preempted for resales made in compliance with the exemption, and (ii) the exemption provided by § 4(a)(7) "shall not be the exclusive means for establishing an exemption from the registration requirements of [S]ection 5."

The new exemption under § 4(a)(7) will be particularly useful for private resales to natural person accredited investors because, as discussed above, it avoids the need to assess investors' sophistication, familiarity with the issuer and ability to "fend for themselves" as required by *Ralston Purina*. [252] Equally important to facilitate such sales is the preemption of "blue sky" laws provided by the exemption, because those laws are more burdensome for offers and sales to natural persons, even accredited investors, than to institutional investors.

For sales of securities of private companies, the information delivery requirement in § 4(a)(7) appears at first glance to be the biggest obstacle to using the new exemption, but it generally should not be too burdensome for sellers.

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Even small companies should be able to provide the required financial information, which need not be audited or reviewed. The information requirement does make resales contingent on the issuer cooperating with the seller by making the required information available. It is common, however, for private companies to contractually regulate subsequent transfers anyway, by imposing pre-approval requirements at the time of an initial investment. In any event, we expect the market may require an issuer in a private offering to covenant to make the information required by § 4(a)(7) available to sellers on request, similar to the covenant to make information available to a prospective investor required by Rule 144A(d)(4).

Finally, § 4(a)(7) is available to affiliates of the issuer. The exemption will therefore provide affiliates with additional secondary market liquidity, which could be particularly valuable where there is no public market for the securities.

In situations other than secondary market trading in private company securities, the use of § 4(a)(7) may be limited. In light of the 90-day seasoning condition for the class of securities sought to be sold, § 4(a)(7) will not be available for the kind of side-by-side transaction that is sometimes used, for example, by an issuer and a selling securityholder in a private placement of a newly issued class of debt or preferred stock, to expand the investor pool beyond QIBs to include institutional accredited investors. Nevertheless, the use of § 4(1 ½) for those private placements has never been viewed as problematic, because those accredited investors are sophisticated and have adequate access to information about the issuer, and offers and sales to them therefore typically do not raise any burdensome *Ralston Purina* (or "blue sky") concerns. The market will likely continue to rely on § 4(1 ½) in these contexts.

Section 4(a)(7) will be available, but burdensome to comply with due to the information delivery requirement, for other resales to institutional investors that are traditionally made in reliance on § 4(1 ½), such as private, secondary block trades. In these cases, because § 4(a)(7) is a nonexclusive safe harbor, we believe sellers will generally treat the choice between § 4(1 ½) and § 4(a)(7) as issuers have historically treated the choice between § 4(a)(2) and Regulation D. Where private offerings by issuers are limited principally to institutional investors, they generally are made under § 4(a)(2) and not Regulation D. Similarly, we believe private resales principally to institutional investors will generally continue to rely on § 4(1 ½) notwithstanding the availability of § 4(a)(7).

In these contexts, we do not expect law firms to change their practices regarding no-registration opinions just because the transactions either cannot or do not comply with § 4(a)(7).

As noted above, it is clear that a broker-dealer cannot use § 4(a)(7) to resell unsold allotments of securities acquired in a public offering. A question remains whether a broker-dealer can effect a firmly underwritten resale, under § 4(a)(7), of securities acquired privately from the issuer (assuming the class of securities

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has been outstanding for 90 days). [253] There is no express prohibition on this type of resale, but in contrast to Rule 144A, § 4(a)(7) does not expressly permit an immediate resale by a broker-dealer following a purchase from an issuer. [254] Moreover, Congress may well have intended the prohibition on issuer use of the exemption to also prohibit sales made in a planned, two-step process effectively on behalf of an issuer.

Broker-dealers will need to consider this question when deciding whether to rely on § 4(a)(7) to expand the universe of potential purchasers in underwritten offerings of private company equity securities, particularly to natural person accredited investors. They also will need to consider the question in connection with reopenings of debt and preferred stock issues, which will often meet the requirement of § 4(a)(7) that the class of securities have been outstanding for 90 days. Of course, broker-dealers can continue to rely on § 4(1 ½) for these types of underwritten offerings so long as sales are made only to institutional accredited investors and to natural person accredited investors that clearly meet the requirements of *Ralston Purina* and raise no "blue sky" concerns.

[5] Resale Outside the United States Under Regulation s

Securities sold in reliance on Rule 144A are restricted securities under the Securities Act. Regulation s, however, provides—as discussed in Chapter 8 —a safe harbor for resales of securities outside the United States, including by investors that have acquired their securities in Rule 144A or other private placement transactions. [255] The only requirements for this safe harbor are that the seller not use directed selling efforts in the United States and that the sale be made in an offshore transaction. [256] For purposes of this safe harbor, the offshore transaction requirement is met if the offer is not made to a person in the United States and either the buyer is outside the United States when the order is given (or the seller and its agent reasonably believe the buyer is outside the United States) or the transaction takes place on one of the markets outside the United States designated by the SEC. [257] Once resold outside the United States pursuant to Rule 904

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under the Securities Act, securities issued by foreign companies generally are considered unrestricted, and may be freely sold anywhere, including into the United States. [258]

This ability to resell restricted securities outside the United States provides perhaps the major source of liquidity for foreign securities (particularly foreign equity securities) privately placed in the United States. For example, common equity shares of a foreign issuer with a foreign trading market that are sold in the United States pursuant to Rule 144A (directly or in ADR form) can be resold on that foreign market. [259] A security sold in a Rule 144A tranche of a foreign public offering can thus be resold into the same secondary market in which the securities originally sold outside the United States will trade. [260] U.S. private placement investors in foreign equity securities have essentially the same liquidity as foreign investors in those securities. [261]

Footnotes

210 For a discussion of the safe harbor provisions of Regulation s, *see* § 8.02.

211 *See supra* Note 16; § 8.03.

212 The one-year distribution compliance period was shortened to match the most shortened holding period for restricted securities of reporting companies in the amendments to Rule 144. *See* SEC Release No. 33-8869 (Dec. 6, 2007).

213 Rule 905 under the Securities Act; *see* § 8.02[2].

214 The SEC staff has indicated that an underwriter may resell, in compliance with Rule 144's volume and manner of sale restrictions, an unsold allotment of securities from a public offering, provided that six months have elapsed since the closing of the last sale under the relevant registration statement. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 128.02 (Jan. 26, 2009). We believe the same analysis should apply to allotment securities from offshore transactions conducted pursuant to Regulation s.

215 *See supra* Notes 5–7 and accompanying text. Resales of restricted securities in the public market by nonaffiliates of the issuer may be made after six months for securities of an SEC-reporting issuer and one year for securities of other issuers.

216 Although the SEC has not addressed the issue, the same rationale should apply to permit § 4(1 ½) sales, which should not constitute a "distribution," during the distribution compliance period.

217 No reported case has addressed the liability of an issuer for remote sales in violation of Securities Act registration requirements. However, the U.S. Supreme Court has narrowed the view of who may be a "seller" from that adopted by some lower courts, holding that a person does not become a "seller" for purposes of § 12(a)(1) solely because his or her actions were a "substantial factor" in causing purchases of

unregistered securities. Rather, there must be evidence that the person sought or received financial benefit for himself or herself (or someone other than the purchaser) as a result of the purchaser's investment. *Pinter v. Dahl*, 486 U.S. 622 (1988). In *In re Deutsche Telekom AG Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91,703 (S.D.N.Y. Feb. 20, 2002), the court expressed the Pinter holding as a two-prong test: to be found as a statutory seller, a person "must have either (1) passed title of the security to the plaintiff or (2) successfully solicited the purchase motivated at least in part by his own financial interest." Under this test, an issuer of Rule 144A securities would not seem to fall within either prong of the test with respect to any remote sale because title passes from the immediate seller, not the issuer, to the purchaser in such a sale, and the issuer does not seek or receive any financial benefit from such a sale. Therefore, an issuer should not be liable for sales in violation of the Securities Act by remote purchasers.

218 A qualified institutional buyer making a resale under § 4(1 ½) not prohibited by the documentation might consider various steps to ensure that the purchaser is in fact sophisticated and able to fend for itself and is aware of the restricted nature of the securities.

219 Until 2009, Rule 144A securities were required to be included in the PORTAL Market in order to clear in DTC. SEC Release No. 34-59384 (Feb. 11, 2009) (Order). Under pressure from the SEC, the rules of the PORTAL Market originally provided that, if a PORTAL security was issued in certificated form, each certificate must bear a legend to the effect that the security is restricted. SEC Release No. 34-33326 (Dec. 13, 1993). The legending requirement was eliminated in 2001. SEC Release No. 34-44042 (Mar. 6, 2001). The practice of including legends has, however, continued.

220 Certain issuers have attempted to simplify the policing of resales in side-by-side offerings by requiring only that a transferor relying on Rule 144A so indicate by checking a box on the reverse of the security. No additional documentation is required. Even this has encountered resistance from intermediaries, which are concerned about "back-office" procedures and compliance, and qualified institutional buyers, which, by taking a broad view of the premise of Rule 144A, have objected to any procedural steps whatsoever not otherwise required by the Rule.

221 *See* Preliminary Note to Rule 144 under the Securities Act ("[I]ndividual investors who are not professionals in the securities business also may be ‘underwriters' if they act as links in a chain of transactions through which securities move from an issuer to the public.").

222 *See, e.g.*, *Roto American Corp.* (avail. Feb. 19, 1971); *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 869 (1959).

223 SEC Release No. 33-5223 (Jan. 11, 1972). The SEC has adopted major amendments to Rule 144 in 1990, 1997 and 2007. SEC Release No. 33-6862 (Apr. 23, 1990); SEC Release No. 33-7390 (Feb. 20, 1997); SEC Release No. 33-8869 (Dec. 6, 2007).

224 Prior to the 2007 amendments to Rule 144, a nonaffiliate selling restricted securities under Rule 144 was subject to a one-year holding period and to other conditions relating to current public information, volume of sales, manner of sale and filing of Form 144; the other conditions ceased to apply after a two-year holding period. For resales by nonaffiliates, the 2007 amendments reduced the holding period to six months with respect to securities of an Exchange Act-reporting issuer and eliminated all conditions other than the holding period and, with respect to securities of an Exchange Act-reporting issuer sold after six months and before one year, the current public information requirement described in the text. SEC Release No. 33-8869 (Dec. 6, 2007).

225 An issuer that submits reports to the SEC voluntarily is not considered a reporting issuer for purposes of Rule 144. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Questions 131.07, 132.09 (Jan. 26, 2009).

226 For purposes of Rule 144, the term "affiliate" means "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with" the issuer. The term "control" is defined broadly as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." The SEC staff has declined to issue no-action letters on affiliate status because

of its facts-and-circumstances nature, but an executive officer or director or beneficial owner of more than 10% of the voting securities of the issuer are rebuttably presumed to be affiliates. Securities held by affiliates of the issuer (whether or not the securities were acquired in a private placement or are otherwise restricted securities) are often referred to as "control securities."

227 With respect to resales by affiliates, the 2007 amendments shortened the holding period from one year to six months with respect to securities of an Exchange Act-reporting issuer and modified the other conditions in several respects. SEC Release No. 33-8869 (Dec. 6, 2007).

228 The information that must be publicly available is defined (except for an insurance company) by reference to Rule 15c2-11 under the Exchange Act, which identifies information concerning an issuer that a U.S. broker-dealer is required to maintain if it publishes quotations for that issuer's securities.

229 While the SEC has not formally defined the term "tranche," it has been used by the SEC in other contexts to mean securities with identical terms. *See, e.g.*, Rule 902(f)(3) of Regulation s under the Securities Act ("[I]n a continuous offering of nonconvertible debt securities offered and sold in identifiable tranches, the distribution compliance period for securities in a tranche shall commence upon completion of the distribution of such tranche.").

230 Rule 144(e)(3)(vi) also provides that all sales of the same class of securities made by two or more affiliates of the issuer, or other persons who have agreed to act in concert for the purpose of selling securities of an issuer, shall be aggregated during any three-month period for purposes of determining the limitation on the amount of securities that can be sold pursuant to Rule 144.

231 A "market-maker" is "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis." § 3(a)(38) of the Exchange Act.

232 *See* § 10.04 for a discussion of offerings on an "undocumented" basis.

233 For purposes of Rule 144, "riskless principal transactions" are defined as "principal transaction[s] where, after having received from a customer an order to buy, a broker or dealer purchases the security as principal in the market in order to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to the market to satisfy the order to sell." Note to Rule 144(f)(1) under the Securities Act. To be eligible for the Rule 144 safe harbor, the offsetting trades must be executed at the same price (excluding any explicitly disclosed markup or markdown, commission equivalent or other fee), must be permitted to be reported as riskless under the rules of a self-regulatory organization and must meet all the requirements of a brokers' transaction enumerated in Rule 144(g) (except for the requirement that the broker does no more than execute the order to sell the securities as agent). Rule 144(f)(1)(iii) under the Securities Act. The SEC amended Rule 144 in 2007 to permit the resale of equity securities by affiliates not only through brokers' transactions and transactions with a market-maker but also, based on input from commenters, through riskless principal transactions, which it believes will help to ensure the Rule 144 restrictions better reflect current trading practices and venues. The SEC also amended Rule 144(g) to except the posting of bid and ask quotations in alternative trading systems from the Rule's nonsolicitation provisions. In order to comply with Rule 144, a broker may not solicit or arrange for the solicitation of customers' orders to buy the securities in anticipation of, or in connection with, the transaction, subject to certain exceptions. The posting of bid and ask quotations by a broker in an alternative trading system will not be deemed a solicitation so long as the broker has published *bona fide* bid and ask quotations for the security in the alternative trading system on each of the last 12 business days. Rule 144(g)(3)(iv) under the Securities Act.

234 SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Interpretive Responses Regarding Particular Situations, Section 528.01 (Jan. 26, 2009).

235 SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Interpretive Responses Regarding Particular Situations, Section 528.08 (Jan. 26, 2009).

236 SEC Release No. 33-8813 (June 22, 2007), 72 Fed. Reg. 36,822, 36,826 (July 5, 2007) (solicitation of

public comments).

237 SEC Release No. 33-6862 (Apr. 23, 1990) (eliminating the tolling provision in Rule 144).

238 *See* Letter from SIFMA, International Swaps and Derivatives Association, Inc., and Managed Funds Association to the SEC (Sept. 21, 2007).

239 SEC Release No. 33-7187 (June 27, 1995) (requesting comment on whether Rule 144 should be amended to address derivatives); SEC Release No. 33-7391 (Feb. 20, 1997) (proposals—on which the SEC never acted—to make Rule 144 unavailable to a holder who hedges during the restricted period, to define a sale for purposes of § 5 to include specified hedging transactions, to adopt a shorter holding period during which hedging could not occur without losing the safe harbor, and to reinstitute tolling); SEC Release No. 33-8813 (June 22, 2007) (proposal to reinstitute tolling); SEC Release No. 33-8869 (Dec. 6, 2007) (determining not to reinstitute tolling).

240 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.03[1], Note 42, and accompanying text for a discussion of SEC interpretive relief granted for certain equity derivative transactions.

241 Counsel often advise that there should be a delay between the purchase of the restricted securities and the short sale, and that, rather than cover the short position with the restricted securities, the investor should, after the Rule 144 holding period, sell the restricted securities in the open market and cover the short position with securities purchased in the open market (a practice referred to as "double-printing"). *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 528.03 (Jan. 26, 2009). A related question is presented by "PIPE" (or private investment, public equity) transactions, in which investors agree to purchase shares in a private placement but closing is conditioned on availability of an effective resale shelf registration statement. Several courts have considered whether a PIPE investor that sells short before the registration statement is effective and covers with registered shares after it is effective has violated § 5 of the Securities Act. *SEC v. Lyon*, 529 F. Supp. 2d 444 (S.D.N.Y. 2008); *SEC v. Berlacher*, Civil Action No. 07-3800-ER, 2008 U.S. Dist. LEXIS 109246 (E.D. Pa. Jan. 23, 2008); *SEC v. Mangan*, No. 3: 06-CV-531, 2008 WL 3925059 (W.D.N.C. Aug. 20, 2008). These courts found that there was no § 5 violation, but the question remains uncertain.

242 *See supra* Note 10.

243 *See The Section 4(1 ½) Phenomenon* (arguing that notwithstanding certain judicial precedent and staff no-action letters to the contrary, § 4(a)(1) provides the only viable statutory basis for private resales of unregistered securities, since § 4(a)(2) is expressly limited to sales by an issuer).

244 *See* text accompanying *supra* Note 70.

245 Offshore sales under Regulation s of securities of non-U.S. issuers generally would not require such procedures. *See* § 7.05[4].

246 Pub. L. No. 114-94, 129 Stat. 1312 (2015); *see* Nicolas Grabar, *FAST Act Amendments to the U.S. Securities Laws*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, *available at* https://corpgov.law.harvard.edu/2016/01/16/fast-act-amendments-to-the-u-s-securities-laws (Jan. 16, 2016).

247 Conditions to reliance on the exemption under § 4(a)(7) are included in §§ 4(d) and 4(e) of the Securities Act.

248 This financial information must include the issuer's most recent balance sheet and profit and loss statement and "similar financial statements" for the two preceding fiscal years (for which the issuer has been in operation) and it must be "reasonably current," meaning it must include a balance sheet and corresponding profit and loss statement as of a date and for a fiscal year ended less than 16 months prior to the sale and, if those items are not as of a date and for a period ending less than six months prior to the sale, be accompanied by an interim balance sheet and profit and loss statement for a date and a period ending less than six months before the transaction date.

249 This information requirement is more burdensome than the information requirements imposed by Rule

144A and Regulation D. First and most importantly, while the information is similar to what an issuer is required to make available if requested by a purchaser under Rule 144A(d)(4), § 4(a)(7) requires a seller to deliver the information to a purchaser. Section 4(a)(7) also imposes the same requirement for all issuers, while Rule 144A has a special rule for foreign private issuers, allowing them to meet the "reasonably current" financial information requirement by complying with the requirements of their home country or principal trading market. The § 4(a)(7) information requirement is also more stringent than Regulation D, where information delivery is mandatory only for offerings that include nonaccredited investors.

250 It is not clear what duty this requirement imposes on a seller with respect to potential securities law violations by the issuer. By comparison, an affiliate can avoid control person liability under § 20 of the Exchange Act if the person "in good faith" was unaware of issuer violations of the Exchange Act. Further, as written, the representation would extend to any violations of the securities laws or regulations (which could include minor violations).

251 *See* § 7.09.

252 *See* § 7.02[1].

253 We believe it is clear that a broker-dealer may purchase restricted securities from a nonsubsidiary affiliate and resell them in reliance on § 4(a)(7), because the new exemption expressly permits use by such affiliates and there is no reason why such use could not be done indirectly *via* a broker-dealer.

254 In Rule 144A, it is explicit that these types of firmly underwritten back-to-back sales are permitted. *See* Note 7 to Rule 144A and Rule 144A(e).

255 Rule 904 under the Securities Act; SEC Release No. 33-6863 (Apr. 24, 1990) (adopting Regulation s); *see* § 8.02[2].

256 Additional requirements apply to resales by dealers, persons receiving selling concessions and certain affiliates. *See* Rule 904 under the Securities Act. Conditions applicable to the Regulation s safe harbor are discussed in § 8.02.

257 *See* Rule 902(h) under the Securities Act; § 8.02[1][a].

258 As discussed in § 8.02[2], in 1998 the SEC adopted amendments to Regulation s that classify domestic equity securities (but not the equity securities of foreign private issuers) as "restricted securities" within the meaning of Rule 144. SEC Release No. 33-7505 (Feb. 17, 1998). The amendments were adopted after the SEC staff expressed concern with alleged abuse of the safe harbor of Regulation s to sell offshore, free from the registration requirements of the Securities Act, securities that later return to the U.S. public markets. The concern applied in particular to sales of restricted securities under Rule 904 to "wash" the restrictions off, followed by resales (or matched sales) back into the United States—especially in the case of securities of U.S. companies trading publicly in the United States.

259 Many Rule 144A offerings of foreign equity securities have been made in ADR form or have given purchasers the option of purchasing ADRs or ordinary shares. In either case, a "restricted" ADR program is established that does not require filing a registration statement with the SEC. The original private placement securities sold in ADR form are deposited in that facility and the resulting ADRs are restricted securities, as are the underlying securities that the ADR represent. *See* § 10.05[3][b].

260 U.S. tax law limits the ability of issuers to offer or sell in the United States debt obligations in bearer form. Combined foreign offerings and U.S. private placements of debt securities sold to U.S. investors generally must be in registered form and not be later exchangeable for bearer form securities. In the common case where the securities sold in a foreign offering are in bearer form, the U.S. portion of the offering is not interchangeable with the offshore portion, and much of the liquidity advantage that the resale safe harbor of Regulation s would otherwise provide is lost. *See* § 8.03[2] for a discussion of U.S. tax law restrictions on the offer and sale of debt obligations in bearer form.

261 *See* § 8.02[2].

U.S. Regulation of the International Securities and Derivatives Markets, § 7.05, PRIVATE OFFERINGS WITH REGISTRATION 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 § 7.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The term "registration rights" refers to a practice that developed to improve the execution of a private placement by having the issuer promise investors a mechanism to resell the securities in the United States without the resale restrictions that apply to privately placed securities. One possible mechanism is a resale registration statement, which the issuer files after the private offering to register

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resales by the investors in the offering. The other possible mechanism is a registered exchange offer—referred to as an "A/B" exchange offer or an "Exxon Capital" exchange offer (after a leading no-action letter)—in which, following the private placement, the issuer offers securities that are materially identical to those initially issued but that, having been sold in a registered exchange offer, can be freely resold. [262] In either case, the issuer enters into a "registration rights agreement" with the financial institutions conducting the initial private offering, in which the issuer undertakes for the benefit of holders of the securities to take the necessary steps—either to establish an effective resale registration statement, or to conduct a registered exchange offer—and generally agrees to pay holders liquidated damages if it fails to meet specified deadlines. [263] Registration rights can improve the attractiveness of the securities by enlarging the population of potential investors, particularly where the principal secondary market is expected to be in the United States. Some key market indices also require that debt securities include registration rights for inclusion in those indices.

[1] Registration Rights Generally

Registration rights are employed in a variety of situations where the resale restrictions applicable to privately placed securities make the securities less attractive, and SEC registration is practicable eventually but not immediately. [264] Conducting a registered offering has become substantially easier for SEC-reporting companies with the refinement of the shelf rules and particularly the 2005 reform establishing automatic shelf registration for well-known seasoned issuers, but there are still several situations where a Rule 144A offering, coupled with registration rights, is used. One is where the registrant is not yet a reporting company, or the registrant or the transaction is ineligible for shelf registration. In such cases, a private placement with registration rights can be executed more quickly than a registered offering. Another case is where the registrant is unable to meet some specific requirement for an SEC-registered offering, such as (i) the presentation of the most recently available financial information of an acquired company or *pro forma* financial statements showing the effects of an acquisition

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or disposition, [265] or (ii) for a foreign private issuer, the presentation of the required most recently available interim financial statements. [266]

The 2008 amendments to Rule 144 led to the development of new procedures that have replaced traditional registration rights techniques in some transactions. Rule 144 now permits a nonaffiliate to resell privately placed securities without restrictions after a one-year holding period, [267] and thus promises a mechanism for unrestricted resales that is much less cumbersome and almost as fast as under many traditional registration rights agreements.

Under the procedures, the privately placed securities are initially issued with a restricted Committee on Uniform Security Identification Procedures ("CUSIP") or an International Securities Identification Number ("ISIN") identifier code, and the global security certificate deposited with the clearing system bears a legend setting forth transfer restrictions. When the required holding period has expired and the issuer certifies to the trustee that the securities have become freely resalable by nonaffiliates, an unrestricted code (reserved at the time of issuance), which may be the Regulation s CUSIP or ISIN, replaces the restricted code and the restrictive legend is removed from the global security. [268] To implement the removal of the legend, the issuer must also certify to the Depository Trust Company ("DTC") at least 15 days prior to the date of the change in CUSIP (in the case of a mandatory change), or ten days (if the terms of the security allow holders the option of retaining the restricted security). [269] To inform the market of the change, Bloomberg has indicated that upon notice from issuers or trustees, it will advise holders through its system of a corporate action

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indicating the change in CUSIP or ISIN, and also make corresponding adjustments to its screen pages. [270] No action from holders is required under the procedures, and there is no need for a new global note to be executed. [271]

These procedures have been more readily adopted for some types of securities than for others. In the investment grade debt market, A/B exchange offers remain the normal practice. Certain key market indices such as the Barclays Capital U.S. Aggregate Bond Index still require securities to be "registered" and not merely "unrestricted" for inclusion, and investment funds may maintain similar requirements for the securities that can be included in some or all of their portfolios. On the other hand, in the convertible debt market, most transactions have done away with resale registration rights altogether in favor of the issuer being required to pay additional interest if it fails to permit delivery of unrestricted securities after a defined period. In the high-yield market, practice is varied, but there appears to be a trend toward using the new procedures, while providing investors with contingent registration rights. [272]

[2] A/B Exchange Offers

In an "A/B" or "Exxon Capital" exchange offer, [273] the issuer of securities that have been sold in a private placement offers to exchange those securities for securities that are identical in all material respects. The SEC has taken the position that, for certain types of securities, the securities issued pursuant to the SEC-registered exchange offer can be freely resold by a nonaffiliate of the issuer without registration. [274]

This SEC position permitting resale by nonaffiliates of the issuer without registration is available for debt securities and investment grade preferred stock that are not convertible into equity securities of a U.S. issuer (other than into preferred stock), as well as warrants or other rights to subscribe for such debt or preferred stock. [275] The SEC has also permitted foreign issuers that are not yet reporting companies under the Exchange Act wider latitude than U.S. issuers to

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make use of A/B exchange offers in connection with equity offerings. Foreign issuers have received no-action relief from the SEC allowing them to conduct registered A/B exchange offers of equity securities and convertible debentures in connection with a subsequent listing or offering of equity securities. [276] This more lenient position reflects the SEC's policy of encouraging foreign listings on U.S. public equity markets by allowing foreign issuers to take a "stepping stone" approach, by first conducting a private placement to institutional investors (usually accompanied by an offshore placement under Regulation s) before pursuing a full public offering in the United States. [277] This exchange-offer structure does not appear to have been used recently, however, perhaps reflecting the general reticence of foreign companies to commit to U.S. equity listings and the accompanying regulatory burdens.

A nonaffiliate reselling securities received in an A/B exchange offer is not required to deliver a prospectus, unless it is a broker-dealer. A broker-dealer that

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receives for its own account registered securities in exchange for restricted securities must agree to deliver a prospectus meeting the requirements of the Securities Act in connection with any resales (and the prospectus and any related letter of transmittal used in the exchange offer must contain a notice to such effect). The prospectus it delivers may be the prospectus for the exchange offer so long as it contains disclosure regarding the plan of distribution with respect to resale transactions. The plan of distribution need not name the broker-dealer or the amount of exchange securities owned by the broker-dealer. According to the SEC staff, by agreeing to deliver or by delivering a prospectus, the broker-dealer will nevertheless not be deemed to have admitted that it is an "underwriter" within the meaning of the Securities Act. [278]

The structure sanctioned by these SEC staff no-action letters has been conditioned upon an agreement by the issuer to provide to the SEC a supplemental letter stating that the issuer is relying upon this no-action relief. The letter must also include representations that the issuer has not entered into any arrangement with any person to distribute the securities to be issued in the exchange and that, to the best knowledge of the issuer, persons participating in the exchange are acquiring the securities in the ordinary course and have not entered into any arrangement or understanding with anyone to participate in a distribution of the securities. [279]

The A/B exchange offer procedure offers advantages to both issuers and investors over the alternative of granting investors resale registration rights. First, issuers in these transactions avoid maintaining an "evergreen" resale registration statement, as is customary in the case of privately offered securities with resale registration rights. [280] Second, from the investor's perspective there is no potential liability in connection with a resale by an exchanging holder under § 12(a)(2) of the Securities Act (unless the seller is a broker-dealer), no prospectus delivery requirement (unless the seller is a broker-dealer) and no requirement to include the names of the holders of securities being exchanged in the registration statement.

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Standard agreements to conduct A/B exchange offers typically set deadlines for the filing and declaration of effectiveness of the exchange offer registration statement and the consummation of the related exchange offer. They also usually require the issuer to maintain the effectiveness of the registration statement for a specified period (often 90 to 180 days) to enable broker-dealers to comply with their prospectus delivery obligations. The issuer must consequently consider whether any development that occurs during this period requires the filing of a prospectus supplement or a post-effective amendment to the registration statement. [281] Any failure to comply with these deadlines typically triggers liquidated damages in the form of the obligation to pay additional interest on debt securities until the failure is cured. This consequence emphasizes the importance of assessing, in connection with the initial private placement, whether any difficult issues are likely to arise that could delay or prevent filing or the effectiveness of the exchange offer registration statement.

[3] “Rule 144A for Life” Offerings

If, generally in the case of debt securities or non-participating preferred stock, an issuer's investor base is willing to hold restricted securities, an issuer may not be required to offer registration rights, whether *via* resale registration or a registered exchange offer. This is particularly true where an issuer does not have reporting obligations under the Exchange Act and does not wish to become a reporting issuer. Such offerings that do not provide for registration rights are referred to as "Rule 144A for Life" offerings, and the offered securities remain unregistered and restricted for the entire period during which they remain outstanding.

Footnotes

262 A/B (or Exxon Capital) exchange offers are discussed at § 7.04[2]. A/B exchange offers are used primarily for nonconvertible debt securities and investment grade preferred stock. They are not permitted for other equity securities (including convertible debt), except in limited circumstances for equity securities of a

foreign private issuer. Resale registration statements are most frequently used for issuances of common stock.

263 If a registered exchange offer is contemplated, debt securities in a Rule 144A placement will need to be issued pursuant to a trust indenture that meets the requirements of the Trust Indenture Act. *See* § 3.05[4]. The same applies if a resale registration statement is used for debt securities, although this practice is less common.

264 Issuers may also offer registration rights to affiliates holding control securities if so requested. *See* §§ 7.05 and 9.05[8].

265 *See* § 4.04[10].

266 *See* § 4.04[4]. In addition, securities that are convertible into U.S.-listed equity are sometimes sold in a Rule 144A private placement even where SEC registration would be available. This practice exists because, in order to facilitate the offering, the issuer will sometimes purchase shares from the investors to mitigate the downward pressure on the shares resulting from the offering, thereby also permitting the investors to establish under their hedge. The issuer would not be permitted to purchase its shares under Regulation M of the Exchange Act if the offering were done on an SEC-registered basis.

267 Under Rule 144, a nonaffiliate can resell securities of an Exchange Act-reporting issuer freely after a six-month holding period, but only if the issuer is current in its periodic reporting. If the issuer ceases to be current ("goes dark"), nonaffiliates must wait one year to resell without restrictions.

268 The SEC has stated that it will not object if issuers remove restrictive legends from securities held by nonaffiliates after all of the applicable conditions in Rule 144 are satisfied, while observing that such removals are at the discretion of the issuer and that disputes over removals are likely to be governed by contract and by state law, rather than federal law. *See* SEC Release No. 33-8869 (Dec. 6, 2007).

269 *See* The Depository Trust Company, DTC Important Notice 4903-09, Optional Use of the Depository Trust Company's ("DTC") Mandatory Exchange Platform for Rule 144A and Reg. S Securities that have become unrestricted securities (Apr. 1, 2009). Similar actions would need to be taken if the securities are held in a different clearing system.

270 SIFMA, *SIFMA Guidance: Procedures, Covenants, and Remedies in Light of Revised Rule 144* (Oct. 2008).

271 In the case of optional resales where an issuer has not undergone procedures to provide for free transferability of the entire tranche of securities, a holder may need to submit a certificate of transfer.

272 *See* Adam E. Fleisher & Jung W. Ju, *Revised Rule 144 and Registration Rights, Market Practice Two Years On*, PRACTICAL LAW, THE JOURNAL (Feb. 2010).

273 *Exxon Capital Holdings Corp.* (avail. May 13, 1988).

274 *See Shearman & Sterling* (avail. July 2, 1993), *Morgan Stanley & Co. Inc.* (avail. June 5, 1991) ("Morgan Stanley") and letters cited therein.

275 The SEC has offered no rationale to explain why preferred stock should be rated investment grade to qualify for relief, whereas debt securities are not subject to any rating requirement. Some exceptions from the rating requirement have been granted, *see K-III Communications Corp.* (avail. May 14, 1993) (permitting the use of a registered exchange offer in connection with unrated preferred stock convertible into debt securities of the issuer), but the SEC staff has informally advised that *K-III Communications* should not be viewed as an extension of *Morgan Stanley* or its progeny since the preferred stock at issue was in the staff's view the functional equivalent of debt. (It remains to be seen whether the removal in July 2011 of references to credit ratings in Securities Act rules and forms pursuant to § 939A of the Dodd-Frank Act, *see* SEC Release No. 33-9245 (July 27, 2011), will affect the SEC's position on this issue.) The SEC also suggested in a subsequent no-action letter that the availability of the exchange offer procedure may depend upon characteristics of the privately placed security, including, among others, whether it is more attractive to qualified institutional buyers and institutional accredited investors and, accordingly, has been sold to them rather than to "retail" investors, whether the security is listed on a national securities exchange and whether it pays distributions semi-annually rather than monthly or quarterly. *See Brown & Wood LLP*

(avail. Feb. 7, 1997). Again, the staff offered no rationale for why those characteristics are significant.

276 *Grupo Financiero InverMexico, S.A.* (avail. Apr. 4, 1995) (granting no-action relief in connection with an exchange offer of convertible debentures in connection with a registered offering or listing of capital stock of the issuer); *Corimon C.A. S.A.C.A.* (avail. Mar. 22, 1993) (granting no-action relief in connection with an exchange offer of ADRs in connection with the listing of similar ADRs); *Transportación Maritima Mexicana, S.A. de C.V.* (avail. June 8, 1992) (granting no-action relief in connection with an exchange offer of ADRs to be conducted concurrently with a global offering outside Mexico, including a registered U.S. offering, of units consisting in part of similar ADRs); *Vitro, Sociedad Anónima* (avail. Nov. 19, 1991) (granting no-action relief in connection with an exchange offer of ADRs to be conducted concurrently with a global offering of common shares, including a registered U.S. offering of ADRs representing common shares). Certain Schedule B issuers have relied on the *Exxon Capital* no-action letters (see, e.g., Corporación Andina de Fomento (SEC File Nos. 333-90296 and 333-88404, filed June 6, 2002, and May 10, 2002, respectively) and Republic of Peru (SEC File No. 333-98403, filed Aug. 19, 2002).

277 It is not clear, however, that the SEC staff would permit a foreign issuer of equity securities to conduct an A/B exchange offer if its obligation to conduct the exchange offer were not also contingent on a subsequent public offering or listing in the United States. *See* Adam E. Fleisher, David E. Webb & Malini Mukhopadhyay, THE MECHANICS OF A/B EXCHANGE OFFERS (Practical Law Company, 2010).

278 *Shearman & Sterling* (avail. July 2, 1993). The SEC has also stated its view that the initial purchasers in the private placement would not normally be considered "underwriters" of the subsequent registered exchange offer or bear liability under § 11 or § 12(a)(2) of the Securities Act. *See* Brief of SEC as *Amicus Curiae* Supporting Defendants, *In re HealthSouth Securities Litigation*, No. CV-03-BE-1500-S (N.D. Ala. Nov. 28, 2006); *see also In re Livent*, 151 F. Supp. 2d 371 (S.D.N.Y. 2001).

279 *See Grupo Financiero InverMexico, S.A.* (avail. Apr. 4, 1995); *Corimon C.A. S.A.C.A.* (avail. Mar. 22, 1993); *Transportación Maritima Mexicana, S.A. de C.V.* (avail. June 8, 1992); *Vitro, Sociedad Anónima* (avail. Nov. 19, 1991).

280 Agreements to conduct an A/B exchange offer do, however, typically require the filing and maintenance of a resale registration statement in certain circumstances if the exchange offer is not available to all investors (including if the initial purchasers are holding allotment securities) or if the SEC repeals its position permitting exchange offers.

281 An issuer eligible to use Form S-3 or F-3 is permitted to incorporate by reference into its exchange offer registration statement any current Exchange Act report filed on Forms 8-K or 6-K (as applicable) after the effective date of the registration statement. An issuer filing on Form S-1 or F-1, however, may only incorporate by reference past, rather than future, Exchange Act reports—as a result, such an issuer may be required to file a post-effective amendment to its registration statement in order to reflect any material development arising after the initial effective date. The amendment to the registration statement is subject to SEC review (like the original registration statement itself), which can require suspending use of the registration statement.

U.S. Regulation of the International Securities and Derivatives Markets, § 7.06, PRIVATE PLACEMENT OF ADRs

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 § 7.06 (11th and 12th Editions 2014-2017)
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Rule 144A offerings of foreign equity securities are sometimes made in ADR form or give investors the option of purchasing American depositary shares ("ADSs") or ordinary shares. In either case, the issuer and the depositary establish a "restricted" ADR program, under which privately placed shares are delivered to the depositary, which issues ADSs that are restricted securities for

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purposes of Rule 144 under the Securities Act. The restricted ADSs are not eligible for registration on Form F-6 with the SEC. [282]

In some cases, the foreign issuer may also plan to set up an "unrestricted" ADR program subsequently. Under the unrestricted program, shares are delivered to the depositary, which issues unrestricted ADSs that are available for public trading, and the program is registered with the SEC on Form F-6. [283] Special issues can arise where a foreign issuer attempts to establish an unrestricted ADR facility within one year after a private placement, since the shares sold in the private placement are restricted securities and not yet eligible for resale under Rule 144, and accordingly may not be deposited in the unrestricted facility. The SEC staff has cautioned that it may be unwilling to declare the requisite F-6 registration statement effective unless the purchasers in the private placement (but not subsequent transferees) have acknowledged in writing the restrictions on transfer and deposit in an unrestricted ADR facility of the privately placed shares. Some banks have resisted issuer requests to require such acknowledgements, arguing that the resulting administrative burden could significantly limit the number of potential investors in the Rule 144A offering. An issuer that accedes to these marketing concerns may not be able to establish an unrestricted ADR facility within one year of the private placement. [284]

Special issues also may arise where a foreign issuer wishes to establish an unrestricted ADR facility immediately upon, or shortly after, completion of an offering outside the United States that is exempt from Securities Act registration under Regulation s. The SEC staff has taken the position that the registration statement on Form F-6 relating to the unrestricted ADSs may not be filed until the expiration of the applicable distribution compliance period (if any) under Regulation s or seasoning period under § 4(a)(3), whichever is longer. [285]

The SEC has also expressed concern regarding the possibility for leakage of restricted securities into the U.S. public market where an issuer proposes to sponsor concurrent restricted and unrestricted ADR programs. These programs can operate as a single combined facility, under which both restricted and unrestricted securities are issued under a single deposit agreement, or as separate facilities. In such cases, the SEC staff has taken the position, as a condition to

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effectiveness of a Form F-6, that it will require various procedures to be implemented in connection with the facility or facilities to prevent leakage, including assigning separate CUSIP numbers to the restricted and unrestricted ADSs and obtaining written certifications acknowledging applicable transfer restrictions on the restricted ADSs or that the ADSs were obtained in an offshore transaction complying with Rule 904 of Regulation s. [286] So-called "collapsible" facilities, which provide, upon effectiveness of the related Form F-6, for automatic fungibility of restricted ADSs with ADSs issued out of an unrestricted facility, have also attracted SEC attention. In such circumstances, the SEC staff has informally taken the position that effectiveness of the Form

F-6 will depend upon implementation of various procedures, including obtaining written certifications on deposit and withdrawal of securities with respect to the restricted ADR facility as to the status of the beneficial owner and compliance with resale restrictions.

Footnotes

282 The ADSs are not eligible for registration because the underlying shares, having been sold in a private placement, do not meet the requirements of General Instruction I.A(2) of Form F-6. Restricted ADSs may be resold under Rule 144 to the same extent the underlying restricted shares could have been. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules 532.16 (Jan. 26, 2009).

283 ADR programs of foreign issuers generally are discussed in § 3.04.

284 If the unrestricted facility is to be exchange-listed, the issuer might consider conducting a registered exchange offer of unrestricted shares for restricted shares at the time it establishes the unrestricted ADR facility. *See* § 7.04[2].

285 *Depositary Receipts* (avail. Apr. 14, 1993).

286 *Depositary Receipts* (avail. Apr. 14, 1993).

U.S. Regulation of the International Securities and Derivatives Markets, § 7.07, CLEARANCE AND TRADING

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 § 7.07 (11th and 12th Editions 2014-2017)
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Under the rules of the principal U.S. clearing system, The Depository Trust Company, securities that are eligible for resale under Rule 144A are eligible for electronic clearing and settlement through DTC. [287] In a typical Rule 144A offering of debt securities or ADSs, DTC holds one or more certificates in global form evidencing the amount of securities issued. Restricted securities placed with QIBs pursuant to the § 4(a)(2) exemption may also be held in DTC if they meet the criteria for resale under Rule 144A. Securities sold to non-QIBs are not normally held in DTC, since resales of such securities are ordinarily subject to "policing" mechanisms to prevent a distribution, and DTC does not have procedures for this purpose. All Rule 144A securities deposited at DTC are required to bear a CUSIP or other identification number different from the number borne by any unrestricted securities of the same class, including, for example, securities that were sold in a concurrent offering under Regulation s and that have "seasoned" for purposes of U.S. securities law. [288] DTC participants (brokers and dealers) trade and settle transactions electronically through book-entry trades recorded on the participants' accounts.

Euroclear and Clearstream are able to participate in DTC indirectly through their depositaries that maintain an account as participants in DTC. This arrangement permits trades to be made between DTC participants and participants in Euroclear and Clearstream.

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Many offerings use a "dual tranche" system, in which two global securities are deposited with DTC, one for the Rule 144A tranche and one for the Regulation s tranche, but it is also possible for an entire issue of securities placed in a global offering to be represented by one global security deposited with DTC and for transactions in the securities to be effected worldwide using a single book-entry system; in such a case all securities are subject to Rule 144A restrictions.

Rule 144A securities trade primarily over the counter among dealers. Transactions in Rule 144A securities conducted by U.S. broker-dealers are generally subject to transaction reporting requirements. [289] Attempts to develop organized markets or trading systems for Rule 144A securities began concurrently with the adoption of Rule 144A, when the SEC approved the PORTAL Market, a system for primary and secondary trading of securities pursuant to Rule 144A with facilities for clearance and settlement of both domestic and foreign securities through DTC, in the case of transactions effected in the United States, and Clearstream Banking, in the case of transactions effected outside the United States. [290]

The PORTAL Market originally was a "closed" trading system, in that it required prequalification of PORTAL Market participants and imposed restrictions on a participant's ability to trade securities out of the system except in transactions that resulted in the delivery of an unrestricted security. The PORTAL rules were substantially amended in 1993 and again in 2007, each time in an effort to make PORTAL a more effective trading venue. [291] But these measures were unsuccessful, and the PORTAL Market ultimately ceased operating in 2008. [292]

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In addition to the PORTAL Market, there have been several other attempts to develop electronic trading platforms for Rule 144A securities. These trading platforms have not been widely used.

Footnotes

287 The Depository Trust Company, Operational Arrangements (Necessary for Securities to Become and Remain Eligible for DTC Services) (Jan. 2012).

288 SEC Release No. 34-33327 (Dec. 13, 1993).

289 FINRA Rules, Rules 6600–6630 and 7700–7730, FINRA MANUAL. FINRA operates TRACE for reporting and disseminating information on secondary market transactions in debt securities, which covers both SEC-registered and Rule 144A debt securities. SEC Release No. 34-43873 (Jan. 23, 2001). Trades in Rule 144A equity securities are reported to the OTC Reporting Facility. On June 30, 2014, FINRA began publicly disseminating Rule 144A corporate debt security transaction data. This data previously was not publicly disseminated due to the prohibition on offers to non-QIBs in Rule 144A transactions. FINRA Rules, Rule 6750. SEC Release No. 34-70345 (Sept. 6, 2013).

290 SEC Release No. 34-27956 (Apr. 27, 1990).

291 SEC Release No. 34-33326 (Dec. 13, 1993); SEC Release No. 34-56172 (July 31, 2007). Pursuant to the 2007 amendments, Nasdaq launched an updated version of the PORTAL Market that sought to reestablish it as a closed trading system permitting qualified participants to trade PORTAL-eligible securities with one another through a centralized electronic quotation and trading platform. The new market established qualification requirements for brokers and dealers and for QIBs that wished to access PORTAL, and implemented quotation, trade negotiation and trade reporting functions in the PORTAL Market for PORTAL-designated securities.

292 SEC Release No. 34-58638 (Sept. 24, 2008). Even though Nasdaq terminated PORTAL security designation processes as of October 26, 2009, existing regulatory obligations for securities previously designated as PORTAL securities were not eliminated until June 2010. SEC Release No. 34-61979 (Apr. 23, 2010) (Order).

U.S. Regulation of the International Securities and Derivatives Markets, § 7.08, SPECIAL CONCERNS OF BROKER-DEALERS

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 § 7.08 (11th and 12th Editions 2014-2017)
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Private placements raise certain specific compliance issues for broker-dealers, including those discussed below.

[1] Application of Regulation T to Rule 144A Transactions

Regulation T, promulgated by the Board of Governors of the Federal Reserve System (the "Board") under § 7 of the Exchange Act, regulates extensions of credit by broker-dealers. [293] Under Regulation T, purchases by broker-dealers of debt securities in a *bona fide* public offering are deemed not to be extensions of credit to the issuer, [294] while purchases of privately offered debt securities are deemed to be extensions of credit. [295] When purchasing privately offered debt securities, therefore, broker-dealers must take steps to comply with Regulation T. [296]

To facilitate the SEC's goal in adopting Rule 144A of achieving a more liquid and efficient institutional resale market for unregistered securities, however, the Board has interpreted Regulation T not to treat a broker-dealer's purchase of an unregistered debt security for resale under Rule 144A, including a purchase in the course of Rule 144A market-making activities, as an extension of credit by the broker-dealer for purposes of Regulation T. [297] The Board's interpretation is applicable to both primary and secondary market transactions.

The theory of the Board's interpretation is that, in purchasing debt securities with the intention to resell them pursuant to Rule 144A, a broker-dealer is "arranging" for an extension of credit by the purchaser of the debt securities in the resale transaction, rather than extending the credit itself. Regulation T permits a broker-dealer to arrange any credit provided that it does not willfully

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arrange credit that violates the Board's other margin regulations, Regulations U and X. [298] The narrow focus of the Board's interpretation leaves open the applicability of Regulation T in circumstances in which, notwithstanding a good faith intention when the security is purchased to resell it under Rule 144A, the broker-dealer is unable to resell it or resells it other than pursuant to Rule 144A.

In adopting its interpretation, the Board declined to accept a proposal made by the Securities Industry Association that it simply declare that a broker-dealer's purchase of a security for resale—whether or not pursuant to Rule 144A—constitutes a permitted arranging rather than an extension of credit. The effect of the Board's refusal is to leave Regulation T relevant for a broker-dealer's purchase, as principal, of privately offered debt securities other than for resale under Rule 144A. In the context of such transactions (including, *e.g.*, initial resales to both QIBs and to accredited investors in traditional private sales), the participating financial institution should consider whether it needs to obtain an appropriate representation from the issuer that the proceeds of the offering will not be used for purchasing, carrying or trading in securities. [299]

[2] Net Capital Consequences of Rule 144A Securities

Restricted securities held by a broker-dealer have traditionally resulted in a 100% charge to its regulatory capital because such securities do not have a "ready market" and "cannot be publicly offered or sold because of statutory, regulatory or contractual arrangements or other restrictions." [300] In the adopting

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release for Rule 144A, however, as well as in several subsequent no-action letters, the SEC and its staff have outlined criteria under which certain Rule 144A-eligible securities and other securities that the SEC may not otherwise deem to have a "ready market" may qualify for reduced capital charges. Application of such reduced capital charges depends on factors such as, among other things, the rating of the securities (or the issuer) by "nationally recognized statistical rating organizations," [301] the availability of public information regarding the issuer, the issuance size and the convertibility of the securities into publicly traded securities that have a ready market. [302]

[3] FINRA Rule 5123

Upon its effectiveness in 2012, FINRA Rule 5123 increased the disclosure and reporting obligations of certain broker-dealers that participate in private placements. Rule 5123 generally requires FINRA members and associated persons to provide disclosure to investors in private offerings describing the anticipated use of offering proceeds and the amount and type of offering expenses and offering compensation (either in the private placement memorandum or a separate term sheet). Rule 5123 requires FINRA members to file this disclosure with FINRA no later than 15 days after the document is provided to investors or indicate in the filing that no written documents were used. [303] Because of its numerous exemptions—which include most offerings to institutional investors (including offerings made pursuant to Rule 144A) and offerings pursuant to Regulation s under the Securities Act, as well as offerings of nonconvertible debt or preferred securities by issuers that meet the eligibility criteria for incorporation by reference in Forms S-3 and F-3)—from a practical perspective the Rule applies mainly to private placements of securities to natural persons in the United States.

Footnotes

293 *See* § 14.07[6][a].

294 *See* Fed. Res. Reg. Serv. ¶5-606.56 (staff opinion, Dec. 20, 1993) (Board staff does not regard the purchase of debt securities offered in a public offering as an extension of credit subject to the margin regulations, with the caveat that the public offering must not be structured "so that the sale in actual practice resembles a private placement.").

295 *See* Fed. Res. Reg. Serv. ¶5-606.4 (staff opinion, Dec. 11, 1984).

296 Where the proceeds of the debt securities will not be used for the purpose of purchasing, carrying or trading in securities, the broker-dealer may obtain a certification of the purpose of the credit on Board Form T-4 and extend and maintain the credit on a "good faith" basis. *See* 12 C.F.R. § 220.6(e); *see also* § 14.07[6][a][i]. Nonpurpose credit extended by a broker-dealer may be subject to applicable net capital charges. *See* FINRA Rules, Rule 4210(e)(7), FINRA MANUAL.

297 *See* Fed. Res. Reg. Serv. ¶5-470.1 (Board interp., July 16, 1990).

298 *See* 12 C.F.R. § 220.3(g). Purchases of privately offered debt securities by nonbroker-dealers, including in transactions under Rule 144A, are extensions of credit that may be subject to the Board's Regulation U (applicable to certain U.S. lenders other than broker-dealers) and Regulation X (applicable to certain U.S. and U.S.-controlled borrowers). For example, Regulation U limits extensions of credit to finance the purchase or carrying of "margin stock" (such credit referred to as "purpose credit") that are secured, directly or indirectly, by "margin stock." *See* 12 C.F.R. § 221.3. "Indirect" security may include, for example, restrictions on the sale, pledge or other disposition of assets where 25% or more of the assets subject to the arrangement consist of margin stock. *See* 12 C.F.R. § 221.2. "Margin stock" includes, among other securities, stock registered on a U.S. national securities exchange (including Nasdaq) and debt convertible into such stock. *See* 12 C.F.R. § 221.2. Accordingly, a U.S. person purchasing a privately offered note (including debt of a foreign issuer) any proceeds of which are used for "purpose credit" and the collateral for which includes "margin stock" may be subject to Regulation U, which among other requirements would limit the amount of credit that may be extended through the note. In addition, even where a privately placed note

is not "purpose credit" but is directly or indirectly secured by "margin stock," Regulation U may require the purchaser to register and make certain related filings with the Board, although the Board staff has by interpretation created an exception from this requirement for nonpurpose credit notes purchased under Rule 144A. *See* Fed. Res. Reg. Serv. ¶5-942.69 (staff opinion, Aug. 30, 1996).

299 *See supra* Note 296.

300 Rule 15c3-1(c)(2)(vii) under the Exchange Act; *see also* § 14.07[2][b][i].

301 [Reserved.]

302 *See* SEC Release No. 33-6862 (Apr. 23, 1990); *Securities Industry Association* (avail. July 27, 2000); *Securities Industry Association* (avail. Aug. 16, 1999); *Securities Industry Association* (avail. Mar. 30, 1996); *Securities Industry Association* (avail. June 12, 1992).

303 As of 2013 FINRA updated the form that firms must use to file offering documents and information pursuant to FINRA Rule 5123. The updated form includes six new questions that are designed to assist FINRA in prioritizing its review of private placement filings. The updated form is available on the FINRA website.

U.S. Regulation of the International Securities and Derivatives Markets, § 7.09, STATE SECURITIES LAW CONCERNS

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 § 7.09 (11th and 12th Editions 2014-2017)
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Institutional private placements of the kind discussed in this chapter are structured primarily to comply with federal securities laws, but they may also be

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subject to state securities laws, traditionally referred to as "blue sky" laws. [304] For transactions in "covered securities," as described below, federal law expressly preempts state securities laws, making them inapplicable. For other transactions, including most private placements by foreign private issuers, there is no federal preemption of state law, and such transactions are typically conducted under exemptions from state law registration requirements.

The National Securities Markets Improvement Act of 1996 (the "NSMIA") [305] amended § 18 of the Securities Act to provide for federal preemption of state laws requiring registration of securities that are "covered securities" or transactions in "covered securities," as defined in § 18. [306] Several categories of preemption are potentially relevant to private placements: (i) where the securities are listed (or will be listed upon completion of the transaction) on a national securities exchange or are senior to listed securities of the same issuer (for example, debt securities of an issuer that has listed common equity), (ii) where the transaction is exempt from registration pursuant to regulations promulgated by the SEC under § 4(a)(2) of the Securities Act [307] and (iii) where the securities are exempt from registration pursuant to § 4(a)(7) of the Securities Act.

The private placement of debt or equity securities of a foreign private issuer with U.S.-listed equity falls squarely within the scope of federal preemption. Other Rule 144A offerings require a two-part analysis. First, the issuer's sale of securities to the initial purchasers is typically conducted in reliance on

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§ 4(a)(2) and not on Regulation D, so it does not have the benefit of federal preemption. [308] However, all state securities laws provide for an exemption from state registration for offers and sales of securities to specified types of institutional investors. While the breadth of these exemptions varies from state to state, most states have adopted provisions similar to those contained in the various versions of the Uniform Securities Act, which exempt offers and sales specifically to broker-dealers or more generally to institutional investors, a term defined to include registered broker-dealers. [309]

Second, a participating financial institution's resale to investors will benefit from federal preemption if the securities are listed or are senior to listed securities. If federal preemption does not apply to the participating financial institution's resale, the placement can be conducted in most states under published interpretations or adopted statutory or regulatory provisions specifically to the effect that sales made in compliance with Rule 144A or to QIBs will be exempt under the applicable state securities laws. [310] Sales in states without specific Rule 144A or QIB exemptions may be made if the purchaser otherwise qualifies under the definition of statutorily specified types of institutions, which vary from state to state. [311]

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An additional concern under state "blue sky" laws arose as a result of the amendments to Rule 144A permitting general solicitation. Broad-reaching general solicitation could constitute offers to noninstitutional investors—and only three states effectively exempt offers by nonreporting issuers to those investors in a Rule 144A context. [312] Accordingly, use of broad-reaching general solicitation in Rule 144A offerings by nonreporting issuers [313] could require registration under most state "blue sky" laws. [314]

Footnotes

304 *See* § 3.02[7] for a further discussion of state "blue sky" laws.

305 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

306 The scope of preemption under the NSMIA also extends to state laws that prohibit, limit or impose conditions on (i) the use of an offering document prepared by or on behalf of the issuer, (ii) proxy statements, reports and other disclosure documents filed with the SEC or (iii) offers or sales based on the merits of the offering or the issuer, in each case, in connection with transactions in "covered securities." *See* § 18(a) of the Securities Act.

307 State securities laws are also preempted with respect to the securities of an investment company registered under the Investment Company Act. Moreover, the NSMIA provides for preemption with respect to offers or sales of securities to "qualified purchasers," as defined by the SEC. The SEC has never acted to provide a widely applicable definition of "qualified purchasers" for this purpose but, in connection with amendments made to Regulation A in 2015, did apply this designation to "any person to whom securities are offered or sold pursuant to a [Regulation A] Tier 2 offering." *See* 17 CFR 230.256. On two prior occasions, first in 2001 and then in 2007, the SEC proposed but did not adopt a definition of "qualified purchasers" that would preempt state securities regulations in connection with offers and sales to "accredited investors" and "large accredited investors," respectively, each as defined in Regulation D under the Securities Act. SEC Release No. 33-8041 (Dec. 19, 2001); SEC Release No. 33-8828 (Aug. 3, 2007) (withdrawn Oct. 1, 2009).

308 *See* § 7.02[2]. An issuer selling directly to investors will often do so in reliance on Rule 506 of Regulation D, rather than on § 4(2), specifically in order to have the benefit of federal preemption, particularly where the availability of state law exemptions is uncertain because not all investors are qualified institutional buyers.

309 For example, § 402(b)(8) of the Uniform Securities Act of 1956 defines the relevant exemption as "any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or *to a broker-dealer*, whether the purchaser is acting for itself or in some fiduciary capacity" (emphasis added). Similarly, § 202(13) of the Uniform Securities Act of 2002 provides an exemption for "a sale or offer to sell to: (A) an institutional investor; (B) a federal covered investment advisor; or (C) any other person exempted by rule adopted or order issued under this [Act]."

310 California (CAL. CODE REGS. tit. 10, § 260.105.13.1 (2011)); Florida (FLA. STAT. ANN. § 517.061(7)); Louisiana (LA. REV. STAT. ANN. § 51:709(4)); Maryland (MD. CODE REGS. 02.02.04, § Rule.04); (MASS. CODE REGS. tit. 950, § 14.401 (2011)); Michigan (MICH. COMP. LAWS § 451.2102a); New Jersey (NEW JERSEY STAT. ANN. § 49:3-49 (West); New York (N.Y. GEN. BUS. LAW § 359-e(a)); Ohio (OHIO ADMIN. CODE § 1301:6-3-02(D) (2003)); Texas (7 TEX. ADMIN. CODE § 109.4); Wisconsin (WIS. STAT. § 551.102); Blue Sky L. Rep. (CCH) ¶¶9,136 & 9695L (Arizona); 15,520 (Delaware); 16,758 (District of Columbia); 21,644 (Idaho); 24,675 (Indiana); 27,579 (Kentucky); 35,587 (Missouri); 36,517 (Montana); 39,623 (New Hampshire); 44,527 (North Dakota); 47,667, 47,668 (Oregon); 49,602 (Puerto Rico); 50,505 (Rhode Island); 57,468 (Utah); 58,414 (Vermont); 61,810U (Washington); 63,641 (West Virginia); and 66,464 (Wyoming).

311 Occasionally, underwriters request that counsel prepare a "blue sky" survey describing the criteria for the state-law exceptions, so as to provide specific guidance to sales personnel. However, this practice, which was standard in public offerings prior to the enactment of the NSMIA, is virtually unheard of in private placements today, at least where they are conducted under Rule 144A or otherwise limited to QIBs.

312 California, Louisiana and Vermont exempt from their registration requirements offers and sales made in compliance with Rule 144A as in effect from time to time. *See supra* Note 310.

313 This could also include Rule 144A offerings by reporting issuers with nonreporting guarantors.

314 It remains to be seen whether any of those states would pursue an enforcement action in such a case. Practitioners may ask the SEC to use its authority under § 18 of the Securities Act to preempt "blue sky" laws for all offers and sales made pursuant to Rule 144A, which would align them with the existing preemption for all offers and sales made pursuant to Rule 506, but this request has been made before, and the SEC has yet to address it.

U.S. Regulation of the International Securities and Derivatives Markets, § 7.10, APPLICATION OF REGULATION M TO PRIVATE PLACEMENTS

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 § 7.10 (11th and 12th Editions 2014-2017)
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Regulation M under the Exchange Act [315] governs the market activities of issuers, selling securityholders, underwriters and other participants in securities offerings, and certain of their affiliates. [316] Regulation M consists of six rules, including a definitional rule (Rule 100). Rules 101 and 102 regulate bids for and purchases of securities in "distribution" in the United States (and certain related securities) by participants in the distribution and certain of their affiliates. Rule 101 regulates bids and purchases by underwriters, prospective underwriters and other distribution participants, and affiliates of such persons that fall within the definition of "affiliated purchaser." Rule 102 regulates bids and purchases by issuers, selling securityholders and their affiliated purchasers. Rule 103 governs passive market making by Nasdaq market-makers participating in a distribution. Rule 104 regulates stabilization to facilitate an offering. Rule 104 also adds disclosure and reporting requirements regarding certain post-distribution activities, including purchases to cover syndicate short positions and the imposition of "penalty bids." Finally, Rule 105 restricts short selling in connection with a registered offering.

The determination whether an offering constitutes a distribution in the United States for purposes of Regulation M is based on the "magnitude of the offering" and the "presence of special selling efforts and selling methods." [317]

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Offerings subject to Rule 101 include private offerings where the indicia of a distribution are present.

Regulation M, however, by its terms has only limited application to transactions under Rule 144A. In particular, Rule 101 and 102 contain exemptions for distributions of Rule 144A-eligible securities of any issuer, U.S. or non-U.S., if such securities are sold in the United States only to QIBs or persons reasonably believed to be QIBs in transactions exempt from registration under § 4(a)(2), Rule 144A or Regulation D under the Securities Act. [318] The exemption also applies if the distribution includes certain persons in the United States not deemed to be "U.S. persons" for the purposes of Regulation s under the Securities Act. [319] Rule 104, which governs stabilizing transactions, contains comparable exemptions. [320] The exemptions would not, however, be available for a distribution of securities that are not Rule 144A-eligible, for example because of the fungibility or information delivery requirement of the Rule, [321] or that are not sold only to QIBs, for example because sales were also made to institutional accredited investors. [322]

Footnotes

315 SEC Release No. 34-38067 (Dec. 20, 1996) (the "Regulation M Release").

316 For a discussion of Regulation M in the context of global offerings and enforcement, see §§ 3.02[8][a] and 11.05[3][c], respectively.

317 Rule 100 of Regulation M under the Exchange Act.

318 Rules 101(b)(10)(i) and 102(b)(7)(i) of Regulation M under the Exchange Act. As a result of the mandate of § 201(a)(2) of the JOBS Act, the SEC amended the exemptions under Rules 101, 102 and 104 of Regulation M to conform to the amendments to Rule 144A by eliminating references to "offered" and "offerees."

319 Rules 101(b)(10)(ii) and 102(b)(7)(ii) of Regulation M under the Exchange Act.

320 Rule 104(j)(2) of Regulation M under the Exchange Act. However, unlike the exemptions provided in Rules 101 and 102 for securities eligible for resale under Rule 144A, the exemption contained in Rule 104(j)(2) is currently limited to the subject security. The SEC has stated that, when Rule 104 was adopted, the scope of the private placement exemption under it was intended to be identical to that provided in Rules 101 and 102. SEC Release No. 33-8511 (Dec. 9, 2004). Accordingly, the SEC proposed to extend the Rule 144A-eligible securities exemption in Rule 104 to reference securities (that is, any security into which a subject security may be converted, exchanged or exercised (whether immediately or not), or which, under the terms of the subject security, may in whole or significant part determine the value of the subject security). *See* SEC Release No. 33-8511 (Dec. 9, 2004). As a consequence of this extension, in the context of an offering of Rule 144A-eligible convertible bonds, for example, Rule 104 would not apply to transactions in the underlying equity securities. This proposal was never adopted. For a discussion of Rule 104 generally, *see* § 3.02[9][b].

321 *See* § 7.02[3][c] and [d].

322 For a further discussion of Regulation M, *see* § 3.02[8][a].

U.S. Regulation of the International Securities and Derivatives Markets, § 8.01, 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 § 8.01 (11th and 12th Editions 2014-2017)
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The Securities Act does not provide an exemption for offers and sales of securities outside the United States. Section 5 of the Securities Act requires, in effect, that any offer or sale of a security made by U.S. "means or instruments of transportation or communication in interstate commerce or of the mails"—the so-called "jurisdictional means"—be registered with the SEC unless an exemption is available. [1]

Historically, the U.S. courts have generally applied the concept of jurisdictional means broadly, and in certain contexts a single telephone call into or from the United States may be enough to establish their use. [2] Moreover, even if the issuer and the underwriters do not use jurisdictional means but others do, and that use by others was reasonably foreseeable, courts may conclude that this contact with the United States is enough to make the registration provisions of the Securities Act applicable. [3] As a theoretical matter, a public offering outside the United States by a U.S. issuer may be subject to the registration requirements of the Securities Act since jurisdictional means would almost certainly be used, at least in a limited way. It is also theoretically possible that a public offering outside the United States by a foreign issuer may be subject to the registration requirements of the Securities Act if U.S. jurisdictional means are used in the offering; however, recent court decisions in the United States suggest that this is unlikely. [4]

The Securities Act also does not provide an exemption for a public offer or sale of a security by an issuer or underwriter or for a dealer in securities unless certain conditions are met. [5] Section 4(a)(3) of the Securities Act affords an

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exemption for offers and sales by U.S. and foreign securities dealers that are not "underwriters," unless the offers or sales occur prior to 40 days after the date the securities in question were first offered to the public or unless the securities are part of an "unsold allotment."

The term "underwriter" is defined in § 2(a)(11) of the Securities Act as "any person who has purchased from an issuer with a view to … the distribution of any security, or participates or has a direct or indirect participation in any such undertaking." The term "distribution" is not defined, and securities lawyers have been unable to conclude that offerings abroad are not distributions for this purpose. This uncertainty arises in part because the SEC, unlike other regulators, has made clear its belief that flowback of securities into the United States after a distribution abroad, even in a recognized international market, can be an indirect distribution in the United States and therefore subject to registration. Thus, members of an underwriting syndicate for an offering of securities outside the United States may be "underwriters" within the meaning of § 2(a)(11) of the Securities Act, especially if the securities are subsequently sold into the United States, and the exemption from the registration requirements afforded by § 4(a)(3) would not be available for offers and sales by such dealers. Moreover, the broad concept of a "direct or indirect participation" in a distribution raises the question whether dealers (other than syndicate members) that participate in the offering, for example, simply by purchasing and reselling the securities being offered, may, depending on their manner of compensation, be "underwriters" whose offers and sales must be registered. [6]

The term "unsold allotment" has been interpreted broadly and includes, at least as a theoretical matter, securities purchased directly or indirectly from an issuer in a chain of transactions between securities dealers not involving a sale to an end-investor. Thus, offers and sales by a dealer that purchased the securities from an underwriter, or from another dealer that purchased the securities from an underwriter, are not exempt from the registration requirements of the Securities Act by virtue of § 4(a)(3), whether or not the 40-day period has elapsed. In any event, offers and sales by dealers that purchased the securities in

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true secondary market transactions are not exempt until 40 days after the securities were first offered to the public. It is generally believed that the concept "offered to the public" for purposes of the 40-day limitation of § 4(a)(3) is not limited to offerings in the United States.

There is thus no express exemption in the Securities Act for offers and sales that are made outside the United States by an issuer, an underwriter or a dealer if there is any use of jurisdictional means in connection with the initial issue or subsequent resales.

[1] Release 4708

Although the registration requirements of the Securities Act apply by their terms whenever jurisdictional means are used to offer and sell securities, the SEC, after public pressure, interpreted their scope less broadly. The SEC first announced its view of the extraterritorial reach of the registration requirements of the Securities Act in 1964 when it published SEC Release No. 33-4708 ("Release 4708"). In that release, the SEC acknowledged that the securities laws were "primarily intended to protect American investors" and concluded that debt securities could be issued by U.S. companies without registration if "the offering is made under circumstances reasonably designed to preclude distribution or redistribution of the securities within, or to nationals of, the United States" or in circumstances that would result in the securities "coming to rest" abroad. [7] This formulation was characteristic of the U.S. approach to regulation at the time—a desire to prohibit doing indirectly what could not be done directly—which led to imprecise general statements such as "coming to rest" that raised as many questions as they purported to answer.

On the basis of Release 4708, and no-action letters issued under it, U.S. securities lawyers developed detailed contractual provisions and related procedures designed to ensure that securities being offered abroad would not flow into the United States or wind up in the hands of U.S. persons as part of their distribution. For debt securities, these provisions typically included: (i) procedures to ensure that securities in definitive form were not available until 90 days after the distribution had been completed, and then only upon certification that the owner was not a U.S. person, (ii) agreements by the underwriters that they would not sell unsold allotments in the United States or to U.S. persons at any time, or other securities sold in the offering and acquired subsequently in the market until the 90-day period had passed, and (iii) agreements by the underwriters that they

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would deliver "confirmations" to other dealers imposing the same selling restrictions on them. [8] The concept of completion of the distribution was integral to these procedures, and the definition of "U.S. person" embraced U.S. nationals resident abroad.

[2] Problems That Emerged Under Release 4708

While the cooperative efforts of the SEC, the private bar and market participants provided a degree of certainty as to whether particular international offerings were required to be registered, certain difficulties emerged. First, as the international securities markets broadened and developed, issues arose that were not contemplated at the time of Release 4708. These included fundamental questions such as the application of the release (which had been addressed specifically to debt offerings by U.S. issuers) to international offerings by foreign issuers, including in particular international equity offerings. Indeed, for equity securities, lockup and certification procedures were not practicable, so the steps taken were limited to variants of (ii) and (iii) described above for debt securities. There were also technical questions— *e.g.*, the application of the registration requirements to "continuous" offerings, such as medium-term note programs in which discrete tranches of debt securities are issued from time to time with varying degrees of frequency, sometimes as often as daily. [9]

Second, the growing internationalization of the securities markets, and in particular the desire of U.S. institutional investors to acquire foreign securities as part of their diversified worldwide portfolios, focused attention on whether the registration requirements of the Securities Act should be subject to a more rigorous territorial limitation. For example, while Release 4708 stated that the registration requirements of the Securities Act were intended to protect U.S. nationals, it was not clear whether as a matter of law such persons were or should be entitled to the protections of the registration requirements when purchasing unregistered securities from abroad in markets outside the United States.

Finally, there was some uncertainty as to when securities offered and sold abroad could be resold in the United States pursuant to the exemptions from the registration requirements afforded by § 4(a)(1) or § 4(a)(3) of the Securities Act. The difficulty was that the registration requirements clearly apply to offers and sales that are part of a distribution, but the Securities Act is silent as to when a distribution is over. While the procedures developed under Release 4708 were reasonably designed to ensure that the securities being offered "came to rest"

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abroad, and thus were adequate to ensure that offers and sales made in accordance with them did not have to be registered, neither the SEC nor the private bar was able to say precisely when securities offered abroad could trade back into the United States under § 4(a)(1) or § 4(a)(3), since there was no definitive answer to the question of whether any particular seller was still participating in a distribution. It also was unclear as a matter of law whether each distribution participant was required to avoid resales until all distributors had sold their allotments or only until it had sold its allotment.

Other exemptions from registration suggested a cautious approach in the absence of official guidance— *e.g.*, the exemption provided by § 3(a)(11) for intrastate offerings if, among other things, there are no resales outside the state in question for a period of nine months, or the exemption provided by Rule 144 under the Securities Act, which at that time restricted resales of privately placed securities for three years. Securities lawyers generally advised that 90 days after completion of the distribution should be allowed before debt securities and equity securities offered abroad with respect to which there was no active U.S. market could be considered to be freely tradable into the United States under § 4(a)(1) or § 4(a)(3). [10] However, the staff of the SEC indicated informally its belief that up to nine months or a year should be allowed for equity and convertible debt of all U.S. issuers and for foreign issuers whose shares were actively traded in the United States.

Footnotes

1 The term "interstate commerce" extends to commerce between the United States and other countries. § 2(a)(7) of the Securities Act.

2 There is limited jurisprudence regarding the application of the registration requirements to offerings outside the United States. The cases so broadly interpreting the concept of jurisdictional means have generally involved efforts by issuers and underwriters to qualify for the intrastate offering exemption of § 3(a)(11) of the Securities Act, often in rather dubious circumstances. It is doubtful that the doctrines articulated in those cases would be applied in full to international offerings by foreign issuers, where considerations of comity would be weighty. Moreover, even if a court were to conclude that jurisdictional means had been used, it would still be possible to find a lack of subject matter jurisdiction. *See infra* Note 4.

3 *See, e.g.*, *United States v. Wolfson*, 405 F.2d 779, 783–84 (2d Cir. 1968) (discussing reasonably foreseen use of the mails).

4 A non-U.S. person who purchased securities outside the United States would have a right to rescission if the registration requirements were violated. In light of recent U.S. court decisions, it is, however, doubtful whether U.S. courts would adopt this position, and unlikely that they would do so in the case of an offering by

a foreign issuer. *See* § 11.10[3] for a discussion of the extraterritorial reach of the U.S. securities laws and the recent court decisions in the United States following the Supreme Court's decision in *Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010).

5 *See* §§ 4(a)(1) and 4(a)(3) of the Securities Act. There are exemptions from Securities Act registration based on types of offerings, such as for certain offerings of one security for another issued by the same company (*see* § 3(a)(9) of the Securities Act) or for offerings of securities that receive court approval following a fairness hearing (*see* § 3(a)(10) of the Securities Act). These exemptions can apply to offerings of securities outside the United States. *See* § 10.06[2], Note 114 and accompanying text; § 9.05[3][b], Note 149 and accompanying text. In addition, there are exemptions for certain types of securities, such as those issued or guaranteed by U.S. banks or U.S. branches or agencies of foreign banks (*see* § 3(a)(2) of the Securities Act and § 3.05[2]), that are also available for offerings of securities outside the United States.

6 The definition of "underwriter" in § 2(a)(11) of the Securities Act states explicitly that the term "shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission."

7 29 Fed. Reg. 9828 (July 22, 1964). This release dealt only with the registration requirements of § 5 of the Securities Act and not with the scope of the antifraud provisions of the securities laws. The same is true of Regulation S under the Securities Act, the successor to Release 4708, discussed later in this chapter.

8 For a discussion of the practices developed on the basis of Release 4708, *see* Alan L. Beller & Gail S. Berney, *Eurobonds*, 19 REV. SEC. COMM. REG., No. 4 (1986).

9 *See* § 10.02[2].

10 Over time, some members of the securities bar became relatively comfortable with a 40-day seasoning period in certain circumstances, since 40 days is the period specified in § 4(a)(3)(A) of the Securities Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 8.02, SAFE HARBOR PROVISIONS OF REGULATION S

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 § 8.02 (11th and 12th Editions 2014-2017)
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In response to the difficulties and uncertainties discussed in § 8.01 above, in 1990 the SEC adopted Regulation S under the Securities Act—a comprehensive approach to the various issues relating to offerings of securities outside the United States that undid or superseded many of the concepts that had previously applied. [11] Regulation S consists of a general statement—which declares simply

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that the registration requirements apply only to offers and sales of securities made in the United States—and two safe harbors. A "safe harbor" under U.S. law is, generally speaking, a set of detailed procedures for ensuring that a general principle is observed. If the detailed procedures are followed, any doubts about how the general principle will be applied can be eliminated.

The general statement does not often serve as a basis for planning offerings outside the United States. Because the consequences of violating the registration requirements are so severe, issuers and underwriters often wish to receive the legal opinion of U.S. counsel that registration is not required. [12] While the territorial principle was a helpful and sensible advance in defining the scope of the registration requirement, in view of the difficulties of applying that principle to transactions that are by definition international in character, U.S. counsel is likely to be reluctant to provide opinions with respect to transactions not covered by one of the safe harbors.

The safe harbors are for (i) offers and sales by issuers, other participants in a distribution and their affiliates, and (ii) resales by others, such as investors that acquire securities in a U.S. private placement (including in a transaction exempt from the registration requirements under Rule 144A). [13]

In 1998, the SEC adopted amendments to Regulation S intended to prevent certain abusive practices by U.S. issuers that developed in connection with equity offerings purportedly made pursuant to the Regulation's safe harbors. [14] The release stated that the amendments to Regulation S were designed to prevent “abuses in connection with sales of domestic equity securities [which] have been common … especially schemes involving the securities of thinly capitalized or ‘microcap’ companies.” [15] These schemes were viewed by the SEC as having been a "guise for distributing securities into the U.S. markets without the protections of § 5 of the Securities Act." [16]

[1] Issuer and Distributors

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In order to fall within the first safe harbor, an offer or sale by an issuer, by distributors—underwriters, dealers and others who participate pursuant to a contractual arrangement in a distribution—or by their affiliates or anyone acting on their behalf, must meet two basic conditions: (i) the securities must be sold in an "offshore transaction" and (ii) there can be no "directed selling efforts" in the United States by the issuer or any distributor (or any of their affiliates).

[a] Offshore Transaction

An offer or sale is an "offshore transaction" if the offer is made outside the United States and either (i) the buyer (who may be a U.S. person) is (or is reasonably believed by the seller to be) outside the United States when the buy order is originated or (ii) the transaction is executed on the physical trading floor of a foreign securities exchange. [17] For purposes of alternative (i) of the definition of

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"offshore transaction," the general rule is that the buyer itself, rather than its agent, must be outside the United States. However, if the buyer is a corporation, partnership or investment company, it is enough that an authorized person employed by it or, in the case of an investment company, by its investment adviser, places the buy order while outside the United States. [18] Offers and sales in the United States to certain U.S. fiduciaries acting for foreign investors, [19] or to certain international organizations, are also considered offshore transactions. [20]

[b] Directed Selling Efforts

"Directed selling efforts" are any activities undertaken for the purpose, or that reasonably could be expected to have the effect, of conditioning the U.S. market for the securities being offered. [21] They include mailing printed material to U.S. investors, conducting promotional seminars in the United States or placing advertisements in publications with a general circulation in the United

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States. [22] The distribution or publication in the United States of information, opinions or recommendations concerning the issuer or any class of its securities—including research reports sent out by a participant in the distribution (or any of its affiliates)—could also constitute directed selling efforts, depending on the circumstances. [23] However, marketing efforts in connection with a registered U.S. public offering, or with a transaction that is exempt from the registration requirements of the Securities Act, such as a U.S. private placement (including general solicitation and general advertising in Rule 506(c) and Rule 144A offerings), [24]

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generally will not be treated as directed selling efforts for a simultaneous offering outside the United States. [25]

The prohibition on directed selling efforts is not intended to interfere with routine corporate communications, news stories or other *bona fide* journalistic activities. Thus, the dissemination by an issuer of routine corporate communications of the kind normally published by companies, such as press releases regarding financial results or the occurrence of material events, will not be deemed to be directed selling efforts. [26] In addition, access by journalists to press conferences and general meetings with company spokesmen, and to notices released to the press, need not be limited, even when the foreign offering is being discussed and the journalists work for publications with a general circulation in the United States, so long as: the press conference or meeting is held, and the notice is released, outside the United States; the information to be disseminated is made available to the foreign and U.S. press generally; and the press conference or release is not intended to induce purchases of securities by persons in the United States. [27]

The requirement that the information be made generally available to the press created uncertainty with respect to the common practice in Europe of granting one-on-one interviews to a limited number of financial publications— *The Financial Times* in particular—in connection with or in anticipation of an offering. If the publication had a general circulation in the United States or, as in the case of *The Financial Times*, a U.S. edition that may also run the interview, one-on-one interviews were discouraged by securities lawyers in the absence of definitive SEC guidance on the question. Uncertainty, some of it unwarranted, also arose as to the ability of the U.S. press to attend general presentations.

Partly in response to these uncertainties, the SEC adopted Rule 135e under the Securities Act, which provides a "safe harbor" to enable members of the press, including the U.S. press and publications with a general circulation in the United States to participate in offshore press activities conducted by or on behalf of non-U.S. issuers. [28] Rule 135e reaffirms the SEC's previous guidance regarding the ability of journalists to obtain access to issuers outside the United States; it allows one-on-one interviews, including "exclusive" interviews, to be granted to U.S. journalists; and it permits the U.S. journalists to participate in meetings with the issuer or specially arranged visits to the issuer, so long as the issuer either holds a general press conference to which both the U.S. and foreign journalists are given access before or after those interviews or meetings or gives foreign journalists the opportunity to conduct similar interviews or to participate in similar meetings. [29]

In general, Regulation S is not intended to interfere with any lawful and customary activities, selling or otherwise, that are conducted outside the United States. [30] Advertising campaigns for an offering outside the United States, including on television and radio, as occurred regularly in European privatizations, are therefore consistent with Regulation S. [31] Care should still be taken as to the information disseminated through such activities about the issuer and the securities being offered, particularly in relation to the consistency of such information with the offering document. [32]

Finally, while dissemination in the United States of a broker-dealer's quotations for a security being offered and sold outside the United States could be deemed directed selling efforts, the dissemination of a foreign broker-dealer's quotations by third-party systems (*e.g.*, a system operated by a foreign marketplace or by a private vendor that disseminates such quotations primarily

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in foreign countries) will not be deemed directed selling efforts, provided that (i) securities transactions cannot be executed between foreign broker-dealers and persons in the United States through the system and (ii) the issuer, distributors, their respective affiliates, persons acting on behalf of any of the foregoing, foreign broker-dealers and other participants in the system do not initiate contacts with U.S. persons or persons within the United States beyond those contacts permitted under Rule 15a-6 under the Exchange Act. [33]

The prohibition on directed selling efforts in the United States applies to each participant in the distribution during any "distribution compliance period" under Regulation S [34] and for so long as such participant is offering an unsold allotment. Because the prohibition on directed selling efforts can extend past the closing date, a number of questions have arisen as to when "tombstone" advertisements [35] can be published in a publication having a general circulation in the United States and when research reports can be circulated in the United States.

Tombstone advertisements in a publication with a general circulation in the United States will not be viewed as directed selling efforts, no matter when publication occurs, so long as less than 20% of the publication's aggregate circulation (including U.S. and foreign editions if they are substantially the same) is in the United States and the advertisement contains an appropriate legend and only the limited information specified by Regulation S. [36] If those requirements are not met, a participant in the distribution should not publish a tombstone advertisement in a publication with a general circulation in the United States until any distribution compliance period under Regulation S has expired and the person publishing the tombstone has disposed of its allotment.

Similarly, research reports may be circulated in the United States at any time if they meet the requirements of Rules 138 and 139 under the Securities Act. [37] If they do not meet those requirements, a participant in the distribution should not circulate research reports in the United States until the expiration of

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any distribution compliance period under Regulation S and the disposition of its allotment. [38]

[c] Additional Requirements

The offshore transaction and directed selling efforts requirements apply to any offering made in a manner that is intended to fall within a safe harbor of Regulation S under the Securities Act. However, in order to qualify for the safe harbor for issuers, distributors, their affiliates and persons acting on their behalf, certain additional requirements may need to be met as well. These requirements vary depending principally on the status of the issuer. [39] In general, the safe harbor provisions are least restrictive when it is least likely that securities offered abroad will flow into the U.S. market (Category 1) and most restrictive when adequate information about the issuer is not publicly available in the United States and existing or potential U.S. market interest is sufficient to suggest that offerings of the issuer's securities outside the United States may not come to rest abroad (Category 3). When adequate information about the issuer is publicly available in the United States (Category 2), the concerns about securities flowing into the U.S. market are reduced, and the restrictions fall between these two extremes. As a result of the amendments to Regulation S adopted in 1998, equity offerings by all U.S. issuers are subject to additional restrictions because of the SEC's concerns about flowback, regardless of availability of information.

The following table provides an overview of offerings that fall under each category: [40]

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TABLE 8-1

Category 1	*Category 2* [41]	*Category 3*
• Equity securities of a foreign issuer, [42] if there is no “substantial U.S. market interest” [43] in that class of equity. • Debt securities of a foreign issuer, if there is no “substantial U.S. market interest” in the issuer's total debt securities. • Any “overseas directed offering.” [44] • Securities backed by the full faith and credit of a foreign government.	• Equity securities of a foreign issuer that is a reporting issuer, [45] if there is “substantial U.S. market interest” in that class of equity. • Debt securities of a foreign issuer, if there is “substantial U.S. market interest” in the issuer's total debt securities. • Debt securities of a U.S. issuer [46] that is a reporting issuer.	• Equity securities of a foreign issuer that is not a reporting issuer, if there is “substantial U.S. market interest” in that class of equity securities. • Equity securities of any U.S. issuer. • Debt securities of a U.S. issuer that is not a reporting issuer.

41 Market practice has developed to apply additional restrictions to two types of offerings of equity securities of reporting foreign issuers that fit within Category 2: certain offerings of equity securities where substantially all of the trading takes place in the United States, whether in ADR form or otherwise; and offerings of ADRs, irrespective of the trading level of the underlying securities in the United States. Some market participants refer to such offerings as “Category 2 ½” offerings. For a further discussion of “Category 2 ½,” *see infra* § 8.02[1][c][ii].

42 Defined in as a “foreign government” or “foreign private issuer” (each as defined in Rule 405 under the Securities Act).

43 For a discussion of “substantial U.S. market interest,” *see* § 8.02[1][c][i].

44 *See* Note 56 and accompanying text.

45 The definition of “reporting issuer” excludes investment companies registered or required to register under the Investment Company Act of 1940. For a discussion of the meaning of “reporting issuer” under Regulation S, *see* Note 57.

46 The technical term used in Regulation S is “domestic issuer,” which means any issuer other than a “foreign government” or “foreign private issuer” (each as defined in Rule 405 under the Securities Act).

The following table provides an overview of the restrictions that apply to offerings that fall under each category:

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TABLE 8-2

Category 1	*Category 2* [47]	*Category 3 Debt*	*Category 3 Equity*

• Offshore transaction. • No directed selling efforts.	• Offshore transaction. • No directed selling efforts. • Offering restrictions. • 40-day distribution compliance period. • Notice to distributors.	• Offshore transaction. • No directed selling efforts. • Offering restrictions. • 40-day distribution compliance period. • Notice to distributors. • Temporary global note.	• Offshore transaction. • No directed selling efforts. • Offering restrictions. • 6-month to 1-year distribution compliance period. • Notice to distributors. • Investor certification of non-U.S. person status • Purchaser agreement on resales and hedging. • Transfer refusal procedures. • Legend (for domestic issuers only).

47 The following restrictions are typically imposed in a "Category 2 ½ " offering:

- offshore transaction;
- no directed selling efforts;
- offering restrictions;
- 40-day distribution compliance period;
- notice to distributors;
- investor certification of non-U.S. person status;
- purchaser agreement on resales and hedging; and
- transfer refusal procedures.

For a further discussion of "Category 2 ½," *see infra* § 8.02[1][c][ii].

[i] *Category 1 Offerings*

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Category 1 offerings include all offerings of securities of a foreign government (or of a governmental body that would be eligible to file Securities Act registration statements on Schedule B), [48] and offerings of a foreign private issuer if there is no "substantial U.S. market interest" in the type of security being offered. As a practical matter, particularly in the case of equity securities, there will be a "substantial U.S. market interest" for very few foreign issuers. Even foreign companies that have offered their shares to the public and obtained a listing on a securities exchange in the United States are, in most cases, unlikely to find that there is a substantial U.S. market interest in their equity securities. [49]

There is no substantial U.S. market interest in a foreign company's *debt* securities if the issuer reasonably believes that when the offering began: (i) its debt securities were held of record by fewer than 300 U.S. persons, *or* (ii) less than $1 billion in aggregate principal amount of its debt securities was held of record by U.S. persons, *or* (iii) less than 20% in aggregate principal amount of its debt securities was held of record by U.S. persons. [50] Commercial paper that

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is exempt from registration pursuant to § 3(a)(3) of the Securities Act need not be counted when applying these tests. [51]

It is important to note that, in the case of debt securities that are guaranteed by the parent of the issuer, the definition of substantial U.S. market interest applies only to the debt securities of the parent company. [52] If, however, the debt securities are guaranteed by an entity other than the parent of the issuer, for example, by a foreign bank, the definition applies to the debt securities of both companies considered separately, and if there is a substantial U.S. market interest for the debt securities of either of them, the offering of the bonds must be treated as falling into Category 2. If a foreign bank has guaranteed a large number of debt securities in bearer form or has its own debt securities outstanding in a pattern that suggests Category 2 treatment is appropriate, the simplest and most prudent course would be to treat an offering of debt securities guaranteed by that bank as falling into Category 2. [53]

There is no substantial U.S. market interest in a foreign company's equity securities if the issuer reasonably believes that in its most recent fiscal year (i) the securities exchanges and inter-dealer quotation systems [54] in the United States did not constitute the single largest market for the class of equity securities being offered *and* (ii) either (a) less than 20% of all recorded trading in that class of securities took place on securities exchanges and inter-dealer quotation systems in the United States or (b) at least 55% of such recorded trading took place on securities markets of a single foreign country. [55]

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Category 1 also includes any "overseas directed offering"— *i.e.*, an offering by a foreign issuer that is directed to the residents of a single foreign country in accordance with local laws and practices, or any offering of straight debt securities by a U.S. issuer that is made in the same manner, but only if the securities of the U.S. issuer are denominated in a foreign currency. [56]

No requirements beyond those relating to offshore transactions and directed selling efforts are required for Category 1 offerings. Some market participants treat offerings of securities of foreign issuers as falling into Category 2 as a matter of course. Where it is possible to determine clearly that an offering falls into Category 1, it does not seem necessary to demand compliance with the additional requirements of Category 2.

[ii] *Category 2 Offerings*

Category 2 offerings consist of all debt offerings of foreign issuers that do not fall into Category 1, all non-Category 1 equity offerings of foreign issuers that are subject to (and in compliance with) the periodic reporting requirements of the Exchange Act [57] and all debt offerings (other than overseas directed offerings) of U.S. issuers subject to and in compliance with the periodic reporting requirements of the Exchange Act.

For Category 2 offerings, certain steps are required beyond satisfying the offshore transaction and directed selling efforts requirements. These may be described as the "distribution compliance period," "offering restrictions" and "notice" requirements.

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Under the "distribution compliance period" requirement, [58] distributors generally may not offer or sell securities sold in the offering to or for the account or benefit of U.S. persons until 40 days after the later of (a) the date the securities are first offered to the public and (b) the closing date for the offering. [59] Unsold allotments may not be sold to or for the account or benefit of U.S. persons at any time. With a number of exceptions, "U.S. person" is defined to include individuals resident in the United States and corporations and other entities organized there. [60] It does not include U.S. nationals resident abroad. [61]

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Except in the case of continuous offerings, which are discussed in Chapter 10, the "distribution compliance period" under Regulation S is not tied to the completion of the distribution of the securities in question (as it was pursuant to Release 4708). This allows distributors to sell securities other than allotment securities free of the restrictions of Regulation S (i) at any time, in the case of securities that were not sold in the offering, or (ii) once the 40-day distribution compliance period has elapsed, in the case of securities sold in the offering and repurchased in the market, even when allotments remain unsold either by them or by other participants in the distribution. [62] It is, however, important to recall in this regard that allotment securities include securities acquired in stabilization activities or in an uninterrupted chain of transactions between dealers (as well as securities acquired directly from the issuer). Accordingly, except in clear cases, it may be difficult as a practical matter to distinguish allotment securities from other securities for the purpose of taking advantage of this provision of Regulation S.

The issuer and the distributors must also comply with the requirement that "offering restrictions" be adopted. [63] The underwriters and selling group members must agree in writing that they will make offers and sales of the securities during the distribution compliance period only in accordance with Regulation S or pursuant to an exemption from the registration requirements of the Securities Act. [64] Moreover, any offering materials or documents used in connection with the offer or sale of the securities during the "distribution compliance period"

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must include statements to the effect that the securities have not been registered under the Securities Act and may not be sold in the United States or to U.S. persons (other than distributors) unless the securities are registered under the Securities Act or an exemption from the registration requirements is available. [65] In particular, these statements must appear in the prospectus or offering circular and in summary form in any advertisement relating to the offering. [66]

Regulation S also requires each distributor that sells securities to a distributor, U.S. or foreign securities dealer or other person receiving remuneration in connection with the sale during the distribution compliance period (or allotment securities at any time) to deliver a confirmation or other "notice" stating that the purchaser is subject to the same restrictions on offers and sales as a distributor. However, the purchaser receiving the notice need not observe the offering restrictions requirements or deliver a similar notice to others unless the purchaser is a dealer or person receiving selling concessions, fees or other remuneration in respect of the securities offered or sold. [67]

In addition, in light of the concerns expressed by the SEC in the 1998 Release with respect to equity issuances by foreign issuers under Regulation S, [68] market practice has developed to apply additional restrictions to two types of

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Regulation S offerings of securities of foreign issuers that are reporting companies under the Exchange Act: certain offerings of equity securities where substantially all of the trading takes place in the United States, whether in American depositary receipt ("ADR") form or otherwise; and offerings of ADRs, irrespective of the trading level of the underlying securities in the United States. Such offerings are referred to by some market participants as "Category 2 ½" offerings, in reference to the fact that although the offerings technically meet the requirements of Category 2, the trading profile of the securities would suggest that some of the policy considerations underlying the additional restrictions contained in Category 3 are relevant to such securities as well.

For these offerings, modified Category 3 procedures are considered appropriate to limit the flowback of such securities into the United States for some period of time, thereby rebutting the suggestion that the securities are merely being parked overseas on a temporary basis in order to avoid the registration requirements of the Securities Act. These procedures are generally structured to include transfer restrictions that apply for 40 days, rather than six months, as would be the case in a Category 3 offering. [69] In addition, other procedures that might be implemented include requiring each investor to certify that it has not engaged in hedging activities with regard to the securities in anticipation of the offering or during the distribution compliance period and, if the issuer has a registered ADR facility (and underlying shares are being offered rather than ADRs), that it will not deposit the offered securities into the registered ADR facility during the distribution compliance period. A registered ADR facility may also be closed to new deposits during the distribution compliance period to police the transfer restrictions; alternatively, new depositors into the facility may be required during the distribution compliance period to certify that the securities they are depositing were acquired by them before the offering. It may also be necessary to have the securities represented by some form of nonfungible security during the distribution compliance period, or held through some form of custodial facility to allow policing of the transfer restrictions. This would be most likely when ADRs are being offered or when common shares are being offered and it is not possible to close the ADR program to new deposits or there is no ADR program and the securities being offered trade in the same form as the securities traded in the United States. When bonds convertible into these types of securities are offered, precluding conversion for 40 days from issuance would be a prudent means of policing the transfer restrictions with respect to the underlying securities. Category 2 offerings of convertible bonds, in particular, have also raised difficult questions regarding the availability of an exemption from SEC registration requirements in connection with hedging activities (for example, a purchase of the convertible bond and then a sale of the underlying security on

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a U.S. exchange) by distributors on behalf of investors and by investors acting for themselves.

[iii] *Category 3 Offerings*

Category 3 offerings consist of (i) equity offerings of foreign issuers not subject to the periodic reporting requirements of the Exchange Act if there is a "substantial U.S. market interest" for the class of securities being offered; (ii) equity offerings of all U.S. issuers; and (iii) debt offerings of U.S. issuers not subject to the periodic reporting requirements of the Exchange Act. [70] Very few offerings of foreign issuers will fall into this category. [71]

There are more elaborate procedural requirements for Category 3 offerings. For both debt and equity offerings, the "distribution compliance period," "offering restriction" and "notice" requirements apply. [72] In addition, in the case of debt offerings, when issued the securities must be represented by a temporary global security that cannot be exchanged for securities in definitive form until the expiration of the 40-day distribution compliance period and then only upon certification of beneficial ownership of the securities by either (i) a non-U.S. person or (ii) a U.S. person who purchased the securities in a transaction that did not require registration under the Securities Act. [73]

In the case of equity offerings, the distribution compliance period is extended to six months [74] (one year if the issuer is a nonreporting issuer), and the following additional conditions apply during the distribution compliance period: [75]

- the purchaser of the securities must certify that it is not a U.S. person and is not acquiring the securities for the account or benefit of any U.S. person, or

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  is a U.S. person who is purchasing securities in a transaction that does not require registration under the Securities Act;
- the purchaser of the securities must agree to resell such securities only in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration, and must agree not to engage in hedging transactions with regard to such securities unless in compliance with the Securities Act;
- the securities of a U.S. issuer must contain a legend to the effect that transfer is prohibited except in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration, and that hedging transactions involving those

securities may not be conducted unless in compliance with the Securities Act; and

- the issuer is required, either by contract or a provision in its bylaws, articles, charter or comparable document, to refuse to register any transfer of the securities not made in accordance with the provisions of Regulation S, pursuant to registration under the Securities Act or pursuant to an available exemption from registration; provided, however, that if the securities are in bearer form or foreign law prevents the issuer of the securities from refusing to register securities transfers, other reasonable procedures (such as legends) are implemented to prevent any transfer of the securities not made in accordance with the provisions of Regulation S.

Moreover, the "offering restrictions" requirement is expanded in equity offerings by U.S. issuers to include an agreement by all distributors not to engage in hedging transactions with regard to the securities during the distribution compliance period unless in compliance with the Securities Act and a requirement that all offering materials and documents state that hedging transactions involving these securities may not be conducted unless in compliance with the Securities Act. [76]

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The Category 3 restrictions, as applied to U.S. companies, have led to significant difficulties. In 1999 and 2000, three exchanges, initially the European Association of Securities Dealers Automated Quotation N.V./S.A. ("EASDAQ") [77] and, subsequently, the Australian Stock Exchange and the OM Stockholm Exchange, wrote to the staff saying that smaller, privately held, nonreporting, growth-oriented U.S. companies wished to list their shares on their respective exchanges in connection with offerings made in reliance on the safe harbor provisions of Regulation S without simultaneous registration under the Securities Act. However, because of the manner in which securities listed on these exchanges were traded and settled, it was not possible for the offerings to comply strictly with some of the requirements of Regulation S. In particular, the certification, agreement, monitoring and stop-transfer requirements of Rule 903(b)(3)(iii)(B)(1), (2) and (4) under the Securities Act could not be implemented due to the book-entry trading systems they operated, and the notice requirements contained in Rules 903(b)(3)(iv) and 904(b)(1)(ii) could not be met by exchange members or participants because their computer systems were not configured in a way that would allow them to comply. [78]

Noting that (i) U.S. firms are not permitted to participate in the markets in question, either as brokers or as market-makers, and (ii) no trading screens would be placed in the United States, the SEC staff issued a series of no-action letters in 1999 and 2000 [79] permitting reliance by nonreporting U.S. issuers on certain alternative procedures for initial public offerings under Regulation S that are made in conjunction with listings on these markets.

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However, it is no longer clear that these no-actions letters can be relied upon. [80] More recently, some European exchanges have considered seeking similar no-action positions, but no relief has been granted. It would be advisable to seek and obtain clearance, formal or informal, before proceeding, rather than relying on the procedures developed specifically for these three exchanges. Even if these procedures are available, some non-U.S. exchanges may be unwilling to impose on their members restrictions regarding transactions with or for the account of U.S. persons.

There have been a number of Category 3 offerings in recent years by U.S. issuers, many of them seeking a listing on alternative markets, such as the Alternative Investments Market of the London Stock Exchange ("AIM"). In 2014 and 2015, the London Stock Exchange issued a series of notices in connection with the enactment of the EU Regulation on Central Securities Depositories. The regulation introduced the requirement for electronic settlement of securities on European trading venues, including securities issued under Category 3. As a result, the UK central securities depository ("CREST") developed procedures to allow the electronic settlement of securities issued under Category 3, which were published by CREST in May 2015. Effective September 1, 2015, the London Stock Exchange adopted amendments to its rules on electronic settlement of

Category 3 securities in line with the EU regulation and CREST's procedures. These amendments removed the exclusion of "Regulation S, Category 3" securities from the rule that requires securities to be recorded in electronic form, and updated the London Stock Exchange's guidance to establish revised procedures for the electronic settlement of these securities while meeting the restrictions imposed under Category 3. [81] Although the SEC staff has not approved these procedures, we understand they have been used in a number of offerings.

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A second difficulty in complying with Category 3 restrictions for offshore U.S. equity offerings relates to the application of the Category 3 restrictions to convertible bond offerings by U.S. companies. This difficulty and the SEC staff's solution to it are discussed in § 10.06[4].

A third difficulty has arisen out of the relationship between Regulation S and Rule 802 under the Securities Act in the context of exchange offers by U.S. companies for the shares of foreign acquisition targets. Rule 802, described in detail in § 9.05[9][c], permits an exchange offer by a U.S. company for shares of a foreign target on the basis of an exemption from the registration requirements of the Securities Act so long as less than 10% of the target's publicly held shares (calculated in the manner specified in the rule) are held of record by U.S. holders. The exemption is not conditioned on compliance with any resale restrictions, such as those contained in Category 3 of Regulation S. Thus, shares of U.S. companies that are sold offshore to foreign target shareholders in transactions that are exempt from registration under Rule 802 may flow back immediately into the U.S. market, subject to the availability of the general exemptions afforded by §§ 4(a)(1) and 4(a)(3) of the Securities Act. This result has been accepted by the SEC, at least where there are some shares in the target that are held by U.S. holders. The SEC staff does not agree, however, that Rule 802 is available when there are no U.S. shareholders in the target. [82] In these circumstances, U.S. companies seeking to avoid registration must rely on the exemption afforded by Regulation S, and the resale restrictions of Category 3 will apply.

The onerous restrictions imposed by Category 3 significantly reduce the value of shares in U.S. companies as acquisition currency. Accordingly, where Rule 802 is not available, U.S. acquirors of foreign companies will likely seek to register their exchange offers with the SEC. However, the applicable registration statement could require the inclusion of financial information about the target, reconciled to U.S. generally accepted accounting principles ("GAAP"), and this may not be readily available. [83] Moreover, the registration process can be time-consuming and costly. In these circumstances, *i.e.*, when Rule 802 is not available because the target has no U.S. shareholders, consideration should be given to approaching the SEC staff in order to seek a relaxation of the Category 3 requirements. Arguments in favor of such a relaxation are that: (i) U.S. issuers report regularly under the Exchange Act, (ii) information about the acquisition will be reported in the ordinary course on Form 8-K, so the market will be appropriately informed, (iii) it is unlikely that the shares will be valued at a discount,

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thus rendering Category 3 restrictions largely superfluous because the incentive for immediate resale to lock in a discount will not be present and (iv) the rigorous application of Category 3 restrictions would place U.S. companies at a disadvantage in relation to competing foreign bidders to which Category 3 restrictions generally do not apply.

[d] Use of the Internet in Regulation S Offerings

As in the case of public and private offerings in the United States, issuers regularly use the Internet in connection with Regulation S offerings, and offering-related materials are often posted on the websites of issuers or other distribution participants. In 1998, the SEC outlined certain procedures that can be used to solicit non-U.S. purchasers over the Internet to ensure compliance with the relevant Regulation S restrictions. [84] First, the website should contain a prominent "meaningful" disclaimer making it clear that the offer is directed only to countries other than the United States. In the case of Category 2 and 3 offerings, the disclaimer should also make clear that the offer is not open to U.S. persons. Second, steps should be implemented that are reasonably designed to guard against engaging in actual sales in the United States or, where applicable, to U.S. persons. [85]

Third, it should be confirmed that there are no indirect indications—such as payment drawn on a U.S. bank—that purchasers are in the United States or, in a Category 2 or Category 3 offering, U.S. persons. Fourth, measures should be taken to ensure that the content of the solicitation does not appear to be targeted to persons in the United States or, where applicable, to U.S. persons. [86]

Issuers also often limit online access to offering materials by imposing an access filter that requires a user to provide residence information confirming that it has a non-U.S. address and, where applicable, that it is a non-U.S. person, before it can access offering material on the issuer's website. The SEC's 1998 outline of the steps that should be taken to guard against sales to U.S. persons did not require such an access filter for a Regulation S offering, but it did say an access filter should be used if there was a concurrent exempt placement in the United States. Also, in the context of SEC-registered offerings, the SEC stated

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that an access filter is necessary [87] in order to rely on Rule 135e for Internet dissemination of press materials:

> Securities Act Rule 135e … permits a foreign private issuer and other offering participants to provide journalists with access to offshore press activities that discuss a present or proposed offering of securities. Rule 135e requires that press-related materials be released only outside the United States and that press conferences be held outside the United States. As a result, we believe that dissemination through the Internet by the issuer or other person covered by Rule 135e of these materials or press conferences will not comply with Rule 135e *unless procedures are implemented to assure that only permitted recipients under the rules are able to access the information.* [88]

Based on informal communications with the SEC staff, we understand that the requirement of access filters for reliance on Rule 135e in an SEC-registered offering, discussed in the April 2000 release, was not intended to apply more generally to require them as a condition to posting offering-related materials on the Internet in any Regulation S offering. We do not believe access filters are required in order to post offering-related materials on the Internet in a Regulation S offering, as long as the other circumstances of the offering do not suggest that the posting could be conditioning the U.S. market. In particular, there should be no sales to U.S. persons and no disclosures suggesting a U.S. marketing focus. The issuer's past practices in posting similar materials, and any applicable local regulatory obligations to do so, would also support the view that the posting is not conditioning the U.S. market.

Where a Regulation S offering is being made in conjunction with a private placement in the United States, access filters have routinely been imposed because of the language in the 1998 release. Now that the prohibition on general solicitation and general advertising has been eliminated for private placements in reliance on Rule 506(c) or Rule 144A, practitioners may question whether access filters are still required in such offerings. For other private placements, for

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example under § 4(a)(2), additional protective measures may be necessary. [89] These matters are described in greater detail in § 7.04.

[e] Impact of U.S. Sales

With two exceptions, the availability of the safe harbor is determined separately for the issuer and each distributor, so that a failure by one of them to comply will not affect the availability of the safe harbor for the others. [90] Directed selling efforts in the United States by the issuer or any distributor will cause the safe harbor to be lost for all of them, and the failure by the issuer or any distributor to adopt offering restrictions in connection with Category 2 and Category 3 offerings will also result in a loss of the safe harbor for all. [91]

Offshore transactions made in compliance with Regulation S will not be integrated with U.S. offerings that are registered under the Securities Act or are exempt from the registration requirements, for example, in accordance with Rule 144A under the Securities Act. [92] Accordingly, offerings outside the United States under Regulation S may be made in conjunction with registered public offerings or exempt offers and sales, including private placements, in the United States. [93]

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Like Release 4708, Regulation S does not say when securities offered outside the United States may be sold into the United States under § 4(a)(1) or § 4(a)(3) of the Securities Act. It is, however, generally understood, and the SEC staff appears to have confirmed, that securities other than unsold allotments [94] and equity securities of U.S. issuers [95] may be sold into the United States immediately, subject in the case of sales by dealers to the 40-day requirement under § 4(a)(3), and subject in the case of sales by distributors and their affiliates in Category 2 and Category 3 offerings to the expiration of the applicable distribution compliance period.

However, the SEC has cautioned that Regulation S does not provide an exemption for resales into the United States by purchasers of securities placed offshore under Regulation S. [96] As a result, "persons who would be considered underwriters under § 2(a)(11) of the Securities Act are not permitted to make unregistered public resales of these securities in the United States in reliance on the § 4(a)(1) exemption from registration." [97] The determination whether a person is an underwriter, particularly in the case of an entity that is not a securities professional, is often based on an analysis of the facts and circumstances involved.

Investors who are not securities dealers and who do not receive a selling concession or similar discount are generally thought to be free to sell securities into the United States at any time under § 4(a)(1) of the Securities Act, subject to any applicable contractual limitations. The same should be true of non-U.S. shareholders, including affiliates, of a non-U.S. target who receive shares in an exchange offer conducted pursuant to Regulation S or Rule 802 under the Securities Act as part of a business combination, so long as the recipients of the shares are not affiliates of the acquiror. [98]

[2] Resales

The second safe harbor of Regulation S under the Securities Act is for resales of securities outside the United States by persons other than the issuer, a

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distributor, any of their affiliates (except any officer or director who is an affiliate solely by virtue of holding such position) or any person acting on their behalf. Under this safe harbor, securities that are initially offered abroad, or in the United States in a private placement (including in a transaction exempt from the registration requirements under Rule 144A), can be resold immediately abroad so long as the "offshore transaction" requirement is met and there are no directed selling efforts in the United States in connection with the resale. [99] In the case of resales by dealers, officers and directors of the issuer, and certain other persons, additional conditions must be met in certain circumstances. [100]

For purposes of the resale safe harbor, the "offshore transaction" requirement is met if the offer is made outside the United States and either (i) the buyer (who may be a U.S. person) is (or is reasonably believed by the seller to be) outside the United States when the buy order is originated [101] *or* (ii) the transaction is executed on a foreign securities exchange or market designated by the SEC (a "designated offshore securities market" [102]). In contrast with the requirement of

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the safe harbor for offers and sales by distributors, there is no need for the sale to take place on a physical trading floor. [103]

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The 1998 amendments to Regulation S added Rule 905 under the Securities Act (and made conforming changes to Rule 144 under the Securities Act) to classify as "restricted securities" within the meaning of Rule 144 equity securities of U.S. issuers that are offered and sold under Regulation S. Thus, equity securities of U.S. issuers originally sold pursuant to Regulation S may be resold, after the expiration of a six-month holding period (or a one-year holding period for a nonreporting issuer), to a U.S. person by a nonaffiliate of the issuer in reliance on the safe harbor provided by Rule 144. [104]

Rule 905 also dealt with abuses of Regulation S where the offshore purchaser used a promissory note to pay all or a portion of the purchase price of equity securities of U.S. issuers and then repaid the promissory note only with the proceeds from the sale of the securities into the United States upon the expiration of the Regulation S distribution compliance period. As the SEC recognized, under such an arrangement, "in economic substance, the issuer is raising funds from the U.S. public markets." [105] The SEC's classification of domestic equity securities as Rule 144 "restricted securities" eliminates this problem by applying the Rule 144 requirement that its restricted period will not begin in the case of domestic equity securities purchased with promissory notes unless and until the promissory note (i) provides for full recourse against the purchaser of the securities, (ii) is secured by sufficient collateral other than the securities purchased and (iii) shall have been discharged by payment in full prior to the sale of the securities. [106]

Rule 905 also provides that the offshore resale under Regulation S of restricted securities that are equity securities of a U.S. issuer will not "wash off" the restricted status of those securities and allow them to be resold freely into the United States by the purchaser. Rather, the securities remain "restricted securities" under Rule 144 until the expiration of the applicable holding period under that rule no matter how many times the securities are resold outside the United States. [107] However, the SEC also noted that it was taking a targeted approach to

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addressing the abuses prompting the 1998 amendments to Regulation S and declined to extend Rule 905 to the securities of foreign private issuers. [108] Accordingly, once resold outside the United States, securities other than equity securities of domestic issuers are unrestricted and generally can be freely resold, including into the United States, subject in the case of sales by dealers to the 40-day requirement under § 4(a)(3) and, in the case of sales by dealers and persons receiving selling concessions, fees or other remuneration in respect of the securities offered in Category 2 and Category 3 offerings, to the expiration of the applicable distribution compliance period. [109]

The resale safe harbor, even as tightened up by Rule 905, was a significant expansion of the position taken by the SEC in no-action letters issued under Release 4708. [110] In those letters, issued in connection with the French privatizations, the SEC staff permitted immediate "regular way" resales on the Paris Bourse of equity securities that were privately placed in the United States in circumstances where there was no U.S. public market for the issuer's securities (other than commercial paper) at the time of the U.S. placement. Based on subsequent statements by SEC staff members, securities lawyers generally believed that this approach to resales should be limited to exchanges where participation by U.S. investors was no greater than on the Paris Bourse. In particular, given the extent of U.S. participation in transactions on the London Stock Exchange, the approach derived from these no-action letters was not thought to be available for resales on that exchange. Resales on other European exchanges were considered by U.S. counsel on a case-by-case basis.

Regulation S extended this approach to debt securities and to all resales outside the United States that satisfy the requirements of the resale safe harbor, without regard to whether there is a U.S. market for the securities in question. One significant effect of this safe harbor is that U.S. investors can resell immediately outside the United States foreign equity securities that they acquired in private placements in the United States (including placements on the basis of Rule 144A). [111] The resale safe harbor thus significantly increased the attractiveness of privately placed securities of foreign issuers because the liquidity of such securities was no longer impaired—resales may be made immediately outside the

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United States into the principal trading market for the securities. [112] Securities lawyers may still look to the doctrines contained in the no-action letters obtained in connection with the French privatizations [113] when considering whether resales on a securities exchange that is not a designated offshore securities market nonetheless have the benefit of an exemption from the registration requirements of the Securities Act.

Footnotes

11 The regulation was first proposed for comment in June 1988, a revised version was proposed for comment in July 1989 and a further revised version was adopted in April 1990. For a discussion of the regulation as originally proposed, *see* Leslie N. Silverman & Daniel A. Braverman, *Registration Requirements for Securities Offered Abroad*, 21 REV. SEC. COMM. REG., No. 22 (Dec. 21, 1988). The SEC received 89 comment letters on Regulation S as originally proposed, and these are outlined in the SEC's Outline of Commentators' Remarks dated April 21, 1989. The following discussion of the regulation draws on Adam Fleisher & Peter Castellon, *Regulation S Selling and Transfer Restrictions: A Basic User's Guide*, *available at* http://www.cgsh.com/cgsh/Regulation-S-Selling-and-Transfer-Restrictions.pdf (July 18, 2012).

12 Issuers and underwriters that violate the registration requirements of the Securities Act are subject to enforcement actions brought by the SEC and investors' right to rescission or damages. *See* § 11.02.

13 For a discussion of U.S. private placements, *see* Chapter 7.

14 *See* SEC Release No. 33-7505 (Feb. 17, 1998).

15 63 Fed. Reg. 9632 (Feb. 25, 1998).

16 63 Fed. Reg. 9632 (Feb. 25, 1998). Many of the abuses were first highlighted by the SEC in a 1995 interpretive release discussing certain "problematic practices" involving the purported offering under Regulation S of equity securities of U.S. issuers and requesting comment as to whether Regulation S should be amended to curb such perceived abuses. SEC Release No. 33-7190 (June 27, 1995). In 1997, the SEC issued a second release that proposed certain amendments to Regulation S and responded to comments received on the 1995 interpretive release, recommending among other things that equity securities of U.S. issuers, as well as equity securities of non-U.S. issuers if more than 50% of the trading volume for those securities takes place in the United States, be classified as "restricted securities" within the meaning of Rule 144 under the Securities Act. The SEC proposed treating such securities of non-U.S. issuers in the same way as equity securities of U.S. issuers despite substantial criticism from commenters on the prior release that the 50% test would be too broad. SEC Release No. 33-7392 (Feb. 20, 1997).

Although the SEC adopted most of the amendments proposed in its 1997 release in 1998, in order to "avoid undue interference with offshore offering practices of foreign companies," the amendments adopted did not apply to equity securities of foreign issuers. SEC Release No. 33-7505 (Feb. 17, 1998). The SEC nonetheless expressed continuing concern about the potential for abusive practices in offerings of equity securities by foreign issuers: "Although the abusive practices under Regulation S have not been evident in offerings by foreign issuers, the [SEC] was concerned that abusive practices might develop in the future since the economic incentives for indirect distributions and resales into the United States are the same for equity offerings by both domestic companies and foreign companies where the principal market for their securities is the U.S." SEC Release No. 33-7505 (Feb. 17, 1998), 63 Fed. Reg. 9632, 9633 (Feb. 25, 1998). The 1998 adopting release points out many of the considerations voiced by commenters that influenced the SEC's decision not to apply the amendments to foreign issuers, but the SEC left open the possibility of changing its position should abusive practices develop in the context of offshore equity offerings by foreign issuers. *See infra* Note 68. The SEC has also brought a number of enforcement actions against entities and individuals believed to be abusing the Regulation S safe harbor. *See, e.g.*, *Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009); *In re Carley*, SEC Admin. Proc. File No. 33-8480 (Sept. 1, 2004); *In re Robert G. Weeks*, SEC Admin. Proc. File No. 3-9952 (Feb. 4, 2002); *SEC v. Cohen*, SEC Litigation Release No. 16583 (June 5, 2000); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846 (S.D.N.Y. 1997), *aff'd without op.*, 159 F.3d 1348 (2d Cir. 1998); *United States v. Sung*, SEC Litigation Release No. 14500 (May 15, 1995).

17 Over the years since this reference was included in Regulation S, most foreign securities exchanges moved away from using a physical trading floor. Electronic systems have replaced the trading floor in many of these markets. Dealer-to-dealer systems involve transactions that cannot easily be analogized to those occurring on a physical trading floor, insofar as they involve transactions with known counterparties. Electronic "black-box" trading systems, however, maintain the anonymity of the buyers and sellers. So long as the buyer remains anonymous, we believe the seller should be able to form a reasonable belief that the buyer is not in the United States, provided the seller does not otherwise believe (due to, for example, independent knowledge of the identities of persons acting as buyers) that such persons are in the United States.

18 55 Fed. Reg. 18,306, 18,310 n.39 (May 2, 1990). Although neither Regulation S nor the adopting release deals expressly with offshore transactions involving U.S. pension funds, an offer or sale to a fiduciary outside the United States acting with discretion for the fund should qualify as an offshore transaction. There remains some uncertainty, however, as to the appropriate treatment of certain offshore accounts of U.S. pension funds under the "U.S. person" definition. *See infra* Note 61.

19 This codifies the no-action position taken by the SEC staff in *Baer Securities Corp*. (avail. Oct. 12, 1979). Although the rule speaks of U.S. fiduciaries who act on a discretionary basis for foreign investors, the principle applies all the more to U.S. fiduciaries who act for them on a nondiscretionary basis. The TEFRA antibearer bond rules, however, generally prohibit offers and sales in the United States of unseasoned debt securities in bearer form, even when the buyer is a fiduciary for a foreign investor. *See* § 8.04.

20 Sales in the United States pursuant to certain employee benefit plans, permitted by Rule 903(b)(1)(iv) of Regulation S, are also considered offshore transactions. *See Cleary, Gottlieb, Steen & Hamilton* (avail. July 24, 1990).

21 Rule 902(c)(3)(vi) under the Securities Act provides that the publication by an issuer of a notice announcing a foreign offering will not constitute "directed selling efforts" if the notice complies with Rules 135 or 135c under the Securities Act. Rule 135 covers notices issued in the context of a U.S. public offering prior to the filing of a registration statement. The notice may only contain certain specified information, including the name of the issuer, the title, amount and basic terms of the securities, the anticipated timing of the offering and a brief statement of the manner and purpose of the offering, but not including a description of the issuer's business or the names of the underwriters. Rule 135c applies to notices with a similar content issued in the context of an offering that is exempt from registration under Regulation S (or otherwise, for example under one of the private placement exemptions), but only if the issuer is subject to the periodic reporting requirements of the Exchange Act or exempt from those requirements pursuant to Rule 12g3-2(b) thereunder and certain other conditions are met. *See also* §§ 7.02[4] and 7.06 for a discussion of publicity considerations in exempt offerings involving both sales outside the United States under Regulation S and in the United States as private placements.

22 SEC Release No. 33-6863 (Apr. 24, 1990). In general, a publication has a "general circulation" in the United States if it "is printed primarily for distribution in the United States, or has had, during the preceding twelve months, an average circulation in the United States of 15,000 or more copies per issue." Rule 902(c)(2) under the Securities Act. The U.S. editions of *The Financial Times* and *The Economist*, and perhaps the U.S. editions of other foreign newspapers and magazines as well, will fall within the definition of a publication with a "general circulation" in the United States. The non-U.S. editions of such newspapers and magazines, however, are not affected. For a discussion of Regulation S offerings utilizing the Internet, *see* § 8.02[1][d].

23 Research reports could be viewed as directed selling efforts, or as inconsistent with an offshore transaction, which would make the Regulation S exemption unavailable. It is common for counsel to prepare one or more memoranda when work on the transaction begins, describing the restrictions in detail. These memoranda serve multiple purposes: they alert offering participants to the existence of restrictions; they

establish a written record of attention to the restrictions, which can be useful in the event a lapse occurs; and they are sometimes used (particularly where the offering is a debut offering in the home market) to implement an understanding among the participating financial institutions about guidelines for research reports.

The distribution of pre-deal research outside the United States in an offering by a foreign private issuer does not usually present the same concerns. In the typical Regulation S -only equity offering, or a typical Regulation S and Rule 144A equity offering in connection with a debut offering in the home market, the principal trading market for its equity is, or is expected to be, outside the United States. In connection with such an offering, the Global Research Settlement and FINRA rules would not prohibit a foreign underwriter (even one affiliated with an SEC-registered broker-dealer and FINRA member) from preparing and distributing pre-deal research to persons outside the United States in a manner that does not involve U.S. jurisdictional means or the participation of any SEC-registered broker-dealer (or analysts associated with that broker-dealer). If the principal trading market is, or is expected to be, in the United States, however, caution is appropriate due to heightened concern in the United States and other jurisdictions about conflicts of interest.

For a further discussion of research reports, *see* text accompanying *infra* Note 37; §§ 3.02[3][e], 7.02[4], Notes 142–143.

24 SEC Release No. 33-9415 (July 10, 2013). While restrictions on general solicitation and general advertising were recently lifted for certain types of private placements, the prohibition on directed selling efforts in a Regulation S -only offering— *i.e.*, where there is no contemporaneous registered or exempt U.S. offering that permits general solicitation and general advertising (*e.g.*, pursuant to Rule 144A)—remains unchanged. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 138.04 (Nov. 13, 2013). For a discussion of when general solicitation and general advertising are permissible in a private placement, *see* Chapter 7.

25 *See* 55 Fed. Reg. 18306, 18320 (May 2, 1990); 78 Fed. Reg. 44,771, 44,786 (July 24, 2013). This is consistent with the SEC's view that "offshore transactions" made in compliance with Regulation S will not be integrated with registered domestic offerings or domestic offerings that satisfy the requirements for an exemption from registration under the Securities Act, even if undertaken contemporaneously. *See infra* text accompanying Notes 90–91. Ironically, more care may have to be taken when there is no concurrent offering in the United States, since efforts in the United States to generate secondary market interest in securities being distributed abroad could constitute directed selling efforts, and it would be difficult to establish that such efforts were directly associated with exempt offers and sales.

While it should also be the case that selling efforts in the United States following the public filing of a registration statement would not constitute "directed selling efforts" if the registration statement were subsequently withdrawn and the public offering abandoned in favor of a private placement or no U.S. offering at all, the SEC staff could take the view that the determination depends on the facts and circumstances, including the extent to which the transaction was marketed prior to withdrawal and the amount of time between withdrawal and the offshore offering. A prudent approach would be to permit at least 30 days between withdrawal of a registration statement and the commencement of an offering under Regulation S. It may be possible, however, to shorten the time between withdrawal of the registration statement and launch of a Regulation S offering if no marketing had been conducted in the United States and a considerable time had passed since filing of the registration statement, or if there had been marketing efforts but a considerable amount of time had passed since they were conducted. *See* the discussion of Rule 155 under the Securities Act in § 7.02[6].

26 SEC Release No. 33-6863 (Apr. 24, 1990).

27 Preliminary Note 7 to Regulation S under the Securities Act; SEC Release No. 33-6863 (Apr. 24, 1990). Rule 902(c)(3)(vii) also requires that the conditions of Rule 135e be satisfied. For a discussion of Rule 135e, *see* text accompanying *infra* Notes 28–29; §§ 3.02[3][c] and 7.02[4].

28 SEC Release No. 33-7470 (Oct. 10, 1997). The SEC also adopted a safe harbor from the tender offer rules

for certain offshore press activities. Rule 14d-1(e).

29 *See* §§ 3.02[3][c] and 7.02[4].

30 Preliminary Note 7 to Regulation S under the Securities Act and SEC Release No. 33-6863 (Apr. 24, 1990).

31 Although publications with U.S. editions—such as *The Financial Times*—as a matter of policy will not agree to restrict news or editorial coverage to certain editions, they will agree to restrictions on where advertisements appear. Accordingly, an issuer can ensure that advertisements relating to an offering do not appear in the United States.

32 *See* § 3.02[3][c].

33 SEC Release No. 33-6863 (Apr. 24, 1990). Similarly, the provision of international offering circulars through an online database will not be deemed to be directed selling efforts so long as the online provider, itself a nondistributor, implements certain measures, including the placement of an initial cautionary screen containing a legend stating, among other things, that the documents on the site relate to securities that have not been registered under the Securities Act, and the use of subscription agreements restricting users from distributing documents obtained from the database outside their respective organizations. *See Europrospectus.com Ltd.* (avail. Apr. 28, 2004); *Perfect Information* (avail. Dec. 22, 2000).

34 *See* § 8.02[1][c][ii].

35 As used in this context, a "tombstone" advertisement is a brief announcement of the completion of a transaction. Offering advertisements under Rule 134 are also sometimes referred to as "tombstone" advertisements. *See* § 3.02[3][d].

36 Rule 902(c)(3)(iii) under the Securities Act.

37 SEC Release No. 33-6863 (Apr. 24, 1990); SEC Release No. 33-7606 (Nov. 3, 1998), *as amended* by SEC Release No. 33-7606A (Nov. 13, 1998), SEC Release No. 33-8591 (July 19, 2005). For a further discussion of research reports, and a detailed consideration of Rules 138 and 139, *see* §§ 3.02[3][e], 7.02[4], Notes 142–143.

38 Section 4(a)(3) of the Securities Act also restricts the circulation of research reports in the United States. *See* § 8.03 and text accompanying Note 115.

39 In the case of securities guaranteed by the parent of the issuer, the category of the offering is determined by reference to the status of the parent guarantor rather than that of the issuer. *See* text accompanying Note 52. In addition, certain nonparticipating preferred stock and asset-backed securities are treated as debt for purposes of determining the appropriate category. Rules 902(a)(1) and 902(a)(2) under the Securities Act.

The SEC staff has also indicated that the category of offering under Regulation S is determined at the time the issuer makes a securities offering in reliance on Regulation S. If changes occur in the issuer's circumstances after it makes the offering that would permit the issuer to qualify for a different category of the safe harbor in the future, the SEC staff has clarified that there would be no change in the distribution compliance period applicable to any outstanding securities issued in reliance on Regulation S. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 277.01 (Jan. 26, 2009).

40 The following tables are based closely on Adam Fleisher & Peter Castellon, *Regulation S Selling and Transfer Restrictions: A Basic User's Guide*, *available at* https://www.clearygottlieb.com/~/media/cgsh/files/publication-pdfs/regulation-s-selling-transfer-restrictions-a-basic-users-guide.pdf (July 18, 2012).

48 For a discussion of the eligibility requirements of Schedule B, *see* § 3.05[1].

49 An important exception to this general rule is that certain emerging market issuers have relatively extensive U.S. shareholder bases. This situation has arisen in a number of cases because the issuer's home market infrastructure is not sufficiently well-developed to accommodate sizable equity offerings or to provide for a stable and liquid aftermarket in such securities. For instance, a number of Latin American, Chinese and other emerging market issuers have more than half of their equity securities held in the United States. Most of these issuers are subject to the reporting requirements of the Exchange Act, which, since there is

substantial U.S. market interest in their equity securities, results in their being treated as Category 2 issuers for purposes of Regulation S. Certain other emerging market issuers, such as Russian companies that have offered equity securities in the United States under Rule 144A and separately established unrestricted ADR programs, may find that there is a substantial U.S. market interest in their shares in circumstances where they are not subject to the reporting requirements of the Exchange Act. As a result, they may be treated as Category 3 issuers for purposes of Regulation S.

50 Rule 902(j)(2) under the Securities Act. For purposes of Rule 902(j)(2), "held of record" has the same meaning as in Rule 12g5-1. *See* § 4.11[2][b], Note 653 and accompanying text for a discussion of Rule 12g5-1.

Although Regulation S refers to debt securities being "held of record," that term is defined to include debt securities that are held in bearer form. It is not clear how a "reasonable belief" should be formed with respect to bearer debt securities. In the absence of official guidance, a foreign issuer should consider the following:

- if the issuer has less than $1 billion of debt securities (excluding commercial paper) outstanding worldwide, there is *per se* no substantial U.S. market interest;
- if the issuer has more than $1 billion of debt securities (excluding commercial paper) outstanding worldwide, but (i) has not offered any securities in the United States (other than commercial paper), (ii) does not have debt or equity securities listed on a securities exchange in the United States or a sponsored ADR program and (iii) does not know of significant holdings of its debt securities by U.S. investors, it would be reasonable to conclude that there is no substantial U.S. market interest for its debt securities; and
- in other circumstances, the offering should be treated as falling into Category 2.
- *See* § 8.04 for a discussion of certain U.S. tax rules that apply to bearer securities.

51 Rule 902(j)(3) under the Securities Act.

52 In the case of debt securities that are guaranteed by subsidiaries of the issuer, the SEC staff has informally advised us that a subsidiary guarantor may rely on the status of its issuer parent under Regulation S as long as the subsidiary guarantor meets the requirements of Rule 3-10 of Regulation S-X, *i.e.*, the subsidiary guarantor is wholly owned by the issuer parent and the subsidiary fully and unconditionally guarantees the issuer parent's securities.

53 Substantial U.S. market interest in the debt securities of a foreign bank or any other entity that guarantees debt securities must be measured by reference to all securities that are issued or guaranteed by the bank or other entity. Letters of credit should be treated as guarantees under Regulation S, and it would be prudent to treat support or "keep well" agreements in the same way. Since the procedures for Category 2 are relatively easy to apply, being prudent does not entail incurring any substantial additional cost.

54 These include the "pink sheets." *See* § 3.01, Note 32.

55 Rule 902(j)(1) under the Securities Act. In determining the category of a particular offering, distributors are entitled to rely on a representation by the issuer that it reasonably believes that there is no substantial U.S. market interest for the kind of security being offered. Where a foreign or U.S. market does not record all trading in a security, only the trading that is otherwise known to the issuer, or can be reasonably measured or approximated, need be considered. Where a substantial market for the issuer's equity securities does not record trading volume, the issuer may reasonably believe that there is not substantial U.S. market interest in that class of securities where less than 20% of the class is held of record by persons for whom a U.S. address appears on the records of the issuer, its transfer agent, voting trustee, depositary or person performing similar functions. SEC Release No. 33-6863 (Apr. 24, 1990).

56 The requirement that the offering be directed to the residents of a single foreign country is not inconsistent with making a U.S. private placement at the same time. The principle that an offering under Regulation S is not to be "integrated" with a contemporaneous registered or exempt U.S. offering applies to overseas-directed offerings just as it does to other foreign offerings. *See infra* text accompanying Notes 92–93.

57 For a discussion of these requirements, *see* Chapter 5. In order to be a Regulation S "reporting issuer," an issuer must file all required Exchange Act reports in the twelve months (or such shorter period as the issuer was required to file reports) before the offer or sale of securities is made in reliance on Regulation S. An issuer that has not filed a report required to be filed under the Exchange Act in the 12 months or such shorter period as the issuer was required to file reports (before the offer or sale) would fail to satisfy the definition of a "reporting issuer" for purposes of Rule 902(i) until the delinquent report in question has been filed.

58 These requirements are set out in Rule 903(b)(2) under the Securities Act. For a discussion of how the distribution compliance period is determined in continuous offerings, *see* § 10.02.

59 *See* Rule 903(b)(2)(ii) under the Securities Act. In the event an issuance of debt securities is re-opened at a later date, market practice is to use temporary global notes to represent, and assign temporary security identifiers (*i.e.*, Committee on Uniform Security Identification Procedures ("CUSIP") and International Securities Identification Number ("ISIN") numbers) to, the securities issued in the re-opening until the distribution compliance period has ended. The securities issued in the re-opening then become fungible with, and assume the CUSIP and ISIN numbers of, the securities issued in the initial offering and the temporary global notes are exchanged for interests in the permanent global notes bearing those numbers.

60 Rule 902(k)(1) under the Securities Act. The definition also includes any nondiscretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated or (if an individual) resident in the United States; and any partnership or corporation incorporated under the laws of any foreign jurisdiction and formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act, unless it is organized or incorporated, and owned, by accredited investors (as defined in Rule 501(a) under the Securities Act, *see* § 7.02[2], Note 35) that are not natural persons, estates or trusts.

Rule 902(k) under the Securities Act specifically excludes the following additional entities from the definition of a U.S. person: certain U.S. fiduciaries acting for non-U.S. investors; any estate of which the professional fiduciary acting as executor or administrator is a U.S. person if the estate also has a non-U.S. executor or administrator who has sole or shared investment discretion and the estate is governed by foreign law; any employee benefit plan established and administered in accordance with the laws of a country other than the United States; and certain foreign branches and agencies of U.S. banks and insurance companies. Rule 902(k)(2) under the Securities Act. Notwithstanding the exclusion of certain U.S.-based entities from the definition of U.S. person, issuers and distributors should nevertheless consider liability issues that could arise from the use of U.S. jurisdictional means in connection with the offer or sale of securities.

61 Rule 902(k) under the Securities Act. As noted earlier, it is not clear whether offshore accounts of U.S. pension funds should be viewed as U.S. persons. *See supra* Note 18. It is clear from the terms of Regulation S itself that a discretionary account (other than an estate or trust) held by a dealer or other fiduciary organized in the United States is a U.S. person (unless held for the account of a non-U.S. person as described below) and that a nondiscretionary account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person is also a U.S. person. Conversely, it is also clear that a discretionary account (other than an estate or trust) held by a dealer or other fiduciary organized outside the United States (a "foreign fiduciary") is not a U.S. person. According to the adopting release for Regulation S, "where a non-U.S. person makes investment decisions for the account of a U.S. person, that account is not treated as a U.S. person." SEC Release No. 33-6863 (Apr. 24, 1990), 55 Fed. Reg. 18,306, 18,316 (May 2, 1990). Moreover, a foreign fiduciary is not itself a U.S. person. Therefore, an offer or sale to a foreign fiduciary for the discretionary account of a U.S. pension fund would appear not to breach the "distribution compliance period" requirement of Regulation S, which prohibits offers and sales to, or for the account or benefit of, U.S. persons.

This, however, may not be the case. The relevant portion of the definition of U.S. person referred to above does not apply to accounts of "estates" or "trusts," and U.S. pension funds are generally organized as trusts. Under Regulation S, trusts having a U.S. trustee are considered to be U.S. persons unless "a trustee who is not a U.S. person has sole or shared investment discretion with respect to the trust assets, *and no beneficiary of the trust … is a U.S. person.*" Rule 902(k)(2)(iii) under the Securities Act (emphasis added). It would thus appear that a discretionary account of a U.S. pension fund held by a foreign fiduciary would be a U.S. person because the trustee of the fund can be expected to be a U.S. person and the "beneficiaries" of the fund— *i.e.*, the employees—will also generally be U.S. persons. Although it is unlikely that the SEC had U.S. pension funds in mind when it crafted the rule with respect to trusts, unless the position is clarified, it would be prudent for distributors not to offer or sell securities to offshore accounts of U.S. pension funds in Category 2 or Category 3 offerings or to fiduciaries acting for such accounts.

62 A distributor holding an unsold allotment of securities in a segregated identifiable account may sell other securities of the same class as if it were not a distributor, so long as such other securities are not borrowed from and will not be replaced by securities that are part of the unsold allotment. SEC Release No. 33-6863 (Apr. 24, 1990).

63 Rule 903(b)(2)(i) under the Securities Act.

64 Rule 902(g)(1)(i) under the Securities Act.

65 Rule 902(g)(2) under the Securities Act. This requirement does not apply to press releases that are not advertisements. For a discussion of legends required for press releases that are advertisements, *see* § 7.02[4]. For offers and sales of equity securities of U.S. issuers, the offering materials or documents must also state that hedging transactions involving those securities may not be conducted unless in compliance with the Securities Act. *See* § 8.02[1][c][iii], Note 75 and accompanying text.

66 Rules 902(g)(2)(i), 902(g)(2)(ii) and 902(g)(2)(iii) under the Securities Act.

67 SEC Release No. 33-6863 (Apr. 24, 1990). For a description of the requirements imposed by Regulation S on resales by a dealer or person receiving selling concessions, fees or other remuneration, *see* Note 100. In addition, dealers are subject to the requirements imposed by § 4(a)(3) of the Securities Act. For a discussion of § 4(a)(3), *see* § 8.03.

68 As noted in *supra* Note 16, the 1998 amendments, as originally proposed, would have moved out of Category 2 and into Category 3 all offerings of equity securities of foreign issuers with principal markets in the United States. The SEC had proposed that the "principal market" for a foreign issuer's securities would be in the United States if "more than 50 percent of all trading in such class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation." *See* SEC Release No. 33-7392 (Feb. 20, 1997), 62 Fed. Reg. 9258, 9264 (Feb. 28, 1997). Many of those commenting on the original proposals had strongly opposed applying the amendments to foreign issuers, arguing that the imposition of Category 3 restrictions would impede both public offerings and trading in those securities in offshore public markets. After considering these comments, the SEC decided that additional restrictions on equity securities of foreign issuers with principal markets in the United States were unwarranted at the time in the absence of a showing that offerings of these securities had in fact abused Regulation S. The SEC noted in the release adopting the 1998 amendments, however, that it "will monitor practices in this area, and will revisit the issue if abuses occur." SEC Release No. 33-7505 (Feb. 17, 1998), 63 Fed. Reg. 9632, 9633 (Feb. 25, 1998).

69 *See* § 8.02[1][c][iii].

70 Equity offerings by U.S. reporting issuers were added to Category 3 as a result of the 1998 amendments to Regulation S.

71 *See supra* Note 49 for a discussion of possible exceptions to the general rule. In addition, a nonreporting foreign subsidiary of a U.S. company may be treated as a U.S. issuer falling within Category 3 if the majority of its executive officers or directors are U.S. citizens, more than half of its assets are in the United States, or its business is administered principally from the United States. *See* the definition of "foreign issuer" in Rule 902(e) of Regulation S under the Securities Act. *See also supra* text at Note 68 for a discussion of market practice for certain offerings of securities of foreign issuers that are subject to the reporting requirements of the Exchange Act, especially where substantially all of their securities trade in the United States.

72 Rule 903(b)(3) under the Securities Act.

73 Rule 903(b)(3)(ii)(B) under the Securities Act. A similar procedure and certification are required in the case of offerings of bearer debt securities as a result of U.S. tax rules. *See* § 8.04.

74 The distribution compliance period was shortened from one year to match the shortened holding period for restricted securities of reporting companies in the amendments to Rule 144. *See* SEC Release No. 33-8869 (Dec. 6, 2007).

75 Rule 903(b)(3)(iii) under the Securities Act.

76 The limitation on hedging derives from the SEC's concern, highlighted in its 1995 interpretive release on "problematic practices" under Regulation S, that hedging during the distribution compliance period could serve to shift the economic benefits and risks back to the United States or to U.S. persons, and thus breach the distribution compliance period requirement in substance if not in form. *See* SEC Release No. 33-7190 (June 27, 1995). The SEC also expressed concern in that release about the issuance of nonrecourse promissory notes for all or almost all of the purchase price, where the expectation of repayment stems from the resale of the equity securities into the U.S. market, or the issuance of recourse notes where the entity providing the notes is unknown to the seller of the securities or has no, or minimal, assets and where, again, the expectation of repayment stems from the resale of the equity securities in the U.S. market. The 1998 amendments to Regulation S did not prohibit the use of promissory notes as consideration for a purchase under Regulation S, as had been proposed originally, but rather dealt with this problem through Rule 905 under the Securities Act, which applies to the resale under Regulation S of equity securities of U.S. issuers. *See* § 8.02[2].

The limitation applies to short selling and other hedging transactions such as option writing, equity swaps or other types of derivative transactions, where the counterparties to the hedging transaction transfer the benefits and burdens of ownership back to the U.S. market during the distribution compliance period in a transaction that does not benefit from an exemption from the registration requirements of the Securities Act, such as Rule 144A. For a discussion of hedging in the context of private placements, *see* § 7.04[2][a].

77 EASDAQ was subsequently acquired by Nasdaq and operated under the name "Nasdaq Europe." However, in 2003 the market ceased operations.

78 EASDAQ and the OM Stockholm Exchange stated that there was no field in which the required language could be placed and that the programming changes that would be required to create such a field would be expensive and time-consuming. Letter from Dirk P. Tirez, General Counsel, European Association of Securities Dealers Automated Quotation N.V./S.A., to Paul M. Dudek, Chief, SEC, Office of International Corporate Finance (July 22, 1999); Letter from Ulf Lindgren, Chief Legal Counsel, OM Stockholm Exchange SE, to Paul M. Dudek, Chief, SEC, Office of International Corporate Finance (Sept. 27, 2000).

79 *OM Stockholm Exchange* (avail. Oct. 11, 2000); *Australian Stock Exchange Limited* (avail. Jan. 7, 2000); *European Association of Securities Dealers Automated Quotation N.V./S.A.* (avail. July 27, 1999).

80 In 2011, the staff granted no-action relief from certain requirements of Category 3 to a domestic reporting issuer which allowed it to obtain a secondary listing of depositary receipts representing its common stock on the Stock Exchange of Hong Kong ("SEHK"). In granting relief, the staff noted that U.S. entities may not participate on SEHK; no SEHK trading terminals may be placed in the United States and that alternative restrictions and procedures would be implemented. The alternative restrictions and procedures implemented were similar to those adopted by the three exchanges discussed in Notes 77 to 79. In addition to those procedures, persons depositing shares in the Hong Kong depositary are required to certify either that they are not, and are not acting on behalf of, a U.S. person or an affiliate of the issuer and will receive the depositary receipts outside the United States; or that they are not, and are not acting on behalf of, a distributor or an affiliate of a distributor or the issuer, are depositing the shares in connection with a sale of depositary receipts under Rule 904 and will not be issued any depositary receipts. *Coach, Inc. & J.P. Morgan Chase Bank N.A.* (avail. Nov. 28, 2011).

81 *See* Guidance to Rule 1550 of the Rules of the London Stock Exchange (Mar. 21, 2016), and the Whitebook published by Euroclear UK & Ireland on May 11, 2015 relating to its proposed "Euroclear UK & Ireland:

Regulation S Category 3 Settlement Service." Physical settlement is no longer available for Category 3 Securities trading on the London Stock Exchange.

82 *See* SEC, Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Third Supplement, Section II, Cross-Border Release, Part C, Question 1 (July 2001) (stating that the exemptions are intended to create an incentive to include U.S. securityholders in a particular offering, not to provide an exemption for offerings made only to foreign securityholders).

83 *See* § 9.05[9][c] (discussing information to be provided for an SEC-registered exchange offer).

84 SEC Release No. 33-7516 (Mar. 23, 1998). Compare this approach with the procedures set forth in the *Europrospectus.com and Perfect Information* no-action letters, *supra* Note 33, where the entity making offering documents available over the Internet was not distributing securities.

85 The SEC staff has informally noted to us that in the context of a Regulation S -only offering, such steps need not be more extensive than procedures generally implemented to ensure compliance with the requirement under Regulation S that purchasers be outside the United States.

86 For example, providing disclosure on the U.S. tax consequences of investing in the securities, or naming U.S. broker-dealer affiliates of the underwriters, would suggest that the material is targeted to the United States or to U.S. persons.

87 Certain information can be disseminated through the Internet without the use of an access filter prior to the filing of a registration statement with the SEC under Rule 135 and following the filing of a registration statement under Rule 134. For a discussion of Rules 134 and 135, *see* § 3.02[3].

88 SEC Release No. 33-7856 (Apr. 28, 2000), 65 Fed. Reg. 25,843, 25,850 n.68 (May 4, 2000) (emphasis added). For a discussion of Rule 135e under the Securities Act, *see* §§ 3.02[4][c] and 7.04.

89 Rule 135c allows reporting issuers and issuers that are exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act to disseminate certain public announcements of unregistered offerings through the Internet without use of an access filer. For a discussion of Rule 135c, *see* § 7.04.

90 SEC Release No. 33-6863 (Apr. 24, 1990).

91 SEC Release No. 33-6863 (Apr. 24, 1990).

92 55 Fed. Reg. 18,306, 18,320 (May 2, 1990); 78 Fed. Reg. 44,771, 44,786 (July 24, 2013).

93 When an offering outside the United States is made in conjunction with a public offering in the United States, a question arises as to how much of the global offering should be registered. For a foreign issuer, it is customary to register the U.S. tranche as well as about 10% to 15% of the offering overseas to cover transfers between underwriting syndicates and trading of the securities into the United States (although consideration should be given to registering a higher percentage if the primary trading market for the foreign issuer's securities is or is expected to be the United States). For a U.S. issuer, it will, as a practical matter, be necessary to register the entire global offering because of Rule 905 under the Securities Act, in the case of equity securities, and because of the likelihood of flowback into the United States, in the case of debt securities. For a further discussion of these issues, *see* § 3.02[3][a]. If an appropriate amount of securities is registered to cover the "flowback" into the United States of the securities offered and sold abroad, the prohibition against directed selling efforts and, in Category 2 and Category 3 offerings, the "distribution compliance period," "offering restrictions," "notice" and other requirements are inapplicable because resales into the United States and to U.S. persons have, in fact, been registered. In connection with such resales, any broker or dealer, whether U.S. or foreign, must comply with Rules 173 and 174 under the Securities Act. *See* § 3.02[1][e], Notes 92 and 94 and accompanying text (discussing when sales by dealers, whether or not acting as underwriters, need to be made on the basis of a prospectus on file with the SEC). With respect to offers and sales made outside the United States pursuant to Regulation S, whether a final offering document will be required to be delivered to investors will depend on local laws and will not be required under U.S. law.

94 *See infra* Note 114.

95 Equity securities of U.S. issuers that are offered and sold under Regulation S are classified as "restricted

securities" within the meaning of Rule 144 under the Securities Act and are subject to additional restrictions on resale. *See* Rule 905 under the Securities Act and *infra* Notes 104–109 and accompanying text.

96 SEC Release No. 33-7392 (Feb. 20, 1997), 62 Fed. Reg. 9258, 9263 (Feb. 28, 1997), stating that "purchasers must determine whether an exemption for resales into the United States is available."

97 SEC Release No. 33-7392 (Feb. 20, 1997), 62 Fed. Reg. 9258, 9263 n.41 (Feb. 28, 1997). Sections 2(a)(11) and 4(a)(1) of the Securities Act are discussed in § 7.02.

98 *See* §§ 9.05[7][c] and 9.05[8].

99 The SEC has cautioned that "[a]ny arrangement to return the restricted securities to U.S. markets may indicate, as suggested by SEC Release No. 33-7190 (June 27, 1995), an evasive scheme to avoid registration, which would invalidate any safe harbor claim." SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Interpretation 528.02 (Jan. 26, 2009).

100 For resales by dealers and persons receiving selling concessions, fees or other remuneration in respect of the securities offered or sold prior to the expiration of the applicable distribution compliance period, Rule 904(b)(1) under the Securities Act requires that the seller must not know that the buyer of the securities is a U.S. person and, if the seller knows that the buyer of the securities is a dealer or person receiving a selling concession, that the seller must send the buyer a confirmation setting out the applicable transfer restrictions. For resales by an officer or director of the issuer who is an affiliate of the issuer solely as a result of being an officer or director, Rule 904(b)(2) under the Securities Act requires that no selling concession, fee or other remuneration be paid in connection with the resale other than a customary broker's commission as would be received by a person executing the sale as an agent.

101 If the buyer is a corporation, partnership or investment company, it is enough that an authorized person employed by it or, in the case of an investment company, by its investment adviser, places the buy order while outside the United States. 55 Fed. Reg. 18,306, 18,310 n.39 (May 2, 1990).

102 Designated offshore securities markets now include the Eurobond market as regulated by the International Securities Market Association, the Australian Stock Exchange Limited, the Bahamas International Securities Exchange (*see The Bahamas International Securities Exchange* (avail. Oct. 20, 2011)), the Barcelona Stock Exchange (*see Barcelona Stock Exchange, Bilbao Stock Exchange, Madrid Stock Exchange and Valencia Stock Exchange* (avail. Mar. 11, 2003) (the "Spanish Stock Exchange Letter")), the Berlin Stock Exchange (*see Berlin Stock Exchange* (avail. Sept. 26, 2000)), the Bermuda Stock Exchange, the Bilbao Stock Exchange (*see* Spanish Stock Exchange Letter), the Bursa Malaysia Securities Berhad and for the limited purpose of permitting the secondary market trading of certain bonds, Bursa Malaysia Bonds Sdn Bhd (*see Bursa Malaysia Securities Berhad and Bursa Malaysia Bonds Sdn Bhd* (avail. Sept. 10, 2010)), the Canadian National Stock Exchange and Pure Trading (*see CNSX Markets Inc*. (avail. Feb. 24, 2010)), the Canadian Venture Exchange Inc. (*see Canadian Venture Exchange* (avail. Mar. 17, 2000) and *Alberta Stock Exchange* (avail. Mar. 9, 1993)), the Cairo and Alexandria Stock Exchanges (*see Cairo and Alexandria Stock Exchanges* (avail. Apr. 16, 2003)), the Channel Island Stock Exchange (*see Channel Island Stock Exchange (CASE)* (avail. Sept. 6, 2002)), the Copenhagen Stock Exchange (now NASDAQ OMX Copenhagen A/S) including First North (*see First North and NASDAW OMX Stockholm AB, NASDAQ OMX Copenhagen A/S and NASDAQ OMX Helsinki Ltd.* (avail. Apr. 24, 2014) (the "First North Letter")), the Eurolist Market and the Alternext Market as operated by Euronext Paris (*see Eurolist and the Alternext Market* (avail. Mar. 16, 2007)), Euronext Amsterdam (*see Euronext Amsterdam* (avail. Apr. 7, 2006)), Euronext Brussels (*see Euronext Brussels* (avail. Nov. 10, 2004)), the Frankfurt Stock Exchange, the OM Helsinki Stock Exchange (now NASDAQ OMX Helsinki Ltd.) including First North (*see* First North Letter), the Stock Exchange of Hong Kong Limited (including the Growth Enterprises Market, *see The Stock Exchange of Hong Kong Limited* (avail. June 27, 2000)), the Hellenic Exchanges—Athens Stock Exchange, SA (*see Hellenic Exchanges & Athens Stock Exchange, SA* (avail. July 15, 2016)), the Irish Stock Exchange, the Istanbul Stock Exchange, the Johannesburg Stock Exchange, the Korea Stock Exchange (*see Korea Stock Exchange* (avail. Sept. 11, 2000)), the Bolsa de Valores de Lima (*see Bolsa de Valores de Lima* (avail. May 14, 1998)), the London Stock Exchange (including SEAQ International, *see First*

Boston Corp. (avail. June 14, 1990) and AIM, *see London Stock Exchange* (avail. Aug. 18, 1998)), the Bourse de Luxembourg, the Madrid Stock Exchange (*see* Spanish Stock Exchange Letter), the Malta Stock Exchange plc (*see The Malta Stock Exchange plc* (avail. July 9, 2013)), the Mexico Stock Exchange, the Borsa Valori di Milano, the Montreal Stock Exchange, the OM Oslo Stock Exchange (including Merkur Market) (*see Oslo Børs—Merkur Market* (avail. Apr. 13, 2016)), the Panama Stock Exchange (*see Panama Stock Exchange* (avail. June 21, 2006)), the Prague Stock Exchange (*see Prague Stock Exchange* (avail. May 28, 2004)), the Stock Exchange of Singapore Ltd., the OM Stockholm Stock Exchange (now NASDAQ OMX Stockholm AB), including First North (*see* First North Letter), the SWX Swiss Exchange (*see SWX Swiss Exchange* (avail. July 3, 2002)), the Taiwan Stock Exchange (*see Taiwan Stock Exchange Corp.* (avail. Dec. 14, 2004)), the Tel Aviv Stock Exchange Ltd. (*see Tel Aviv Stock Exchange Ltd.* (avail. May 12, 1999)), the Tokyo Stock Exchange (including the Tokyo Stock Exchange's Market of High Growth and Emerging Stocks ("Mothers") (*see Tokyo Stock Exchange Inc.* (avail. Aug. 20, 2004))), the Toronto Stock Exchange, the Valencia Stock Exchange (*see* Spanish Stock Exchange Letter), the Vienna Stock Exchange (*see Wiener Börse* (avail. Dec. 14, 2004)) and the Warsaw Stock Exchange. The SEC originally designated certain of these exchanges pursuant to no-action letters, and subsequently codified those designations when it amended Regulation S in 1998. SEC Release No. 33-7505 (Feb. 17, 1998). The SEC may designate other foreign securities exchanges if requested to do so.

103 We have considered whether trades made using the International Order Book of the London Stock Exchange constitute "trades on" a designated offshore securities market. Based on discussions with the SEC, we are of the view that they do, whether or not the securities in question have been admitted to the Official List of the U.K. Listing Authority. The International Order Book is the central trading mechanism for the most liquid depositary receipts representing shares of non-U.K. companies, including both depositary receipts that have been admitted to the Official List and those that have not been so admitted. We rely on two theories in reaching our conclusion. First, the International Order Book could be considered simply a part of the London Stock Exchange, based on the no-action letters issued with respect to the AIM and SEAQ International, which confirm (rather than designate) each to be a designated offshore securities market because it is part of the London Stock Exchange, and the close working relationship and ongoing information exchanges between the International Order Book and the London Stock Exchange. Second, language contained in the release adopting Regulation S supports the view that trades in the International Order Book should constitute trades on a designated offshore securities market because they are reported to the London Stock Exchange. The release states that transactions executed "in, on or through the facilities of a designated offshore securities market" include all transactions reported to that market, and that trades executed between sessions, reported to the exchange and included in exchange trading volume, will be deemed to occur on that market. *See* SEC Release No. 33-6863 (Apr. 24, 1990).

104 For a discussion of Rule 144 and its amendments, *see* § 7.04[2].

105 SEC Release No. 33-7505 (Feb. 17, 1998), 63 Fed. Reg. 9632, 9637 (Feb. 25, 1998).

106 Rule 144(d)(2) under the Securities Act.

107 Since resales of equity securities of U.S. issuers under Regulation S do not "wash off" the Rule 144 restricted status, standard Rule 144 procedures (including legending) should be applied during the applicable restricted period. These procedures, however, may be incompatible with the trading practices of many offshore markets, particularly those that accommodate only uncertificated securities and those with rules prohibiting the listing of legended securities. *See supra* Notes 77–81 and accompanying text. *See also* § 7.04[2] for a discussion of Rule 144 and the amendments that significantly shortened the Rule 144 holding period for nonaffiliate holders of restricted securities.

108 *See* SEC Release No. 33-7505 (Feb. 17, 1998).

109 *See supra* Note 100 for a discussion of the restrictions application to dealers and persons receiving selling concessions, fees or other remuneration in respect of the securities offered or sold.

110 *See, e.g.*, *College Retirement Equity Fund* (avail. Feb. 18, 1987).

111 For a discussion of the restrictions on resale in the United States of privately placed securities, including

securities sold under Rule 144A, *see* Chapter 7.

112 When securities are offered and sold outside the United States under Regulation S and in the United States on a private placement basis (under Rule 144A or otherwise), there are in effect two classes of securities until the restrictions applicable to the privately placed securities end upon resale outside the United States or the expiration of the applicable Rule 144 holding period for unrestricted resale by nonaffiliates. This distinction can result in lack of fungibility of the two classes of securities. This lack of fungibility may not, however, prove to be particularly problematic where there is little or no U.S. trading in those securities, which is often the case in the context of equity securities where the only or principal trading market for the securities is outside the United States.

113 *See* text accompanying *supra* Note 108.

U.S. Regulation of the International Securities and Derivatives Markets, § 8.03, SECURITIES ACT § 4(a)(3)

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 § 8.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Regulation S is only part of the regulatory scheme that applies to offerings of securities outside the United States. In order to appreciate its implications fully, Regulation S must be taken in context, which includes § 4(a)(3) of the Securities Act, discussed below, and the antibearer bond rules of the Internal Revenue Code, which are discussed in § 8.04.

Section 4(a)(3) of the Securities Act exempts from the registration provisions of the Securities Act offers and sales of securities by U.S. and foreign securities dealers, subject to compliance with certain requirements. In the context of a Regulation S offering, these requirements have the effect of prohibiting all U.S. and foreign securities dealers (whether or not they are participants in the distribution) from offering or selling in the United States unsold allotments at any time, [114] and other securities sold in the offering until 40 days after the commencement of the offering. [115] Thus, even in the case of a Category 1 offering, to

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which the "distribution compliance period" does not apply, dealers are subject to the requirements of § 4(a)(3) of the Securities Act. [116]

In addition, because a research report with respect to a company's shares may be viewed as an offer of those shares, § 4(a)(3) may prevent the distribution of research reports in the United States during the 40-day period by both participants and nonparticipants in the offering. Broker-dealers that are not participating in the offering generally ignore this risk. Broker-dealers that are participating in the offering generally refrain from distributing research reports in the United States during the 40-day period, except perhaps in circumstances where they have sold their allotments and there was a significant preexisting trading market for the shares; in these circumstances, the report could be said to relate to the outstanding shares trading in the market, and not to the shares being distributed. In addition, the broker-dealer must take care to deliver only the preexisting shares, rather than the shares sold in the offering, at least during the 40-day period, to satisfy any orders that may have been stimulated by the research report. It should also be permissible for a broker-dealer participating in the offering to distribute in the United States research reports where Rule 138 or Rule 139 is available. [117]

Even where Rule 138 and Rule 139 are unavailable, underwriters can still distribute research reports outside the United States notwithstanding the unavailability of the § 4(a)(3) exemption, as long as they take measures to prevent the reports from being delivered in the United States. These measures include limiting the persons and locations to which reports are addressed, including legends on the reports themselves, providing separate warnings to recipients against redissemination, and monitoring how and to whom the reports are distributed. [118]

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When there is already an active market for the issuer's securities outside the United States, these limited-distribution research practices are rarely relied on, because they are often inconsistent with the way ongoing research is distributed; but in such cases the Rule 138 and Rule 139 safe harbors are often available.

Footnotes

114 The SEC staff has indicated that an underwriter may resell an unsold allotment of securities from a public offering, provided that six months have elapsed since the closing of the last sale under the relevant

registration statement and the underwriter complies with the volume and manner of sale restrictions of Rule 144 under the Securities Act (although the resale would not technically be under Rule 144 and no Form 144 need be filed). SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, Question 128.02 (Jan. 26, 2009). We believe the same analysis should apply to allotment securities from offshore transactions conducted pursuant to Regulation S.

115 The restrictions of § 4(a)(3) of the Securities Act will not have the effect of precluding U.S. sales when the "flowback" into the United States of securities originally offered and sold abroad has been registered with the SEC, in connection with a concurrent U.S. public offering or otherwise. *See supra* Note 93. Nor will the restrictions of § 4(a)(3) preclude Rule 144A resales (if available) or other private placements into the United States.

116 It is important to remember that for purposes of § 4(a)(3), unsold allotments include any securities purchased directly from an issuer, or indirectly in a chain of transactions between securities dealers that has not been interrupted by a sale to an end-investor. This raises the practical question, referred to earlier, of how to distinguish allotment securities from others. *See* Note 62 and accompanying text.

117 *See* Rule 138 and Rule 139 under the Securities Act. For a further discussion of the distribution of research reports, *see* §§ 3.02[3][e] and 7.02.

118 Banks acting as initial purchasers or placement agents may also broadly disseminate research reports in the United States in connection with a Rule 144A or Rule 506(c) placement and not jeopardize the private placement exemption or the Regulation S exemption, even where Rules 138 and 139 are unavailable. However, if the private placement is part of an initial public offering outside the United States where by definition there is no pre-existing market for the issuer's shares, the unavailability of the § 4(a)(3) exemption for the 40 days following that offering would make a broad U.S. distribution of research problematic. This limitation on the broad U.S. distribution of research in international IPOs has little impact as a practical matter, because banks generally restrict the distribution of research in the United States in those offerings in any event for the reasons discussed in § 3.03[3][e]. Banks may distribute research reports to accredited investors in the United States in connection with a Rule 506(b) or § 4(a)(2) private placement, although if the offering is a distribution for purposes of Regulation M, this would not be permitted during the Regulation M restricted period. By contrast, Rule 101 of Regulation M provides an exemption for offerings to qualified institutional buyers in transactions exempt from registration under § 4(a)(2) of the Securities Act, Rule 144A or pursuant to Regulation D, and an exemption for research satisfying the conditions of Rules 138 or 139.

U.S. Regulation of the International Securities and Derivatives Markets, § 8.04, INTERNAL REVENUE CODE ANTIBEARER BOND RULES

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 § 8.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The antibearer bond rules (generally referred to as Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA")) of the U.S. Internal Revenue Code of 1986, as amended (the "Internal Revenue Code" or "I.R.C."), impose additional regulatory restrictions on offerings of debt securities that are treated as *bearer-form* [119] debt obligations for U.S. tax purposes. [120]

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Section 502 of the Hiring Incentives to Restore Employment Act, [121] which was enacted on March 18, 2010 (the "HIRE Act"), imposes significant restrictions on U.S. issuers' ability to issue debt securities in bearer form. Those restrictions generally apply only to debt securities issued after March 18, 2012.

Section 8.04[1] below describes the application of the TEFRA restrictions to debt securities issued after March 18, 2012. Section 8.04[2] then describes the application of the TEFRA restrictions to debt securities issued on or before March 18, 2012.

[1] Application of TEFRA Restrictions to Issuances After March 18, 2012

The TEFRA restrictions, as amended by the HIRE Act for debt securities issued after March 18, 2012, [122] impose certain sanctions on issuers and holders of debt obligations in bearer form. [123] These sanctions are designed to restrict access by U.S. investors to debt obligations in bearer form and therefore apply to obligations issued by both U.S. and foreign issuers. [124] As a result of the amendments made by the HIRE Act, the sanctions apply even if all of the investors are located outside the United States, subject to the limited exception discussed below.

[a] Issuer Consequences

Under the TEFRA restrictions, U.S. issuers that issue debt in bearer form after March 18, 2012 will be denied deductions for interest paid on the debt. [125] The interest also will not qualify for the "portfolio interest" exemption from U.S.

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withholding tax, although other withholding tax exemptions, such as those applicable under an income tax treaty, will continue to apply. [126] In addition, both U.S. and non-U.S. issuers may be subject to a substantial excise tax. [127]

The excise tax is the only TEFRA-related penalty that typically is imposed on a non-U.S. issuer that issues bearer-form debt obligations. [128] The excise tax rules provide, however, that a debt security will not be subject to the excise tax if (i) it is issued under "arrangements reasonably designed to ensure" that it will be issued only to non-U.S. persons, (ii) interest on the obligation is payable only outside the United States and its possessions and (iii) the face of the obligation contains a notice that any holder who is a U.S. person will be subject to limitations under the U.S. income tax laws (collectively, the "foreign-targeted" requirements). [129] Accordingly, the HIRE Act generally does not eliminate non-U.S. issuers' ability to issue debt in bearer form. Although the HIRE Act does not specify the requirements necessary to satisfy the "arrangements reasonably designed" standard, the IRS has announced that it intends to issue rules "identical to" the TEFRA "C" and "D" regulations that apply to debt issued on or before March 18, 2012 and which are discussed in detail in § 8.04[2]. [130] Regulations have not yet been issued.

[b] Holder Consequences

A holder of a debt obligation that is issued in bearer form will not be allowed to deduct losses incurred with respect to the obligation [131] and will be required to treat gain on the sale of the obligation as ordinary income (and not capital gain). [132] However, these consequences do not apply to debt obligations meeting certain exceptions in the applicable Treasury Regulations, [133] or if the

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issuer was subject to the excise tax in connection with the issuance of the debt obligation. [134]

In addition to the restrictions on offerings of debt obligations in bearer form discussed here, it should be noted that obligations issued directly (or through affiliated entities) by the U.S. government, government-owned agencies and government-sponsored enterprises and obligations backed by any such securities (where more than 50% of the income or collateral supporting the obligations consists of interest on or principal of such U.S. government securities) have been required to be issued in registered form for many years. [135]

Debt obligations that (i) are issued by a natural person, (ii) are not of a type offered to the public or (iii) have a maturity of not more than one year are not "registration-required" obligations and may be issued in bearer form without incurring U.S. tax sanctions. [136] However, U.S. issuers (but not foreign issuers) of commercial paper must comply with the U.S. tax law restrictions to ensure that their obligations are not subject to U.S. information reporting requirements and backup withholding tax and, in the case of obligations with maturities of more than 183 days, that interest on such obligations is "portfolio interest" that is exempt from U.S. withholding tax. [137]

U.S. issuers of debt obligations in registered form must receive a statement—which generally must be signed by the beneficial owner of the obligation under penalties of perjury—to the effect that the beneficial owner is not a U.S. person in order for interest on the obligations to qualify as "portfolio interest" that is exempt from U.S. withholding tax. [138] Although short-term commercial paper generally is not subject to this requirement, [139] documentation of a holder's non-U.S. status generally is required in order to establish an exemption from U.S. information reporting requirements and backup withholding tax. It is impractical, however, to obtain certification of non-U.S. beneficial ownership from purchasers of short-term commercial paper. Accordingly, the applicable Treasury Regulations provide that, solely for purposes of establishing an exemption from information reporting requirements and backup withholding tax, original issue discount obligations having a maturity of 183 days or less will not be subject to a certification requirement, provided the commercial paper is issued in accordance with certain specified requirements, including compliance with the

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"foreign-targeting" rules. [140] Certification is required for commercial paper issued by a U.S. issuer with a maturity of more than 183 days.

[c] Application of Post-March 18, 2012 Rules to Non-U.S. Issuers

In some foreign markets, debt securities may be offered and sold in bearer form to satisfy local custom or market preferences and, in a small and decreasing minority of cases, to comply with local law. Non-U.S. issuers may continue to use the foreign-targeting procedures described in § 8.02[1][c] above to issue bearer-form debt securities without being subject to issuer sanctions. Alternatively, in most bond offerings by a non-U.S. company, [141] it is possible to avoid the application of the TEFRA restrictions by structuring the offering in a manner that causes the bonds to qualify as registered-form obligations for U.S. tax purposes, [142] while nevertheless allowing the bonds to be denominated as bearer obligations, in which case they generally are treated as such for purposes of local market preferences or customs. For instance, as discussed above, bonds that are represented by a bearer-form global note nonetheless will be considered registered-form securities for U.S. tax purposes so long as the global note is held throughout its term by a depositary and physical securities in bearer form are made available to investors only in certain limited circumstances. [143] The difference between the market's view of what constitutes a bearer instrument (which depends principally on the designation of the instrument as a bearer bond) and the technical U.S. tax definition (which depends on the manner in which an interest in the instrument may be transferred) makes it possible to structure offerings

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that are considered in bearer form from a non-U.S. perspective but nevertheless qualify as registered-form obligations for TEFRA purposes.

In substantial global bond offerings by non-U.S. issuers, depositary banks frequently enter into book-entry registration agreements with the issuer, pursuant to which they agree to hold the global note in a manner that causes the bonds to qualify as registered-form obligations for U.S. tax purposes. [144] These measures are routinely adopted in global bond offerings in which significant U.S. demand is anticipated from the outset. [145] The fact that book-entry agreements currently are an optional addition to, rather than a standard feature of, global bond documentation in the context of offerings by non-U.S. companies has restricted their use in contexts not involving a clear U.S. nexus. Even if a global bond offering is not thought to be of interest to U.S. investors, however, the use of book-entry arrangements can produce significant benefits and minimize exposure to costs or risks. Such arrangements normally will have no substantial non-U.S. consequences. [146]

[2] Application of TEFRA Restrictions to Issuances on or Before March 18, 2012

This section discusses the TEFRA rules that apply to debt securities issued on or before March 18, 2012. A principal difference in these rules as compared to the rules for debt securities issued after March 18, 2012 is that they provided U.S. issuers with a general exemption from U.S. tax sanctions for bearer-form debt securities that met the following three general requirements, which were intended to establish that the issuance was targeted at foreign investors [147]:

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- issuers and dealers must offer and sell bearer obligations pursuant to arrangements that are reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons (the "arrangements reasonably designed" requirement);
- interest on bearer obligations must be payable only outside the United States and its possessions; and
- a statement must appear on the face of bearer obligations, including any bearer coupons, to the effect that any U.S. person who holds the obligation will be subject to limitations under the U.S. tax laws. [148]

[a] “Arrangements Reasonably Designed”

Treasury Regulations under the Internal Revenue Code provide procedures for offering debt obligations in bearer form in compliance with the "arrangements reasonably designed" requirement. [149] For obligations issued on or before September 7, 1990, the regulations were linked to the U.S. securities laws and provided that the obligations satisfied the requirement if they were not required to be registered under the Securities Act because they were intended for distribution to non-U.S. persons. [150]

The IRS ceased to rely on the securities laws in May 1990 when it adopted Treasury Regulation § 1.163-5(c)(2)(i)(D) (which is generally referred to as "TEFRA D" or the "D Rules"). [151] Under the D Rules, obligations issued after September 7, 1990 are subject to independent U.S. tax law requirements that go beyond those imposed by the U.S. securities laws. These requirements impose restrictions on offers and sales of bearer-form debt obligations and on delivery

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of such obligations in definitive form and require certification of non-U.S. beneficial ownership.

The D Rules were adopted by the IRS in response to the adoption of Regulation S under the Securities Act by the SEC. Regulation S by and large embodies a territorial approach to the application of U.S. rules: many offers and sales of securities may be made without registration under the Securities Act to persons outside the United States regardless of their nationality. The antibearer bond provisions of the I.R.C., however, continue to restrict offers and sales of bearer debt securities to U.S. persons wherever they may be. As a result, additional U.S. tax law restrictions on offers and sales of bearer debt securities were deemed necessary. In addition, the IRS continued to require certification of non-U.S. beneficial ownership by purchasers of bearer debt securities.

[i] *The D Rules*

The D Rules restrict offers and sales of bearer-form debt obligations in connection with their original issuance, require obligations sold during the applicable "restricted period" to be delivered only outside the United States and require certification of non-U.S. beneficial ownership.

The D Rules provide that an issuer (or, subject to the safe harbor rule discussed below, a distributor) of bearer-form debt obligations may not offer or sell such obligations to a U.S. person or to a person within the United States during an applicable "restricted period." [152] The restricted period for an obligation commences on the earlier of the closing date and the first date on which the obligation is offered to persons other than distributors and ends 40 days following the closing date. [153] However, the offering and sale limitations imposed during the restricted period will apply to the unsold allotment of a distributor until the distributor actually sells the securities. [154]

A "distributor" with respect to any obligation is: (i) any person who offers or sells the obligation during the restricted period pursuant to a written contract with the issuer, (ii) any person who offers or sells the obligation during the restricted period pursuant to a written contract with a person described in (i), or (iii) any person who acquires the obligation from an affiliate for purposes of offering or selling the obligation during the restricted period, if that affiliate is the issuer or a distributor described in (i) or (ii). [155]

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The D Rules contain an important safe harbor for offers and sales by distributors. Under the safe harbor, if the distributor (i) agrees to comply with the offering and sale restrictions of the D Rules and (ii) has in effect procedures reasonably designed to ensure that its employees or agents who are directly engaged in selling the obligation are aware that the obligation cannot be offered or sold during the restricted period to a U.S. person or to a person within the United States, the distributor will be deemed to satisfy the D Rules' restrictions on offers and sales. [156] Thus, an issuer will not be subject to U.S. tax sanctions as a result of an inadvertent sale of a bearer-form debt obligation to a U.S. person by a distributor that has satisfied the requirements of the safe harbor.

The D Rules do not elaborate on the type of procedures that will be considered reasonable for purposes of the safe harbor provision. However, many market participants have established policies to ensure that their sales employees are aware of applicable sales restrictions, to identify securities that are subject to such restrictions and to document their procedures regarding compliance with the restrictions. The measures appropriate for a particular market participant will depend on its circumstances. Issuers generally require dealers to represent to the issuer that they have reasonable procedures in effect with respect to the offering.

Notwithstanding the general restrictions, the D Rules permit issuers and distributors to sell bearer-form debt obligations during the restricted period to: (i) distributors purchasing for resale, (ii) foreign branches of U.S. financial institutions [157] purchasing for their own account or for resale, (iii) U.S. persons purchasing through foreign branches of U.S. financial institutions and holding the obligation through U.S. financial institutions, (iv) international organizations and (v) foreign central banks. [158] However, securities generally may not be *offered* for sale to U.S. persons (other than those listed in (i) and (ii) above). [159] In light of this restriction, the practical significance of the rule permitting U.S. persons to acquire securities through foreign branches of U.S. financial institutions may be limited.

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As described above, the D Rules generally prohibit an offer to a person who is within the United States. Consequently, while Regulation S preserves the securities law exemption for offers and sales in the United States to U.S. professional fiduciaries acting on a discretionary basis for non-U.S. persons, the D Rules do not permit offers of bearer-form debt obligations to a U.S. office of such a fiduciary.

In addition to restricting offers and sales, the D Rules prohibit delivery of a definitive obligation in bearer form in the United States at any time in connection with a sale of the obligation made during the restricted period. [160] The D Rules also provide that in order to take delivery of an obligation in definitive bearer form (or to receive a payment of interest prior to delivery in definitive form), a holder or a financial institution acting on the holder's behalf must provide certification to the issuer stating that:

- the obligation is owned by a person that is not a U.S. person;
- the obligation is owned by a foreign branch of a U.S. financial institution, or by a U.S. person that acquired the obligation through a foreign branch of a U.S. financial institution and holds the obligation through a U.S. financial institution, and such financial institution has agreed to comply with the information reporting requirements and other rules for bearer-form debt obligations held by or through financial institutions; or
- the obligation is owned by a financial institution (U.S. or foreign) for purposes of resale during the restricted period and has not been acquired for purposes of resale directly or indirectly to a U.S. person or to a person in the United States. [161]

A limited exception to this certification requirement is available for obligations issued in a qualifying offering intended principally for sale in the local markets of a single foreign country. [162] This rule was intended to permit U.S. issuers to obtain access to markets where local law or practice makes it impossible

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to obtain certification. However, the exception is available only for countries specifically designated by the IRS as jurisdictions in which certification is not permissible. [163] To date, the IRS has designated Germany and Switzerland as local markets that qualify for this special rule. [164]

An obligation targeted for sale in a country designated by the IRS must satisfy additional requirements relating to the terms of the obligation and the manner in which it is distributed. Under these requirements, principal and interest on the obligation must be denominated only in the currency of a single foreign country [165] and must be payable only within that country. In addition, the obligation must be offered and sold in accordance with customary local practices and documentation, the issuance of the obligation must be subject to guidelines or restrictions imposed by the country's governmental, banking or securities authorities, and the obligation may not be listed or be the subject of an application for listing on an exchange located outside the country. Finally, the distributors of the obligation must covenant to use reasonable efforts to sell the obligation within the country and more than 80% of the issue must be offered and sold to nondistributors by distributors maintaining an office located in the foreign country. [166]

The following table outlines the certifications and distribution compliance period that apply to standard underwritten offerings of debt and equity securities under the TEFRA D Rules. "Category" refers to the category of transaction under Regulation S. "S" means Regulation S ; "D" means the D Rules. Except where noted, the distribution compliance period lasts for 40 days and, under the TEFRA D Rules, any certification regarding non-U.S. status will generally be given at the end of such period. [167]

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TABLE 8-3

	U.S. Issuer				*Foreign Issuer*				
	Debt			*Equity*	*Debt*		*Equity*		
Category	1	2	3	3	1	2	1	2	3
Certification	D*	D*	S/D*	S**	D*	D*			S**
Distribution Compliance/ Restricted Period	D	S/D	S/D	S**	D	S/D		S	S**

* There is no certification requirement for an offering that qualifies for the local offering exemption of TEFRA D. Generally, these will be overseas-directed offerings in respect of countries specifically designated by the IRS that fall within Category 1 of Regulation S. Thus far, the IRS has designated only Germany and Switzerland. [169]

** The distribution compliance period is for six months (one year if the issuer is a nonreporting issuer) and special rules apply.

[ii] *The C Rules*

Treasury Regulation § 1.163-5(c)(2)(i)(C) ("TEFRA C" or the "C Rules") provides alternative procedures that non-U.S. issuers may use to satisfy the "arrangements reasonably designed" requirement. [170] Under the C Rules, the requirement will be met if a debt obligation is issued only outside the United States and the issuer does not significantly engage in interstate commerce with respect to the issuance of the obligation, either directly or through an agent, an underwriter or a member of the selling group. The C Rules define "interstate commerce" as trade or commerce in obligations or any transportation or communication relating thereto between a foreign country and the United States. [171]

An issuer that uses the means of interstate commerce in connection with the issuance of an obligation will, in most cases, be significantly engaged in

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interstate commerce with respect to the issuance. [172] The C Rules provide by way of illustration that an issuer will be significantly engaged in interstate commerce if:

- there are negotiations or communications regarding the sale of the obligation between the issuer or an underwriter or member of the selling group and the purchaser while either of them is in the United States;
- the U.S. office of an underwriter or the issuer is involved in the offer or sale of the obligation, either directly with the prospective purchaser or through the issuer in a foreign country;
- the obligation is delivered in the United States; or
- the obligation is advertised in the United States. [173]

The C Rules impose fewer procedural restrictions than the D Rules on the issuance by a foreign issuer of bearer debt obligations. In particular, the C Rules do not require certification of non-U.S. beneficial ownership on delivery of definitive bearer obligations, and debt obligations issued under the C Rules need not bear the TEFRA legend (discussed below). However, the requirement that payments of interest on bearer debt obligations be made outside the United States does apply. [174]

The comparative disadvantage of the C Rules is that, unlike the D Rules, they do not provide safe harbor protection against a distributor's inadvertent noncompliance with the selling restrictions applicable to an issue. The broadly worded requirements of the C Rules—that an issuer "not significantly engage in interstate commerce with respect to the issuance … either directly or through its agent, an underwriter, or a member of the selling group" [175]—have also been of concern to issuers. The regulations indicate that any communication between an underwriter and a prospective purchaser with respect to a sale while either of

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them is located in the United States can constitute engaging in interstate commerce for this purpose. [176] Many issuers have concluded that the benefit of safe harbor protection under the D Rules, in view of the broad market acceptance of the procedures required by these rules, outweighs the procedural advantages available under the C Rules.

Whether the C Rules should be used for an offering of bearer debt obligations of a foreign issuer should be determined on a case-by-case basis in light of the relevant facts and circumstances. Certain offerings, however, are more obvious candidates for the C Rules than others. For example, it may be sufficient to use the C Rules if the debt obligations are privately placed outside the United States with a limited number of foreign investors purchasing for their own account or in the case of non-U.S. dollar-denominated debt obligations that are issued only in local markets. On the other hand, the C Rules may be less suitable for a public offering of debt obligations in the Euromarket, especially in the case of U.S. dollar-denominated obligations. The C Rules should not be used if there is a concurrent placement of debt obligations in the United States under Rule 144A or otherwise.

[b] Interest Payable Outside the United States

The requirement (applicable whether the C or D Rules are followed) that interest be payable only outside the United States and its possessions will be met if payments of interest can be made only upon presentation of a coupon (or upon making of a demand for payment) outside the United States and its possessions. [177] In addition, if the issuer is a U.S. issuer or a foreign issuer with significant U.S. connections, [178] payments generally may not be made by transfer of funds to the payee in the United States or mailed to an address in the United States. The regulations permit other issuers to make payments on bearer-form debt obligations in this manner, but (perhaps to avoid confusion) bond documentation typically uses payment terms appropriate for U.S. issuers.

[c] Legend Requirement

The following statement in English (referred to as the "TEFRA legend") must appear on the face of each bearer-form debt obligation and coupon:

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Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in §§ 165(j) and 1287(a) of the Internal Revenue Code. [179]

Footnotes

119 A debt obligation will be treated as a bearer obligation for U.S. tax purposes if it is not considered registered for such purposes. A debt obligation will be registered for U.S. tax purposes if it either (i) is registered with the issuer or its agent, and the transfer of the debt obligation may be effected only by surrender of the old obligation and either the reissuance of the old obligation to the new holder or the issuance of a new obligation to the new holder, or (ii) may be transferred only through a book-entry system maintained by the issuer or its agent. Treas. Reg. § 5f.103-1(c).

For debt obligations issued after March 18, 2012, an obligation also will be treated as being in registered form if it is held through a "dematerialized book entry system" or any other book-entry system specified by the Secretary of the Treasury. Although the Internal Revenue Code does not define "dematerialized book entry system," Notice 2012-20 (2012-13 I.R.B. 574 (Mar. 7, 2012)) provides that Treasury and the Internal Revenue Service intend to issue regulations that will provide that an obligation will be treated as in registered form if it is held through (i) a dematerialized book-entry system in which beneficial interests are transferable only through a book-entry system maintained by a clearing organization (or by its agent); or (ii) a clearing system in which the obligation is effectively immobilized. For this purpose, an obligation is treated as "effectively immobilized" if: (i) it is represented by one or more global securities in physical form that are issued to and held by a clearing organization (or by a custodian or depositary acting as its agent) for the benefit of purchasers of interests in the obligation under arrangements that prohibit the transfer of the global securities except to a successor clearing organization subject to the same terms; and (ii) beneficial interests in the underlying obligation are transferable only through a book-entry system maintained by the clearing organization (or its agent). Notice 2012-20 further provides that an obligation is treated as transferable only through a book-entry system even if holders are permitted to obtain physical certificates in bearer form in the following limited circumstances: (i) the termination of the clearing organization's business without a successor, (ii) a default by the issuer or (iii) at the issuer's request upon a change in tax law that would be adverse to the issuer but for the issuance of physical securities in bearer form. The Treasury Department and IRS have yet to issue such regulations. However, the Department of the Treasury 2016–2017 Priority Guidance Plan (Aug. 15, 2016) now includes "[r]egulations relating to the definition of registered form under §§ 149(a) and 163(f)" (item 1 under "Financial Institutions and Products").

120 In some foreign markets, debt securities typically are offered and sold in bearer form. As discussed in more detail below, however, in many bond offerings the rules relating to immobilized obligations may make it possible to avoid the application of these TEFRA restrictions by structuring the offering in a manner that causes the bonds to qualify as registered-form obligations for U.S. tax purposes, while nevertheless denominating the bonds as bearer obligations, which generally is sufficient to satisfy local market preferences.

121 Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

122 HIRE Act § 502(a), amending I.R.C. § 163(f)(2).

123 Debt obligations that are not "registration-required" obligations, as discussed below, may be issued in bearer form without incurring the sanctions. I.R.C. § 163(f)(2)(A).

124 *See* Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (JCS-38-82), Dec. 31, 1982, p. 190.

125 I.R.C. § 163(f)(1).

126 I.R.C. §§ 871(h)(2) and 881(c)(2). *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11), Mar. 2011, p. 222.

127 I.R.C. § 4701. The amount of the excise tax is 1% of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) from the issue date to the maturity date of the obligation. As discussed below, the "arrangements reasonably designed" exception will continue to apply for purposes of the TEFRA excise tax. Thus, notwithstanding the sanctions described in the text, a U.S. or non-U.S. issuer that issues debt in bearer form after March 18, 2012 in compliance with the TEFRA D rules generally will not be subject to the excise tax.

128 I.R.C. § 4701.

129 I.R.C. § 4701(b)(1), as amended by HIRE Act § 502(e).

130 Notice 2012-20, § 6, 2012-13 I.R.B. 574 (Mar. 7, 2012).

131 I.R.C. § 165(j)(1).

132 I.R.C. § 1287(a).

133 Treas. Reg. §§ 1.165-12(c) (exceptions from loss deduction denial) and 1.1287-1(c) (exceptions from ordinary income treatment).

134 I.R.C. §§ 165(j)(1) and 1287(a).

135 § 163(f)(2)(A); Treas. Reg. § 1.163-5(c)(1); *see* Letter from Donald T. Regan, Secretary of the Treasury, to Robert Dole, Chairman of the Senate Committee on Finance (Sept. 7, 1984); *see also* 31 U.S.C. § 3121(g), as amended by HIRE Act § 502(d).

136 I.R.C. § 163(f)(2)(A).

137 Interest on obligations with maturities of 183 days or less generally is not subject to U.S. withholding tax. *See* I.R.C. § 871(g)(1)(B)(i).

138 I.R.C. §§ 871(h)(2)(B) and 881(c)(2)(B).

139 *See supra* Note 137.

140 Treas. Reg. § 1.6049-5T(b)(10)(i). The foreign-targeted requirements are discussed in the text accompanying Note 129 and in § 8.02[1][c]. The regulations also require that the obligation on its face include the following statement:

> By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder).

141 The structure discussed in this paragraph may not suitable for offerings by U.S. companies, because, as discussed above, non-U.S. investors may be unwilling to provide the investor-specific U.S. tax certifications that are required to receive interest payments free of U.S. withholding tax on bonds that are treated as registered-form obligations for U.S. tax purposes.

142 Bonds that are considered to be in *registered form* for U.S. tax purposes are not subject to the TEFRA restrictions discussed above.

143 *See supra* Note 119. If the depositary agrees to maintain a book-entry system recording the ownership of the global note on the issuer's behalf, the notes also generally would be treated as in registered form. This structure, however, is unlikely to provide significant additional flexibility, given the "effectively immobilized" rule described *supra* in Note 119. Alternatively, it typically is possible to satisfy any local law or market preferences for physical securities by providing for the availability of registered-form (as opposed to bearer-form) physical securities in those circumstances.

144 Such arrangements should be designed such that the bonds are treated as "effectively immobilized" as described in Note 119.

145 A number of substantial non-U.S. issuers relied on a similar technique to facilitate the sale in the United States of instruments that were required to be denominated as bearer obligations for non-U.S. reasons, under the U.S. tax rules in effect prior to the HIRE Act. *See* IRS Private Letter Rulings 9343018 and 9343019 (both July 29, 1993), which deal with debt offerings by the World Bank and by a U.K. bank. New debt offerings using this technique generally should be designed in accordance with Notice 2012-20, as discussed in Note 119, rather than in accordance with these older Private Letter Rulings.

146 There may continue to be circumstances in which the arrangements do not make sense in the context of a particular offering, but that is likely to be the case in only a very small proportion of international bond offerings. Following the adoption of standardized documentation, the only such likely circumstances are where the documentation of an existing facility immutably requires that physical bearer-form securities be made available, or where the offering is targeted to one of the few remaining markets where local market practice requires that definitive bearer securities be made available in definitive bearer form, in circumstances other than those specified by Notice 2012-20.

147 As discussed in § 8.02[1], *supra*, non-U.S. issuers may continue to rely on the procedures described in this section in connection with the issuance of debt securities in bearer form.

148 Pre-HIRE Act I.R.C. § 163(f)(2)(B). As discussed in § 8.04[1], the rules for debt securities issued after March 18, 2012 provide that the otherwise applicable excise tax will not apply to bearer-form debt securities

that are issued according to procedures that meet requirements substantially identical to these three requirements.

149 Treas. Reg. § 1.163-5(c)(2)(i). The IRS has announced that it intends to issue regulations providing that rules "identical to" the rules in these regulations will apply to debt securities issued after March 18, 2012 for purposes of establishing an exemption from the otherwise applicable excise tax. Notice 2012-20, § 6. The IRS has not yet issued these regulations. *See supra* Note 130 and accompanying text.

150 Treas. Reg. § 1.163-5(c)(2)(i)(A). The regulations adopted the U.S. securities law definition of "U.S. person" and provided that an opinion of counsel could be relied on in determining that obligations were not "registration-required" because they were intended for distribution to non-U.S. persons. The obligations also had to be offered for sale and delivered in connection with their original issuance only outside the United States and its possessions. Treas. Reg. § 1.163-5(c)(2)(i)(B) prescribed rules for satisfying the "arrangements reasonably designed" requirement in cases where the obligations were registered under the Securities Act and in certain other cases.

151 T.D. 8300, 55 Fed. Reg. 91, 19622 (May 10, 1990).

152 Treas. Reg. § 1.163-5(c)(2)(i)(D)(1).

153 Treas. Reg. § 1.163-5(c)(2)(i)(D)(7).

154 Treas. Reg. § 1.163-5(c)(2)(i)(D)(7). The securities must be sold to someone who is neither related to the distributor nor another member of the selling group.

155 Treas. Reg. § 1.163-5(c)(2)(i)(D)(4). A confirmation or other notice of the transaction is not a written contract for purposes of this rule. Two corporations are affiliates for these purposes if one of them owns, directly or indirectly, stock possessing 50% or more of the voting power and value of the stock of the other or if a third corporation owns, directly or indirectly, stock possessing 50% or more of the voting power and value of the stock of each corporation.

156 Treas. Reg. § 1.163-5(c)(2)(i)(D)(1)(ii)(B).

157 For this purpose, "financial institutions" include banks, broker-dealers, insurance companies, finance companies, mutual funds, pension plans and investment advisers. Treas. Reg. § 1.165-12(c)(1)(iv).

The exemption for securities purchased by or through a foreign branch of a U.S. financial institution requires the financial institution to certify that it will comply with the information reporting requirements and other rules for bearer-form debt obligations held by or through financial institutions. This certification can be made on a blanket basis and renewed every three years.

158 Treas. Reg. § 1.163-5(c)(2)(i)(D)(1)(iii)(B), (C) and (c)(2)(i)(D)(5).

159 Treas. Reg. § 1.163-5(c)(2)(i)(D)(1)(iii)(C) refers to the "sale" of an obligation, while Treas. Reg. § 1.163-5(c)(2)(i)(D)(1)(iii)(B) refers to "an offer or sale" of an obligation.

160 Treas. Reg. § 1.163-5(c)(2)(i)(D)(2).

161 Treas. Reg. § 1.163-5(c)(2)(i)(D)(3). A temporary global security generally is not a definitive obligation for this purpose. If definitive obligations are not made available for delivery within a reasonable period of time after the end of the restricted period, the issuer will be deemed to have failed to satisfy the certification requirement. A "permanent" global security exchangeable for definitive obligations would be viewed as a definitive obligation for these purposes. However, U.S. issuers generally took steps to ensure that obligations in definitive bearer form could be withdrawn from such a "permanent" global security in order to avoid exposure to arguments that the obligations should be considered to be in registered form (which would trigger additional tax certification requirements as a prerequisite to obtaining the portfolio interest exemption from U.S. withholding tax).

162 Treas. Reg. § 1.163-5(c)(2)(i)(D)(3)(iii).

163 Treas. Reg. § 1.163-5(c)(2)(i)(D)(3)(iii)(F).

164 Notice 90-55, 1990-2 C.B. 344.

165 Although the IRS has not ruled on the question, it would appear that Germany's adoption of the euro may

have eliminated the ability of German-targeted issues to rely on this exemption.

166 Treas. Reg. § 1.163-5(c)(2)(i)(D)(3)(iii).

167 For a discussion of the certifications required under Regulation S, *see* § 8.02[1][c][ii] and [iii].

169 Issues targeted to Germany may no longer be eligible for this special rule. *See supra* Note 165 and accompanying text.

170 The C Rules are not available with respect to obligations guaranteed by, convertible into a debt or equity interest in, or substantially identical to an obligation issued by, a U.S. person that owns 10% or more of the combined voting power of the issuer. Treas. Reg. § 1.163-5(c)(2)(ii).

171 Treas. Reg. § 1.163-5(c)(2)(iii).

172 *See, e.g.*, Treas. Reg. § 1.163-5(c)(2)(iii). Examples 3 and 4 make clear that a single telex originating in the United States and that is related to the issuance of the bearer instrument is sufficient to be "significantly engaged in interstate commerce" with respect to the issuance of the obligation.

However, the means of interstate commerce may be used without violation of the C Rules in connection with certain activities that are merely of a "preparatory or auxiliary character" and that do not involve communication between a prospective purchaser and the issuer or an underwriter while either of them is in the United States. The C Rules provide examples of such activities. *See* Treas. Reg. § 1.163-5(c)(2)(iii)(A).

173 Treas. Reg. § 1.163-5(c)(2)(iii)(B).

174 *See* § 8.04[2][a].

175 Treas. Reg. § 1.163-5(c)(2)(i)(C).

176 *See supra* Note 172.

177 Treas. Reg. § 1.163-5(c)(2)(v).

178 Such issuers include non-U.S. issuers that are "controlled foreign corporations" or that have significant income effectively connected with the conduct of a U.S. trade or business. Treas. Reg. § 1.163-5(c)(2)(v)(A).

179 Treas. Reg. § 1.163-5(c)(1)(ii)(B). Temporary global notes and obligations issued under the C Rules need not contain this legend.

U.S. Regulation of the International Securities and Derivatives Markets, § 9.01, 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 § 9.01 (11th and 12th Editions 2014-2017)
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This chapter discusses a variety of issues relating to the acquisition of significant interests in companies whose securities trade in the United States or that conduct business in the United States—by investors, by acquirors and by companies themselves (of their own securities). [1]

Section 9.02 discusses what constitutes a tender offer and sets forth the rules applicable to tender offers generally. While the term "tender offer" is not defined in the Exchange Act or any rule thereunder, the SEC has developed a list of eight factors, discussed in this section and known as the "Wellman factors," to be taken into account in determining whether a tender offer for securities exists. If a course of conduct related to the acquisition of securities rises to the level of a tender offer, § 14(e) of the Exchange Act and Regulation 14E thereunder will apply—regardless of whether the relevant security is classified as equity or debt and regardless of whether it (or any other security of the relevant issuer) is registered under § 12 of the Exchange Act [2]—and govern disclosure, timing and other procedural requirements and prohibit certain types of activities.

Section 9.03 addresses issuer repurchases of its own equity securities, both through open market repurchase programs and issuer tender offers. It begins with a discussion of insider trading considerations and how the possession of material nonpublic information affects the timing and procedures (including with respect to the use of Rule 10b5-1 plans and accelerated share repurchase ("ASR") transactions) for an issuer's repurchase of its own equity securities. The section then discusses how issuers can minimize the risk that their equity security repurchases will not be challenged as involving manipulative practices, including through reliance on the nonexclusive safe harbor from liability for manipulation provided by Rule 10b-18 under the Exchange Act. Lastly, this section discusses when an issuer's repurchase of its own equity securities, registered under § 12 of the Exchange Act, is subject to regulation as a tender offer under § 13(e) of the Exchange Act and Rules 13e-4 and 13e-3 thereunder (the latter insofar as an issuer tender offer may result in an issuer "going private"), which set forth the disclosure, filing and other procedural requirements applicable to those issuer self-tenders.

Section 9.04 discusses liability management, which broadly encompasses the tools issuers use to manage their ongoing contractual obligations with respect to their debt securities, including consent solicitations (modification and amendment of the terms of debt securities with the consent of a specified

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percentage of the holders), open market repurchases of debt securities, privately negotiated buy-back programs for debt securities and debt tender and exchange offers. A liability management transaction will be most extensively regulated if it involves the issuance of a new security, in which case the registration requirements of the Securities Act will apply, or a tender offer, in which case certain of the Exchange Act provisions regulating tender offers (excluding those applicable only to equity securities) will apply, as discussed in this section.

Section 9.05 covers the regulation of tender and exchange offers for equity securities by third-party bidders under the U.S. securities laws. Any person that makes a tender or exchange offer (a tender offer involving the issuance of bidder securities) and, after consummation, would be the direct or indirect beneficial owner of more than 5% of any class of equity securities registered under § 12 (whether or not entitled to vote), must comply with the procedural and disclosure requirements of § 14(d) of the Exchange Act and the rules adopted by the

SEC thereunder. Unlike the laws of many countries, the Exchange Act does not contain a "mandatory bid" requirement—an obligation to make a tender offer to all shareholders once a specific ownership level is reached. This section also addresses the registration requirements, proxy solicitation rules (which do not apply to foreign private issuers [3]) and limitations on communications applicable to business combinations—where an acquisition or merger is effected through a statutory transaction involving a shareholder vote, instead of a tender or exchange offer.

The U.S. tender offer rules, absent an exemption, generally apply to tender and exchange offers by bidders for the securities of foreign target companies if the target securities are registered under the Exchange Act. Even if the securities are not registered under the Exchange Act, some of the U.S. tender offer rules apply absent an exemption if the offer is made to holders who are U.S. residents. These rules thus differ from the rules of many other countries, the application of which turns not on the residence of the investor but rather on the jurisdiction of incorporation (or sometimes the jurisdiction of listing) of the target company. This difference reflects the fundamental goal of the U.S. securities laws, which is protection of U.S. investors regardless of the nationality of the bidder or the target or of the investor protections afforded by their regulators in their home markets. As a consequence of the SEC's approach, there are often conflicts between its rules and the rules imposed on a bidder by the target's jurisdiction of incorporation or listing.

The SEC has adopted a number of rules to mitigate these conflicts when the target's U.S. shareholder base is less significant. The SEC's rules (i) exempt from its tender offer regulation tender and exchange offers for the securities of foreign targets if U.S. ownership of the target is 10% or less, (ii) provide limited relief from certain provisions of the tender offer rules in such tender or exchange offers if U.S. ownership is 40% or less and (iii) exempt from Securities Act registration the securities issued in such exchange offers if U.S. ownership of the target is 10% or less. The exemption from Securities Act registration is also available for business combinations requiring a shareholder vote involving foreign issuer target companies with U.S. ownership of 10% or less. In each case, ownership levels must be determined in accordance with SEC rules.

In addition, the Exchange Act contains margin regulations that regulate the use of credit in financing positions in securities, including for purposes of tender offers. These regulations are also discussed in § 9.05.

Chapter 9 then covers two other important statutes (and related rules) applicable to the acquisition of substantial stock positions or entire businesses. Section 9.06 discusses the antitrust reporting requirements under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"). These rules apply even to acquisitions by one foreign company of an interest in another foreign company if certain tests relating to the companies' U.S. revenues or assets are satisfied. Section 9.07 discusses the reporting and review requirements applicable to acquisitions of U.S. businesses by foreign persons that may affect U.S. national security under the Exon-Florio provision of the Defense Production Act of 1950. [4]

The chapter concludes with a brief examination of U.S. country- and person-specific sanctions regimes in § 9.08. Although the scope of sanctions such as those administered by the Office of Foreign Assets Control and imposed pursuant to the Iran Sanctions Act encompasses much more than business combinations and similar transactions, violation of these sanctions can carry substantial penalties, making it crucial for persons contemplating such transactions involving sanctioned countries or persons, or companies doing business in such countries, to consider their exposure to the sanctions in advance.

Footnotes

1 Chapter 6 separately addresses the disclosure requirements applicable to investors' ownership, post-acquisition and on a continuing basis, of significant equity interests in companies that are public in the United States.

2 There is one exception, Rule 14e-5, which applies only to tender offers for equity securities and is discussed in § 9.05.

3 The U.S. proxy solicitation rules, applicable to shareholder votes to approve business combinations, do not apply to foreign private issuers, regardless of whether their shares are registered under the Exchange Act. Rule 3a12-3 under the Exchange Act.

4 Additional industry-specific approval or reporting requirements apply to certain significant acquisitions of securities or assets (including acquisitions taking the form of business combinations). These most typically arise in regulated industries, such as telecommunications, television, radio, railroad, airline, banking and insurance. These industry-specific requirements are beyond the scope of this book.

U.S. Regulation of the International Securities and Derivatives Markets, § 9.02, EXCHANGE ACT REGULATION OF TENDER OFFERS

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 § 9.02 (11th and 12th Editions 2014-2017)
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[1] What Is a Tender Offer?

The Williams Act, [5] adopted in 1968, amended the Exchange Act to add provisions regulating the accumulation of securities. [6] Key provisions of the Williams Act apply only to accumulations that constitute "tender offers" within the meaning of the Williams Act.

The term "tender offer" is, however, not defined in the Exchange Act or any rule thereunder. While the SEC has declined to promulgate a definition of "tender offer," [7] it has developed a list of eight factors to be taken into account in determining whether a course of conduct related to the acquisition of securities rises to the level of a tender offer under the Williams Act. These factors are generally known as "*Wellman* factors," after the U.S. district court decision in which they were first discussed. [8] The *Wellman* factors are:

- active and widespread solicitation of public shareholders;
- solicitation for a substantial percentage of the target's outstanding stock;
- an offer price representing a premium over prevailing market price;
- firm rather than negotiable terms;
- solicitation contingent on a minimum number of shares or subject to a fixed maximum;
- an offer open for a limited period of time;
- pressure on public shareholders to sell; and
- public announcements preceding or accompanying purchases. [9]

Although the SEC has indicated that the *Wellman* factors are relevant to determining whether acquisitions constitute a tender offer, it has not specified how to

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weigh the respective factors or how many factors must be satisfied to constitute a tender offer.

Courts have generally considered the *Wellman* factors relevant to the analysis of whether a tender offer is present; at the same time, however, they have emphasized that the Williams Act was intended to protect the public from undue pressure, and accordingly, should not ordinarily be applied to purchases in the open market or in privately negotiated transactions with sophisticated investors. [10] In *SEC v. Carter Hawley Hale Stores, Inc.*, for example, the court affirmed a lower court decision holding that an issuer that repurchased approximately 55% of its shares in the open market had not made a tender offer when only the first two of the eight factors were present. [11] In *Hanson Trust PLC v. SCM Corp.*, the defendant bought 25% of the stock of the issuer through one open market purchase and five privately negotiated transactions—four with institutional holders and one with a professional individual investor. [12] The defendant had previously made a tender offer for the issuer's stock, but had withdrawn its offer hours before commencing the private and open market purchases. [13] The court in

Hanson held that because the five private sellers were highly sophisticated professionals, knowledgeable in the marketplace and informed of the facts necessary to exercise their professional skills and appraise the offer, the protection of the tender offer regulations was not necessary. Additional factors influencing the

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court's decision included: (i) there was no active or widespread advance publicity or public solicitation for shares, (ii) the price at which the defendant bought was not a premium over market price, and (iii) the defendant was obligated to buy the shares once agreement was reached with each individual seller, and the purchases were not contingent on the defendant's acquisition of a fixed number of shares. [14]

As previously noted, [15] the leading cases on determining whether acquisitions constitute a tender offer involve equity securities, [16] and the application in the context of debt securities of the standards that have been developed in those cases remains unelaborated.

[2] Provisions Applicable to Tender Offers for Any Type of Security

Section 14(e) of the Exchange Act and, with one exception, Regulation 14E thereunder apply to tender offers for any security [17] by any person, including the issuer (but excluding sovereign issuers as discussed below in this paragraph), regardless of whether the relevant security is classified as equity or debt and whether it (or any other security of the relevant issuer) is registered under § 12 of the Exchange Act. Rule 3a12-3(a) under the Exchange Act provides an exemption from § 14 of the Exchange Act for sovereign issuers.

Section 14(e) of the Exchange Act, a broadly worded antifraud provision, makes it unlawful for any person "to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer." Thus, even if specific disclosure requirements [18] do not apply to a particular tender offer, all of the facts and circumstances relating to the proposed tender offer should be examined against the general standard of § 14(e) to determine what disclosures should be made in the offering documents. There also is a specific insider trading rule under § 14(e) applicable in connection with tender offers. [19]

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Regulation 14E under the Exchange Act largely shapes the timing of all tender offers in the United States. Under Rule 14e-1, the bidder must hold the tender offer open for (i) at least 20 business days from the date when the tender offer is first published or sent or given to securityholders and (ii) at least ten business days from the date when the notice of an increase or decrease in the percentage of the class of securities being sought or the consideration offered is first published or sent or given to securityholders. [20] In addition, according to the SEC's announced interpretation of the rule, the tender offer must remain open for at least five to ten business days (depending on the level of materiality) from the date of any other material change in the terms of the offer or waiver of any material conditions of the offer. [21] For example, the SEC has interpreted the waiver or reduction of a minimum tender condition as a material change to an offer that could require an extension of the tender offer such that the offer must remain open for five U.S. business days following the date of the announcement of the waiver or reduction. [22]

In tender offers subject to a financing condition, the SEC has stated that "when an offer is not financed, or when a bidder's ability to obtain financing is uncertain, a material change will occur in the information previously disclosed when the offer becomes fully financed," [23] requiring an amendment to the bidder's disclosure filing on Schedule TO (if applicable) [24] and extension of the offer for an additional five U.S. business days. [25] The SEC takes the view that such a condition to the offer exists (the satisfaction of which is a material change) even where bidders have obtained commitments from third-party financing sources

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and any resulting conditions to the offer relate only to the eventual funding of such committed financing. [26]

The bidder must pay the consideration offered or return the securities deposited by or on behalf of securityholders "promptly" after the termination or withdrawal of the tender offer. [27] The SEC has confirmed that prompt payment in U.S. offers is generally understood to mean payment within three business days of expiration of the offer. [28] In the event that the tender offer is extended, the bidder must issue a notice of such extension (including disclosure of the approximate number of securities deposited to date) by the earlier of (i) 9:00 A.M. Eastern time on the next business day after the scheduled expiration date of the offer, and (ii) if the class of securities is registered on one or more national securities exchanges, the first opening of any one of such exchanges. [29]

The target company is also required to publish certain information, including a recommendation to its securityholders to accept or reject the bid or an expression of its neutrality and the reasons for that recommendation or neutrality, within ten business days following commencement of the offer. [30]

Rule 14e-4 provides that, in a tender offer for less than all of the securities of a given class (a partial tender), short tenders (*i.e.*, tenders by persons who do not own the subject security) are prohibited.

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Finally, Rule 14e-8 prohibits a bidder from announcing an offer without an intention to commence and complete it, as a means to manipulate stock prices, or without a reasonable belief that it will have the means to purchase the subject securities in order to consummate the offer. [31]

Beyond the specifically enumerated requirements of the Williams Act and the rules thereunder, the SEC has developed doctrines regarding permissible practices in tender offers that should also be borne in mind in structuring a tender offer, including the illusory offer doctrine and the prohibition on conditions subsequent.

Under the illusory offer doctrine, a bidder's offer must have clear terms and conditions such that an outside observer at the expiration date can determine, based on objective facts that are not within the bidder's control, whether the offer is successful or not. As a corollary, the conditions to a tender offer must be objective conditions that are outside the control of the bidder.

The prohibition on conditions subsequent means that all conditions to tender must be satisfied or waived at expiration (with limited exceptions, including for regulatory approvals).

Additional restrictions apply to (a) third-party tender offers in respect of equity securities that are registered under § 12 of the Exchange Act and (b) issuer tender offers in respect of equity securities if the relevant issuer has registered any class of its equity securities under § 12 of the Exchange Act (whether or not the class being tendered for is so registered). These include requirements regarding the filing of disclosure for the tender offer (covering specifically enumerated items) with the SEC, the provision of withdrawal rights to tendering holders, [32] extension of the tender offer to all holders of the subject class of securities, payment of the same price for all purchases of the security that is the subject of the tender offer, and a prohibition on purchases of the subject security outside the tender offer, as discussed in § 9.03[2] and § 9.05.

Footnotes

5 Williams Act of 1968, Pub. L. No. 90-439, 82 Stat. 454.

6 The Williams Act added provisions to §§ 13 and 14 of the Exchange Act related to beneficial ownership disclosure requirements, and the regulation of tender offers and changes in control. The beneficial ownership disclosure requirements are discussed in Chapter 6.

7 In 1979, the SEC proposed a definition of "tender offer," *see* SEC Release No. 33-6159 (Nov. 29, 1979), but no definition of the term was ever adopted.

8 *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

9 *See Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

10 *See Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985); *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985); *Stromfeld v. The Great Atlantic & Pacific Tea Co.*, 484 F. Supp. 1264 (S.D.N.Y. 1980); *see also Clearfield Bank & Trust Company v. Omega Financial Corp.*, 65 F. Supp. 2d 325 (W.D. Penn. 1999); *Anago Inc. v. Tecnol Medical Products, Inc.*, 792 F. Supp. 514 (N.D. Tex. 1992).

In the cross-border context, one court has noted in *dictum* that "[c]aution in finding that an unconventional tender offer has occurred is particularly necessary 'in the context of cross-border buying programs, where a foreign buyer may be acting in compliance with the laws of its own jurisdiction and the home jurisdiction of the issuer and unwittingly run afoul of a broadly interpreted tender offer rule in [the United States].'" *E.ON AG v. Acciona, S.A.*, No. 06 Civ. 8720 (DLC), 2007 WL 316874, at *12 (S.D.N.Y. Feb. 5, 2007) (citing *E.ON AG v. Acciona, S.A.*, 468 F. Supp. 2d. 559 (S.D.N.Y. 2007)).

It should also be noted that the eight-factor test was developed by the SEC to determine whether there has been a creeping tender offer in the context of common stock, and all of the court decisions regarding creeping tender offers have been in that context. Because the market for debt securities generally is more institutional in nature than the market for common stock, courts may well be even more reluctant to find that substantial open market purchases of debt securities constitute creeping tender offers.

11 *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945, 953 (9th Cir. 1985).

12 *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985).

13 Purchases of large blocks of stock accumulated by arbitrageurs and other investors during the pendency of a bid are commonly known as "street sweeps." The use of state takeover statutes and modern poison pill rights plans has largely eliminated street sweeps for common stock. *See* § 9.05[12][a] and § 9.05[12][b] for a detailed discussion of these takeover defenses.

14 *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 57–59 (2d Cir. 1985).

15 *See supra* Note 10.

16 Including *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983). *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47 (2d Cir. 1985); and *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985).

17 Rule 14e-5 applies solely to equity securities. *See* § 9.05[2][a].

18 In particular, those applicable to equity tender offers that are subject to disclosure requirements under the Williams Act (*See* § 9.03[2] and § 9.05) and to exchange offers that are registered under the Securities Act.

19 Rule 14e-3 under the Exchange Act; *see* § 11.06[4]. These rules are in addition to the more generally applicable insider trading prohibitions of Rule 10b-5 under the Exchange Act, which are discussed in §§ 11.05[2] and 4.10[1].

20 Rules 14e-1(a) and 14e-1(b) under the Exchange Act. For discussion of relief the SEC has granted from these minimum time periods, *see* § 9.04 (discussing relief in the context of tender offers for debt securities) and § 9.03[2] (discussing relief in the context of tender offers for equity securities).

21 Although Rules 14d-4(d)(2) and 13e-4(e)(3) under the Exchange Act, establishing a five business day requirement for dissemination of material changes, apply by their terms only to equity securities, the SEC views the five to ten business day dissemination requirement described in the sentence above as applying to all tender offers, including those subject only to Regulation 14E. *See* SEC Release No. 34-24296 (Apr. 3, 1987) and SEC Release No. 33-7760 (Oct. 22, 1999).

22 *See* SEC Release No. 34-24296 (Apr. 3, 1987).

23 P.F. Chang's China Bistro, Inc., CIK # 0001039889, SEC Comment Letter, dated May 21, 2012, Re: P.F. Chang's China Bistro, Inc. Schedule TO-T filed May 15, 2012 by Wok Acquisition Corp., Wok Parent LLC, Wok Holdings Inc., and Centerbridge Capital Partners II, L.P., SEC File No. 005-54977.

24 Rule 14d-3(b)(1) under the Exchange Act.

25 *See*, *e.g.*, A.C. Moore Arts & Crafts, Inc., CIK # 0001042809, SEC Comment Letter, dated October 21, 2011 Re: A.C. Moore Arts & Crafts, Inc. Schedule TO-T filed October 18, 2011 by Nicole Crafts LLC, Sbar's

Acquisition Corporation and Adolfo Piperno, SEC File No. 005-53645.

26 *See*, *e.g.*, MModal, Inc., CIK # 0001441567, SEC Comment Letter, dated July 21, 2012 Re: MModal, Inc. Schedule TO-T filed by One Equity Partners V, L.P., *et al*. filed on July 17, 2012, and Schedule TO-T/A filings submitted by One Equity Partners V, L.P., *et al*. filed on July 24 and July 25, 2012, SEC File No. 005-86102.

27 Rule 14e-1(c) under the Exchange Act. *See* § 9.05[9][b] with respect to an exception to this requirement under the Tier II rules in connection with certain foreign offers made in accordance with home country requirements.

28 SEC Release No. 33-8917 (May 6, 2008), 73 Fed. Reg. 26,876, 26,890 n.143 (May 9, 2008) (citing SEC Release No. 34-43069 (July 24, 2000)). *But see infra* Notes 128-132 and accompanying text for cross-border requirements. The SEC has proposed an amendment to Rule 15c6-1(a) under the Exchange Act that would shorten the standard settlement cycle in the United States for most securities transactions from three business days after the trade date (T+3) to two business days (T+2). SEC Release No. 34-78962 (Sept. 28, 2016). If adopted, this rule change would be suggestive, by analogy, that prompt settlement within the meaning of Rule 14e-1(c) might be read to require an equivalently shortened settlement cycle for tender offers.

29 Rule 14e-1(d) under the Exchange Act. In the context of foreign offers made in accordance with home country requirements, the SEC has granted relief from the extension announcement requirements where there is a conflict between SEC regulations and the securities laws of another nation. *See VimpelCom Ltd*. (avail. Feb. 5, 2010) (Russia); *EGS Acquisition Co. LLC* (avail. Nov. 5, 2008) (Philippines).

30 Rule 14e-2 under the Exchange Act. The SEC will not generally enforce Rule 14e-2 against a foreign target company unless the company has a separate obligation, as a result of the Exchange Act registration of the target securities, to take a position regarding the tender offer. *See* the discussion of Rule 14d-9 under the Exchange Act in the text accompanying *infra* Notes 118-120.

31 In practice, Rule 14e-8 tends to be enforced only in egregious situations. *See, e.g.*, *SEC v. Weintraub*, 2011 WL 6935280 (S.D. Fla. Dec. 30, 2011).

32 Although withdrawal rights are not generally required in "Regulation 14E-only" exchange offers, in order to commence an exchange offer that is registered under the Securities Act prior to effectiveness of the related registration statement, the offeror must provide withdrawal rights to the same extent as would be required if the exchange offer were subject to the requirements of Rule 13e-4 or Rules 14d-1 through 14d-11 even if those rules do not apply by their terms. *See* Rule 162 under the Securities Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 9.03, REPURCHASES OF EQUITY 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 § 9.03 (11th and 12th Editions 2014-2017)
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[1] Open Market Repurchase Programs for Equity Securities

[a] Insider Trading Considerations

Purchases of equity securities by an issuer are subject to the general prohibitions against insider trading contained in the U.S. federal securities laws, particularly Rule 10b-5 under the Exchange Act. [33] An issuer may be, or may be alleged to be, in violation of these prohibitions if it purchases any equity securities (either as part of an established program (other than a 10b5-1 plan as described below in § 9.03[1][b][iii]) or in an isolated transaction) prior to the public announcement of information about the issuer that might reasonably be expected to have a positive effect on the price of such securities. Accordingly, an issuer should either (i) disclose any such nonpublic information before initiating a repurchase program or (ii) refrain from repurchasing securities (other than with respect to purchases made by an agent on its behalf in accordance with an established 10b5-1 plan) when corporate developments (for example, developments regarding litigation matters, major new clients, acquisitions or divestitures) have occurred that may be reasonably likely to cause the price of the securities to increase but have not yet been announced to the public. There are four measures many issuers take to reduce the risk that repurchases of securities may be claimed to violate the prohibition against insider trading.

[b] Reducing the Risk of Violating Prohibitions on Insider Trading

[i] *Verification Procedures*

Many issuers establish an internal procedure under which an officer or committee is expressly charged with monitoring when repurchases may be conducted or when they should be suspended, for example due to an emerging, but as of yet undisclosed, development. Practices in this respect vary widely and should be tailored to an issuer's other internal procedures for compliance and risk management.

[ii] *Window Periods*

Many issuers limit repurchases to regular "window periods" tied to the release of interim and annual earnings reports and other material information and the public filing of such information with the SEC and any relevant securities

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exchange. This approach is not mandatory under U.S. securities law, but it is widely used. An issuer that takes a more ad hoc approach should be sure that it has robust verification procedures. Typically a window period begins when two full trading days (or in some cases, one full trading day) have passed after the release of earnings (or other material information), in order to ensure that the information has effectively reached the market. Practices vary more widely as to when the window period closes, but typically an issuer will cease repurchases at some point before the release of earnings each quarter when it has begun to develop knowledge of its performance for the period. In any case, an issuer will immediately close a window period and cease repurchasing upon acquiring any material nonpublic information.

[iii] *10b5-1 Plans*

Rule 10b5-1 under the Exchange Act provides an affirmative defense against insider trading liability for transactions conducted under a "contract, instruction or plan" that meet certain conditions designed to ensure that the transactions are not made on the basis of material nonpublic information. [34] Issuers often establish a Rule 10b5-1 trading plan to better shield repurchases, including repurchases intended to comply with Rule 10b-18 under the Exchange Act (described below), from potential insider trading liability and to permit repurchase programs to continue following the close of window periods.

In a typical 10b5-1 repurchase plan, the issuer gives instructions to a broker, at a time when it has no material nonpublic information, to conduct repurchases pursuant to specific parameters, and the broker then conducts repurchases pursuant to those instructions without any further issuer involvement.

[iv] *Accelerated Share Repurchase Transactions*

Accelerated share repurchase ("ASR") transactions vary in their details and complexity, depending on an issuer's objectives. Under a simple ASR, the issuer enters into a contract with a bank, under which the bank delivers shares to the issuer at inception in exchange for payment by the issuer of the amount the issuer wants to spend to effect repurchases. At final settlement, the bank may deliver additional shares to the issuer or the issuer may deliver shares or cash to the bank, with the amount of the delivery generally determined by comparing the number of shares the bank originally delivered to a number of shares equal to the amount initially paid by the issuer divided by the average market price of the issuer's shares during the contract term.

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The bank would typically borrow shares from lenders for the initial delivery to the issuer, and during the contract term, the bank would typically purchase shares in the open market to return to securities lenders and for any further delivery to the issuer at settlement.

An ASR has the advantage of allowing the issuer to retire the shares it receives at the inception of the transaction. However, it also requires an upfront cash outlay, and depending on the structure, an issuer may be required to return shares or pay an additional amount at settlement. In addition, it is difficult to suspend once launched.

ASRs are typically structured to qualify as 10b5-1 plans on the basis that market purchase decisions are made by the bank without the involvement of the issuer. [35] Although the issuer's repurchases under an ASR and the bank's related market activity are not eligible for the Rule 10b-18 safe harbor (discussed in § 9.03[1][d]) [36], ASRs are often structured consistent with many of the safe harbor's requirements.

[c] Disclosure

[i] *Form 20-F Issuer Repurchase Disclosure Requirements*

The SEC requires that periodic and annual reports, including Form 20-F, disclose information on issuer repurchases in a tabular format. [37] This disclosure requirement covers all repurchases of equity securities registered under § 12 of the Exchange Act for the relevant period, generally including the total number of securities purchased (reported on a monthly basis), the average price paid per security, the total number of securities purchased as part of a publicly announced repurchase plan or program and the maximum number (or approximate dollar value) of securities that could yet be purchased under such plans or programs. [38]

[ii] *Exchange Requirements*

An issuer with securities listed on the NYSE is required to notify the NYSE in connection with its repurchase or disposal of issued and listed securities within

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ten days after the close of the fiscal quarter in which the repurchases occur. [39] The notice must state the total amount of shares repurchased during that quarter and the balance held by the issuer at the end of the quarter. If there are both repurchases and dispositions of securities during a quarter, both the total amount reacquired and the total amount disposed of should be disclosed. However, the NYSE has indicated that foreign issuers with listed ADRs will not separately need to furnish notification of repurchases of their ADRs. If securities that were previously repurchased are subsequently resold, an issuer is required to provide notice to NYSE of its plans to increase the outstanding amount of listed securities. [40]

Nasdaq does not have a similar notification obligation in connection with repurchases of securities. However, it would typically require pre-notification in the event that an issuer determined to issue a press release or make an SEC filing regarding a repurchase program, [41] and might separately require notification (no later than ten days after the occurrence) of any aggregate decrease of any class of securities listed on Nasdaq that exceeds 5% of the amount of securities of the class outstanding. [42]

[d] Market Manipulation Considerations and Rule 10b-18

If an issuer repurchases its equity securities on the open market, it must ensure that such purchases do not involve fraudulent or manipulative practices. Rule 10b-18 under the Exchange Act [43] provides a nonexclusive, limited safe harbor from liability for manipulation under §§ 9(a)(2) and 10(b) of the Exchange Act [44] in connection with purchases of common equity securities in the market

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by or for issuers or affiliated purchasers [45] so long as they adhere to the following requirements of Rule 10b-18: [46]

Manner: On any given day, all bids and repurchases by the issuer and its affiliated purchasers must be made through only one broker or dealer. The single broker or dealer restriction does not, however, apply to repurchases that were not solicited by or on behalf of the issuer or its affiliated purchasers.

Timing: On any given day, repurchases by the issuer and its affiliated purchasers must not: (a) constitute the opening transaction, (b) for a security that has an ADTV [47] of at least $1 million and a public float value of at least $150 million, be made during the 10 minutes before the scheduled close of the primary trading session in the security's principal market, and during the 10 minutes before the scheduled close of the primary trading session in the market where the purchase is made, and (c) for all other securities, be made during the 30 minutes before the scheduled close of the primary trading session in the security's principal market, and the 30 minutes before the scheduled close of the primary trading session in the market where the purchase is made. This timing provision does not apply for a certain period following a market-wide trading suspension.

Volume: On any given day, the total volume of repurchases by the issuer and its affiliated purchasers must not exceed 25% of the purchased security's ADTV. However, once every calendar week, in lieu of purchasing under 25% of

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the ADTV limit for that day, the issuer or an affiliated purchaser is permitted to effect one "block" [48] purchase, provided that no other purchases under Rule 10b-18 are effected that day and the block purchase is not included when calculating the security's four-week ADTV. During the trading session following a market-wide trading suspension, this volume provision is modified to permit repurchases not exceeding 100% of the ADTV for the security.

Price: The issuer and its affiliated purchasers must not repurchase securities at a price that exceeds the highest independent bid or the last independent transaction price (whichever is higher) quoted or reported in the consolidated system at the time the purchase is made.

A failure to meet any one of the four conditions by the issuer and any affiliated purchasers on any day will result in the loss of the safe harbor for all repurchases made on that day.

Rule 10b-18's safe harbor is unavailable for issuer repurchases effected (i) during the restricted period under Regulation M [49], (ii) as a purchase of a fractional interest in a security evidenced by a script certificate, order form, or similar document, (iii) pursuant to Rule 13e-1 during a third-party tender offer [50] or (iv) pursuant to a tender offer subject to Rule 13e-4 (or specifically excepted from Rule 13e-4) under the Exchange Act [51] or § 14(d) of the Exchange Act [52]. In addition, except as described below, Rule 10b-18's safe harbor is unavailable for repurchases during the period from the time of public announcement of a merger, acquisition or similar transaction involving a recapitalization [53] until the earlier of the completion of such transaction or the completion of the vote by target shareholders. In order to allow certain ordinary course repurchases not related to the merger (or other covered transaction) during this period, the exclusion from the Rule 10b-18 safe harbor does not apply to purchases effected after the announcement of a merger (or other covered transaction) so long as the total amount of the issuer's repurchases effected on any single day does not exceed

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the lesser of 25% of the security's ADTV and the issuer's average daily purchases under Rule 10b-18 during the three full calendar months preceding the date of the announcement of the merger (or other covered transaction) and certain other conditions are met. [54] In addition, the issuer may effect a block purchase pursuant to paragraph (b)(4) of Rule 10b-18, provided that the issuer does not exceed the average size and frequency of block purchases effected during the three full calendar months preceding the date of the announcement of such transaction.

Although Rule 10b-18 is a nonexclusive safe harbor, and in theory there are other ways for an issuer to make nonmanipulative repurchases, issuers may be reluctant to conduct such repurchases without the benefit of Rule 10b-18's protection. It should be noted that the Rule 10b-18 safe harbor applies only to repurchases effected in the United States and not to repurchases effected in markets outside the United States.

[2] Issuer Tender Offers for Equity Securities

A company, including a foreign company, that repurchases its securities from U.S. residents is subject to regulation under the Williams Act if its repurchases rise to the level of a tender offer. [55] Additionally, disclosure in connection with repurchases of securities is subject both to Rule 10b-5 under the Exchange Act, in terms of completeness and accuracy, and to §§ 9(a)(2) and 10(b) of the Exchange Act, in terms of possible market manipulation. [56]

The Exchange Act provisions that the Williams Act introduced impose special obligations in the context of tender offers for equity securities. [57] These are additional to the requirements that apply to tender offers in general. While § 14(e) and Regulation 14E under the Exchange Act (which include an antifraud provision and various procedural requirements for tender offers) apply to all tender offers, [58] §§ 14(d) and 13(e) of the Exchange Act and the rules promulgated under them apply only to tender offers for equity securities. Section 14(d) and the rules thereunder apply in the context of third-party equity tender offers (which are discussed in § 9.05). Those rules, however, do not apply to issuer self-tenders for equity securities, which are instead governed by § 13(e) and

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Rule 13e-4 thereunder generally, and Rule 13e-3 insofar as an issuer tender offer may result in the issuer "going private."

Rule 13e-4, which substantially parallels the rules for third-party tenders under § 14(d), applies to any tender or exchange offer by an issuer with a class of equity securities registered under § 12 of the Exchange Act for its own equity securities (whether or not the subject class is itself so registered). [59] Rule 13e-4 imposes substantial filing and disclosure obligations on the issuer. When an issuer that has equity securities registered under the Exchange Act makes a tender offer for any class of its equity securities (whether or not registered under the Exchange Act), it is required by Rule 13e-4(b)(2) to file with the SEC, as soon as practicable on the day that the tender offer commences, a statement on Schedule TO providing disclosure about, *inter alia*, the terms of the offer, the issuer, the securities sought, the source of the funds used to purchase the securities, the purpose of the offer and, if material, the financial condition and results of the issuer. The issuer must also disseminate certain information to the holders of the securities for which the offer is made and comply with certain procedural rules relating to the timing of the offer, withdrawal of tendered securities by their holders, pro rata acceptances of tendered securities and payment of the best price to all tendering holders. [60] In addition, before an issuer may purchase, by way of tender offer or otherwise, any of its equity securities (whether or not registered under the Exchange Act) while a third-party's tender offer for equity securities of the issuer that are registered under the Exchange Act is outstanding, the issuer must file certain additional information with the SEC. [61]

Rule 13e-3 under the Exchange Act imposes additional requirements, beyond those set out in Rule 13e-4, on certain issuer self-tenders for equity securities (generally referred to as "going private transactions"). Under Rule 13e-3, any issuer that has registered a class of equity securities under the Exchange Act and that purchases or makes a tender offer for any of its equity securities (and any affiliate of such an issuer that makes such purchase or offer) will be subject to additional restrictions if the purchase or tender offer has a reasonable likelihood of causing, or is intended to cause, (i) the class of equity securities to cease to be registered under the Exchange Act, (ii) such issuer's periodic reporting

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obligations under the Exchange Act to be suspended or terminated or (iii) the class of equity securities, if listed on a national securities exchange, to cease to be so listed. [62] The issuer (or affiliate) must file with the SEC a statement on Schedule 13E-3, which requires disclosure about, *inter alia*, the terms of the offer, the issuer or affiliate, the subject company, the securities sought, the source of funds used to purchase the securities, the purpose of the offer, alternatives to the transaction and the fairness of the transaction. The issuer (or affiliate) must also include most of the Schedule 13E-3 information in any related registration statement or tender offer disclosure document distributed to holders of the securities. [63] These requirements do not apply to certain transactions (i) by a person that became an affiliate of the issuer as a result of a tender offer within the prior year or (ii) involving an exchange of equivalent securities. [64]

One area in which the SEC staff has approved significant relief from Williams Act provisions governing issuer self-tenders relates to the use of a formula to price a tender offer. An issuer is generally required to specify a fixed price for the subject securities over the 20-business day period during which a tender offer must remain open under the Williams Act, [65] and to hold the offer open for at least 10 business days following any change in the consideration offered or the percentage of the subject class that is sought for purchase. [66] In a series of no-action letters over the years, the SEC staff has permitted the use of formula pricing mechanisms based on average trading data over a specified period of time to determine offer consideration. The SEC staff first permitted formula pricing to be used for equity tender offers in the context of third-party exchange offers for equity securities, pursuant to the no-action letter it issued *Lazard Freres & Co.* (avail. Aug 11, 1995). [67] This relief was subsequently extended to issuer cash offers in a letter for *TXU Corp.* (avail. Sept. 13, 2004), where the staff granted no-action relief relating to Rules 13e-4(d)(l), 13e-4(f)(l)(ii) and 14e-1(b) when TXU used a pricing formula to determine the purchase price it offered for its outstanding equity-linked securities and convertible notes. [68]

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Conditions to reliance on the no-action letters permitting formula pricing for issuer self-tenders for equity securities generally include that: (1) the offer document discloses the pricing mechanism for determining the final consideration; [69] (2) the trading price of the subject securities is closely correlated to the trading price of the reference common stock; [70] (3) the issuer's common stock is listed on a national securities exchange; (4) the formula is fixed throughout the offer period and tied to the volume weighted average trading prices of the relevant common stock over a specified period; (5) the offer materials disclose a minimum and maximum offer price; (6) if there is a change in the formula or in the minimum and maximum price, the offer will remain open for at least 10 business days; (7) the daily indicative calculated purchase prices per subject security are published on a webpage and a toll-free number is provided for securityholders to obtain pricing related information; (8) printed materials for withdrawal are made available and procedures for withdrawal are disclosed in the offering materials; and (9) the final price is published on the offer webpage and in a press release at the time specified.

Historically, the SEC staff has held the view that there should be a two-day window between determination of the final price (through application of the pricing formula announced at the launch of the offer) and the expiration of the offer, so that the final price would be required to be determined no later than the 18th business day of a 20-business day tender offer. [71] The staff has also favored an averaging period of no less than 10 trading days for determining the reference price used in the pricing formula. [72] The SEC staff has become more flexible on these parameters over time, issuing no-action relief in respect of structures in which the final price is determined on the expiration date for the tender offer [73]

and structures utilizing a three trading day averaging period to determine the reference price used in the pricing formula. [74]

Other notable relief has been granted in the context of issuer self-tenders relating to employee compensation. The SEC has issued an exemptive order regarding employee stock option exchanges that permits issuers to make such exchange offers in order to reprice outstanding employee stock options without complying with the rules requiring tender offers to be extended to all securityholders of a class at the same price. The order contains conditions designed to ensure that this relief is only given in the context of compensatory offers and that adequate disclosure is provided to employees. [75] Similar relief has been extended on a case-by-case basis to issuer tender offers for compensatory purposes, such as where the issuer seeks to repurchase "out of the money" employee stock options that are not expected to regain value. [76] The SEC staff has provided relief from prompt payment requirements in such offers where consideration included a deferred right to cash payment contingent on continued employment. [77]

Footnotes

33 *See* §§ 11.05[2][a] and 4.10[1].

34 *See* §§ 5.05[7] and 11.05[2][a][i].

35 If the ASR provides the issuer an option the exercise of which might affect the bank's market activity, the bank may require the issuer to represent it has no material nonpublic information as a condition to exercising that option.

36 SEC, Division of Market Regulation, Answers to Frequently Asked Questions Concerning Rule 10b-18 ("Safe Harbor" for Issuer Repurchases) (Nov. 17, 2004), Question 13.

37 There is no U.S. federal securities law requirement to disclose issuer share repurchases on a more current basis. However, many issuers routinely disclose the adoption of programs for repurchase of their shares in press releases in the interest of informing the market of their share repurchase plans.

38 Item 16E of Form 20-F.

39 NYSE Listed Company Manual § 204.25.

40 NYSE Listed Company Manual § 204.20.

41 NASDAQ Marketplace Rules, Rule 5250, NASDAQ Manual.

42 NASDAQ Marketplace Rules, Rule 5250(e), NASDAQ Manual

43 17 C.F.R. § 240.10b-18. *See also* Securities Exchange Act Release No. 19244 (Nov. 17, 1982), 47 Fed.

Reg. 53,333, 53,334 (Nov. 26, 1982).

44 Some repurchase activity that meets the safe harbor conditions may still violate the antifraud and anti-manipulation provisions of the Exchange Act. "[R]egardless of whether an issuer's repurchases technically satisfy the conditions of the Rule, the safe harbor is not available if the repurchases are fraudulent or manipulative, when viewed in the totality of the facts and circumstances surrounding the repurchases (*i.e.*, facts and circumstances in addition to the volume, price, time, and manner of the repurchases)." *See* SEC Release No. 34-48766 (Nov. 10, 2003), 68 Fed. Reg. 64,952, 64,953 n.5 (Nov. 17, 2003). *See also SEC v. Wachovia Corp.*, SEC Litigation Release No. 18958 (Nov. 4, 2004). In connection with First Union Corp.'s stock-for-stock friendly bid for Wachovia Corp. in 2001, both First Union Corp. and Wachovia Corp. carried out significant purchases of First Union Corp. stock during May and June 2001, including, in particular, following the making of a competing hostile offer by SunTrust Banks Inc. Neither First Union nor Wachovia disclosed the repurchases until after the shareholders voted on the merger, when Wachovia disclosed the repurchases in its second quarter Form 10-Q. On November 4, 2004, without admitting or denying any allegations in the SEC's complaint, Wachovia consented to entry of a judgment alleging violations of §§ 13(a) and 14(a) of the Exchange Act and Rules 12b-20, 13a-13 and 14a-9 thereunder, enjoining Wachovia from future violations of the federal securities laws and requiring Wachovia to pay a $37 million penalty. In discussing the judgment, the SEC cited its 2003 Rule 10b-18 release. The SEC argued that Wachovia knew that its First Union purchases could have had the effect of supporting the price of First Union common stock and making the offer appear more attractive to Wachovia shareholders.

For a discussion of §§ 9(a)(2) and 10(b) of the Exchange Act in the context of market manipulation, *see* § 11.05[3].

45 Rule 10b-18(a)(3). An affiliated purchaser is a person acting, directly or indirectly, in concert with an issuer for the purpose of acquiring the issuer's securities or an affiliate of the issuer who, directly or indirectly, controls the issuer's purchases or whose purchases are controlled by or under common control with those of the issuer. However, an affiliated purchaser does not include (i) any broker, dealer or other person solely by reason of its effecting purchases on behalf of the issuer or for its account, or (ii) an issuer's officer or director solely by reason of such person's participation in the decision to authorize purchases by or on behalf of the issuer.

46 Rule 10b-18(b)(1)–(4). Purchases pursuant to Rule 10b-18 do not include purchases effected by or for an issuer plan by an agent independent of the issuer (as defined in Rule 100(b) of Regulation M) and, as a result, do not need to be taken into account for compliance with these requirements. If an issuer plan will be making purchases in the market, it is important for the issuer to determine whether or not the person directing those purchases would be considered an agent independent of the issuer for purposes of both Rule 10b-18 and Regulation M. *See* § 3.02[9][a].

47 "ADTV" is defined in Rule 10b-18(a)(1) as the average daily trading volume reported for the securities during the four calendar weeks preceding the week in which the purchase under Rule 10b-18 is to be effected.

48 "Block" is defined in Rule 10b-18(a)(5) and, in general, (i) has a purchase price of U.S. $200,000 or more, (ii) is at least 5,000 shares and has a purchase price of at least U.S. $50,000, or (iii) is at least 20 "round lots" of the security and totals 150 percent or more of the trading volume of the security, or, in the event that trading volume data is unavailable, is at least 20 "round lots" of the security and totals at least one-tenth of one percent of the outstanding shares of the security, exclusive of any shares owned by an affiliate.

49 *See* § 3.02[9] for a discussion of Regulation M under the Exchange Act generally.

50 *See* § 9.05[2][b].

51 *See* § 9.03[2].

52 *See* § 9.05[1].

53 This exclusion does not apply to repurchases during a merger, acquisition or recapitalization in which the consideration is solely cash and there is no valuation period. Rule 10b-18(a)(13)(iv)(A) under the Exchange Act.

54 Rule 10b-18(a)(13)(iv)(B) under the Exchange Act.

55 Significant relief from the rules referenced in this paragraph as applied to cross-border tender offers (embodied in the 2008 Cross-Border Amendments) is discussed in § 9.05[9].

56 *See* § 9.03[1].

57 Convertible debt securities are equity securities for purposes of the Exchange Act pursuant to § 3(a)(11), and tender offers for them will thus be subject to the additional provisions of the Williams Act that apply to equity securities.

58 Excepting Rule 14e-5, which applies solely to tender offers for equity securities. Section 14(e) and Regulation 14E are discussed in § 9.02[2].

59 Thus, for example, a tender offer for convertible bonds originally sold on an exempt basis under Regulation S and Rule 144A under the Securities Act would nevertheless be subject to Rule 13e-4 if the issuer of those bonds has a class of equity securities registered under the Exchange Act (as convertible bonds constitute "equity securities" within the meaning of § 3(a)(11) of the Exchange Act), even though the bonds themselves are not so registered.

An affiliate that makes a tender offer for a class of the issuer's registered equity securities will be subject to the provisions of § 14(d) of the Exchange Act and Regulation 14D thereunder rather than the rules for issuer self-tenders. *See* the discussion of those provisions in § 9.05[1].

60 Rule 13e-4(f) under the Exchange Act.

61 Rule 13e-1 under the Exchange Act.

62 Rule 13e-3(a)(3) under the Exchange Act. *See* the discussion of termination of Exchange Act registration under Rule 12h-6 in § 5.05[9].

63 Rule 13e-3(e) under the Exchange Act.

64 Rule 13e-3(g) under the Exchange Act. Even if an issuer satisfies these going private requirements of the Exchange Act (and, if applicable, the self-tender rules), it would have to comply with exchange requirements to delist shares from an exchange. *See* § 4.11.

65 Rules 13e-4(d)(1), 13e-4(f)(1)(i) and 14e-1(a) under the Exchange Act.

66 Rules 13e-4(f)(1)(ii) and Rule 14e-1(b).

67 *See also* staff letters for *AB Volvo* (avail. May 16, 1997) and *Epicor Software Corporation* (avail. May 13, 2004).

68 *See also* staff letters for issuer cash tender offers to purchase convertible notes in *GenCorp Inc*. (avail. Dec. 19, 2014), *Group 1 Automotive* (avail. May 16, 2014), *CNO Financial Group, Inc.* (avail. Feb. 11, 2013), *Textron, Inc*. (avail. Oct. 7, 2011), and for combined cash and common stock offers for convertible notes in *Sonic Automotive, Inc*. (avail. July 24, 2012) and *American Equity Investment Life Holding Company* (avail. Aug. 23, 2013).

Note that while the line of staff letters pertaining to pricing formulas for setting exchange ratios often involve common stock, those pertaining to issuer cash tender offers relate only to convertible debt.

69 In the case of cash tenders, the offer document typically also includes an illustrative table showing calculations of the purchase price.

70 Use of a third party's common stock as a reference for formula pricing (rather than the issuer's own common stock) has been approved under appropriate circumstances. *See*, *e.g.*, *The Procter & Gamble Company Exchange Offer* (avail. Sept. 1, 2016) and *Lockheed Martin Corporation* (avail. July 11, 2016) (using proxy pricing based on the common stock of other party to merger agreement).

71 The structure was first given relief in *Lazard Freres & Co.* (avail. Aug. 11, 1995).

72 *Lazard Freres & Co.* (avail. Aug. 11, 1995). *See also BBVA Privanza International (Gibraltar) Limited* (avail. Dec. 23, 2005), *TXU Corporation* (avail. Sept. 13, 2004), *Epicor Software Corp*. (avail. May 13, 2004) and *AB Volvo* (avail. May 16, 1997).

73 First seen in no-action letters for *McDonald's Corporation* (avail. Sept. 27, 2006) and *Weyerhaeuser Company* (avail. Feb. 23, 2007). For more recent use, *see The Dow Chemical Company* (avail. Sept. 2, 2015), *PHH Corporation* (avail. June 12, 2015), and *Weyerhaeuser Company* (avail. June 26, 2014).

74 *See, e.g.*, *The Procter & Gamble Company Exchange Offer* (avail. Sept. 1, 2016), *Lockheed Martin Corporation* (avail. July 11, 2016), *Weyerhaeuser Company* (avail. Feb. 23, 2007), and *Kraft Foods Inc.* (avail. July 1, 2008); *see also McDonald's Corporation* (avail. Sept. 27, 2006) (using a two-day averaging period).

75 *See* SEC, Division of Corporation Finance, Issuer Exchange Offers Conducted for Compensatory Purposes (Mar. 21, 2001).

76 *See, e.g.*, *Microsoft Corp.* (avail. Oct. 14, 2003), *Martha Stewart Living Omnimedia, Inc.* (avail. Nov. 7, 2003) and *Comcast Corp.* (avail. Oct. 7, 2004).

77 *See, e.g.*, *Microsoft Corp., Martha Stewart Living* and *Microtune, Inc.* (avail. Sept. 13, 2007); *see also CNET Networks, Inc.* (avail. Feb. 28, 2007) (cash payment deferred to avoid potential adverse tax consequences).

U.S. Regulation of the International Securities and Derivatives Markets, § 9.04, LIABILITY MANAGEMENT

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 § 9.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Introduction

Liability management is an umbrella term describing a family of transactional tools used to manage the ongoing contractual obligations of an issuer with respect to its existing debt securities. These tools include consent solicitations, open market purchase programs, cash tender offers and exchange offers.

The degree to which a given liability management transaction is regulated depends largely on whether it (1) involves the issuance of a new security and thus requires compliance with, or exemption from, the registration requirements of the Securities Act, [78] and (2) is a "tender offer" under the Williams Act. As discussed above in § 9.02, the Williams Act imposes significant restrictions on transactions that qualify as "tender offers" under that act, with certain provisions

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(including the act's general antifraud provision and regulations relating to the duration of offers) applying to all tender offers and other provisions (including provisions requiring the filing of disclosure on Schedule TO) applying only to certain tender offers in respect of equity securities.

[2] Consent Solicitations

The terms of most debt securities allow modification and amendment with the consent of the holders of a specified percentage of those securities. The customary way to obtain consents in respect of widely held debt securities is through a consent solicitation. The issuer generally prepares a consent solicitation statement, outlining the provisions to be modified, and circulates it to the holders. In most cases, the holders are offered a consent fee in exchange for agreeing to the proposed modification. A consent solicitation may be combined with a cash tender offer (creating an "exit tender") or with an exchange offer (creating an "exit exchange").

Consent solicitations are generally lightly regulated, although they may be subject to common law requirements of good faith and fair dealing as well as state antifraud provisions. [79] In two prominent decisions, the Delaware Court of Chancery (construing New York law) indicated in dictum that failure to extend a consent solicitation related to an exit tender to all holders, thereby giving all interested holders the ability to receive the related fee, could violate the covenant of good faith and fair dealing that is implied under New York law. [80] A subsequent decision of that court, however, held that such payments are permissible (at least under the circumstances presented in that case). [81] The English High Court, in contrast, has construed analogous common law principles as applied under English law to prohibit exit tenders whose terms have coercive effect. [82] While contemporary English cases have no precedential effect for U.S. purposes, this decision could nonetheless have persuasive value for future U.S. plaintiffs challenging the terms of particularly aggressive exit tenders.

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Additional considerations affecting the structuring of a consent solicitation arise in the context of debt securities issued under an indenture that has been qualified under the Trust Indenture Act (or that contains a contractual provision equivalent to the provision of the Trust Indenture Act described below, as is common in debt offerings in the Rule 144A market). In *Marblegate Asset Management v. Education Management Corp.*, [83] the U.S.

District Court for the Southern District of New York gave an expansive interpretation to the prohibition within § 316(b) of the Trust Indenture Act against "impairment," without the consent of all affected holders, of the holders' right "to receive payment of the principal of and interest on [a qualified] indenture security, … or to institute suit for the enforcement of any such payment." Marblegate involved a debt restructuring outside bankruptcy in which a majority of holders tendered their existing notes with an exit consent to modifications including release of the collateral for the subject class of securities, substantially reducing the likelihood, as a factual matter, that securities of the subject class that were not exchanged would ultimately be repaid. [83.1] Although no term explicitly governing the right of the holders to receive interest or principal on a certain date was modified, the court nonetheless held that the restructuring had violated § 316(b) by effectively undercutting the protections that would make such payment occur in practice. In response to the *Marblegate* decision and another Southern District decision applying similar analysis, [84] 28 law firms issued an opinion white paper noting that the cases "contain language that suggests a significant departure from the widely understood meaning of Trust Indenture Act § 316(b) that has prevailed among practitioners for decades" and laying out guidelines for rendering legal opinions in light of that development. [85] On January 17, 2017, the Second Circuit Court of Appeals (the "Second Circuit") overturned the *Marblegate* decision.

Consideration of the so-called new security doctrine also may affect the structuring of a consent solicitation. If the modifications sought in a consent solicitation would be so fundamental as to effectively create a new "security" for purposes of the Securities Act, the transaction will be regulated as a deemed exchange offer rather than being subject only to the light regulatory regime applicable to consent solicitations. [86] Treatment of a consent solicitation as a deemed offer to exchange (x) the security as modified by the proposed amendments for

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(y) the outstanding security in its existing form results in the need for registration under, or exemption from, the Securities Act and compliance with the Trust Indenture Act. Additionally, if the existing security is widely held, a consent solicitation that is treated as a deemed exchange offer would generally become subject to regulation as a tender offer under the Williams Act. Existing guidance on the new security doctrine is limited and does not establish a bright line for what changes transform a consent solicitation into a deemed exchange offer. In general, however, amending covenants that do not affect basic financial terms (such as the principal amount, interest rate, redemption premium and maturity) should not create a deemed exchange, while amendments to the basic financial terms generally should. [87]

[3] Open Market Purchase and Privately Negotiated Buy-Back Programs for Debt Securities

Purchases of debt securities in open market transactions or privately negotiated buy-back programs can be used to accumulate substantial positions in a debt security (or to retire a substantial portion of the amount outstanding, in the case of purchases by the issuer) without triggering the tender offer provisions of the Williams Act so long as the purchases are made in accordance with appropriate procedures. Open market purchase programs are typically implemented by the acquiring party (most commonly the issuer) giving instructions to a broker-dealer to purchase a limited amount of debt securities at prevailing market prices in accordance with stipulated procedures and limits. The broker will typically post bids on a screen based trading system, but to limit the risk that an open market purchase program will be treated as a "creeping," or de facto, tender offer, the program will include a limitation on the percentage of the subject securities to be purchased, limitation of the bid price to within the prevailing bid and ask spread and the exclusion of publicity and of cross conditioning of purchases. Other than posting bids, the broker's role in an open market program is necessarily passive and such programs typically result in relatively small purchases (less than 25%) of the outstanding debt of the target series. Privately negotiated buy-back programs include a more active role by the broker, generally including direct calls to a small number of holders. Due to the active inquiries by the broker, additional limitations are typically imposed to prevent the occurrence of a tender offer. The calls are limited to a small number of holders having great sophistication (such as qualified institutional buyers within the meaning of Rule 144A under the Securities Act), a limit on the percentage of a

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series that may be purchased and exclusion of publicity and of cross conditioning of purchases. Because, as discussed above, the SEC has not defined the term "tender offer" and evaluation of whether a tender offer is present is based on facts and circumstances, [88] the procedures applied to an individual open market purchase program or buy-back program require specific analysis based on the relevant facts.

[4] Cash Tender Offers for Debt Securities

As discussed above, a cash tender offer for nonconvertible debt securities is subject to regulation under Regulation 14E under the Exchange Act, imposing requirements (modified as described below) including a minimum 20 business day duration and the requirement that the offer remain open for at least 10 business days following any change in the consideration offered or the percentage of the subject class that is sought for purchase. [89] A cash tender offer does not, however, require procedures limiting execution of the kind necessary for buy-back programs (described in § 9.04[3]). Cash tender offers for nonconvertible debt securities are typically made to all holders (although making the offer to all holders is not required unless relying on relief that is conditioned on an offer to all holders or tendering for a security the terms of which require that any offer be made to all holders).

Given the dynamics of market pricing of debt securities (which generally trade on the basis of a constantly changing reference rate, such as a benchmark U.S. Treasury security rate or LIBOR, plus a spread to reflect credit quality), it is difficult, as a practical matter, to hold an offer to purchase debt securities open for 20 business days at a given price, extending as necessary to ensure the offer remains open for at least 10 business days after any change in the price offered. To respond to this difficulty, beginning in 1990 the SEC staff issued a series of no-action letters allowing "short-dated" tenders for debt securities, executed on a shorter time frame and with floating pricing. On January 23, 2015 the SEC staff issued a no-action letter (the "short-dated tender offer relief letter") revising and harmonizing its previous guidance and indicated that previous no-action letters regarding short-dated tenders were superseded. [90] The short-dated tender offer relief letter allows issuers, and in some cases their affiliates, to hold a tender offer for the issuer's debt securities open for only five business days rather than

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the 20 business days specified by Rule 14e-1 under the Exchange Act and to base the consideration offered on a fixed spread to a benchmark rate. Conditions to the relief, which applies only to tender offers for debt securities made by the issuer or an affiliate that qualifies under the letter's terms, include immediate widespread dissemination of the offer on a timely basis, tender for any-and-all outstanding subject securities (*i.e.*, without any limit on who may participate or the maximum amount to be accepted), provision of required withdrawal rights, no use of early or rolling settlement, no use of a contemporaneous consent solicitation (a so-called exit consent), the lack of an existing default, event of default or bankruptcy or restructuring event, timely announcement of changes to the offer and the offer consideration, provision of a "guaranteed delivery" mechanism that allows a certifying holder to deliver a notice during the offer period and deliver the subject securities by the close of business on the second business day after expiration of the offer, and no use of indebtedness that is effectively senior to the subject securities (whether as a result of ranking, structural subordination or shorter weighted average life to maturity) to finance the offer. Additionally, if the issuer is a reporting company, it must furnish the press release announcing the offer on a Form 8-K with the SEC prior to noon, Eastern time, on the first business day of the offer. Although filing obligations of reporting foreign private issuers are not addressed in the incoming letter to the SEC staff, the SEC staff has subsequently clarified that those issuers should furnish announcement press releases on Form 6-K within the foregoing time frame. [91] Cash tender offers pursuant to the short-dated tender offer relief letter must be made to all record and beneficial holders in order to qualify for relief under the short-dated tender offer relief letter.

The conditions enumerated in the short-dated tender offer relief letter limit the circumstances under which it may be relied upon. In particular, tender offers that include a consent solicitation, are made to less than all holders or for less than the full outstanding amount of the subject securities, or that are made by third parties that are not a qualifying affiliate of the issuer do not benefit from the letter.

One alternative approach to tender offers for debt securities that would not fall within the short-dated tender offer relief letter that effectively shortens the period of market risk for the issuer involves the use of an early tender fee. Because Regulation 14E does not require that all holders that accept a tender offer receive the same price for their securities, [92] the bidder can offer holders that accept a tender offer prior to a set time preceding the expiration of the offer an

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"early tender premium." By encouraging early participation, an early tender fee effectively shortens the time a bidder must wait for meaningful evidence of the level of participation in the offer (and thus of the potential need to amend) and limits the period during which market prices might undercut the offer's success. Given the requirement that a tender offer must be open for at least 10 business days following any change in the consideration offered, tender offers that provide for an early tender fee customarily set the deadline for tenders eligible to receive that fee at the 10th business day of a 20-business day offer (this is sometimes referred to as a 10/10 structure). In a similar vein, tender offers with an exit consent often include a deadline (also generally the 10th business day of a 20-business day offer) by which tenders must be received in order to be eligible to receive a consent fee (subject to extension if the requisite consents necessary to approve the proposed amendments are not received prior to the initial deadline).

Another alternative approach to tender offers for debt securities that would not fall within the short-dated tender offer relief letter that involves a shorter period of market risk for the issuer is a tender offer that is open for 20 business days, during which time the price floats for the first 18 business days and is fixed for the last two business days (that is, expressed as a fixed spread over U.S. treasuries to be set after the close on the 18th day). Although this structure does not comply with the requirements of Rule 14e-1, the staff has approved this structure on a case-by-case basis following an informal review process. This structure was first used by the Times Mirror Company and was memorialized in a no-action letter. [93] In the past, in order to receive informal approval to use this structure, issuers have approached the staff with a written request prior to commencing the tender offer, among other things, describing the structure and making certain representations about the trading characteristics of the securities compared to U.S. treasury trading, the number of market makers who make an active market in the securities and the types of investors holding the securities. This structure has now become sufficiently common that prior staff approval should no longer be necessary so long as the representations that would have been made to the staff are applicable. [94] It remains, however, significantly less common than the early tender fee structure described in the preceding paragraph.

Additionally, because Regulation 14E does not require mandatory withdrawal rights in tender offers, [95] in tender offers for debt securities the bidder can purchase the subject securities as they are tendered rather than waiting until the

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offer expires (unless relying on relief that excludes rolling settlement of purchases, including the short-dated tender offer relief letter and Rule 162 under the Securities Act (which permits early commencement of registered tender offers)).

[5] Debt Exchange Offers

In an exchange offer, the bidder offers to purchase outstanding securities in exchange for another security rather than in exchange for cash. From a regulatory perspective, every exchange offer has embedded within it an offering of new securities (with associated Securities Act issues) and a potential tender offer (with associated Williams Act issues).

[a] Williams Act Considerations

The fact that the consideration offered in an exchange offer consists of securities rather than cash does not materially affect the analysis as to whether the exchange offer is a tender offer under the Williams Act. An exchange offer will generally qualify as a tender offer unless appropriate procedures limiting the scope and manner of the exchange offer are put in place (comparable to those described for buy-back programs in § 9.04[3]).

If an exchange offer for debt securities is classified as a tender offer, it may qualify for relief from Williams Act requirements under the short-dated tender offer relief letter so long as it meets the requirements described in that letter (outlined in § 9.04[4]) and two additional requirements. The first requirement is that the consideration offered in the exchange offer must consist of "qualified debt securities" as defined in the letter and, if desired, cash. "Qualified debt securities" means debt securities that (a) are identical to the subject securities in all material respects other than maturity date, interest payment and record dates, redemption provisions and interest rate, (b) pay interest solely in cash (no payment in kind) and (c) have a weighted average life to maturity that is longer than the subject securities. The second requirement is the debt exchange offer must be limited to qualified institutional buyers (within the meaning of Rule 144A under the Securities Act), non-U.S. persons (within the meaning of Regulation S under the Securities Act) or both, and all excluded holders must be given a concurrent option to receive cash in a fixed amount determined by the bidder, in its reasonable judgment, to approximate the value of the qualified debt securities offered in the exchange offer.

[b] Securities Act Considerations

An exchange offer may be registered under the Securities Act or it may be structured to be exempt from registration under § 4(a)(2) of the Securities Act,

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Regulation S under the Securities Act or § 3(a)(9) of the Securities Act. Because they involve an offer and sale of securities, exchange offers are subject to the antifraud prohibitions in Rule 10b-5 under the Exchange Act and, in the case of registered exchange offers, §§ 11 and 12 of the Securities Act and, in the case of § 3(a)(9) exempt exchange offers, § 12 of the Securities Act.

[i] *Registered Exchange Offers*

In a registered exchange offer, the bidder prepares and files with the SEC a registration statement on Form F-4 or S-4. Like a registered offering for cash, a registered exchange offer triggers Exchange Act reporting obligations for the bidder.

[ii] *Private/Offshore Exchange Offers*

If registration is impractical or undesirable, an exchange offer can be structured to be exempt from registration under § 4(a)(2) of the Securities Act (a private exchange offer) or Regulation S under the Securities Act (an offshore exchange offer). While it is possible to include accredited investors (as defined in Rule 501 of Regulation D under the Securities Act) in a private offering, private exchange offers for debt securities are generally limited to qualified institutional buyers (within the meaning of Rule 144A under the Securities Act).

As a first step for a private/offshore exchange offer, issuers generally issue a press release regarding the potential for a transaction and send a letter of inquiry (sometimes referred to as a "pathfinder letter") to all holders of the subject securities to determine which holders are eligible to participate. The press release and the pathfinder letter should be carefully drafted to avoid rising to the level of an "offer" for purposes of § 5 of the Securities Act. Only after a holder has established its eligibility to participate by return of a completed pathfinder letter (or the making of representations equivalent to those in a pathfinder letter electronically) does that holder receive documentation for the exchange offer.

Advantages of a private/offshore exchange offer over a registered exchange offer are that a private/offshore exchange offer does not trigger Exchange Act reporting requirements, is more lightly regulated, is subject to less stringent disclosure liability and is usually possible to execute more quickly. Advantages of a private/offshore exchange offer over a § 3(a)(9) exchange offer are that there are no limitations on the services that a financial advisor or investment bank may provide and that the issuer of the new securities need not be the same as the issuer of the subject securities. Disadvantages of a private/offshore exchange offer are that a private offer will not reach ineligible holders and will result in the new securities being subject to transfer restrictions that may not be required for a § 3(a)(9) exchange offer.

[iii] *Section 3(a)(9) Exchange Offers*

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Section 3(a)(9) of the Securities Act provides that an offer of "any security exchanged by the issuer with its existing securityholders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange" is exempt from the registration requirements of the Securities Act. The SEC staff has confirmed that an issuer and its employees may solicit and recommend exchanges in a § 3(a)(9) offer of securities without rendering the offer ineligible for the exemption, provided that the employees do not receive special compensation for their efforts and that the issuer does not hire extra employees for solicitation purposes. [96]

If a financial advisor or investment bank is engaged to assist in a § 3(a)(9) exchange offer, that party will be limited in the compensation it may receive and in the activities it may perform. In a series of no-action letters, the SEC staff has indicated that financial advisors or investment banks assisting in § 3(a)(9) exempt transactions may generally receive compensation that is fixed as a flat fee (and not contingent on the consummation of the transaction or the amount of securities tendered in the exchange) without affecting availability of the § 3(a)(9) exemption. [97] Although compensation should not be structured as a success-based fee or tied to the amount of securities exchanged, it may be based on the number of holders targeted or contacted in the transaction. [98] Financial advisors or investment banks assisting in § 3(a)(9) exempt transactions may also be reimbursed for their reasonable out-of-pocket expenses, including fees for legal counsel, and compensation may be paid on a fixed date or in fixed monthly fees. [99] The no-action letters also provide specific examples of activities that financial advisors or investment banks can perform without rendering the transaction ineligible for the § 3(a)(9) exemption. [100]

Although § 3(a)(9) provides an exemption from registration under the Securities Act, it does not exempt an exchange offer from Trust Indenture Act qualification requirements, including the filing of a Form T-3 (which is used to qualify a debt indenture under the Trust Indenture Act in the context of an

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unregistered offering). [101] Where Trust Indenture Act qualification is required, § 306(c) of the Trust Indenture Act prohibits offers until the appropriate application for qualification has been filed with the SEC.

Footnotes

78 *See* § 1.02.

79 *Katz v. Oak Industries, Inc.*, 508 A.2d 873 (Del. Ch. 1986); *Kass v. Eastern Air Lines, Inc.*, 12 DEL. J. CORP. L. 1074 (Del. Ch. 1986); *cf. GPC XLI L.L.C., et al. v. Loral Space & Communications Inc.*, *et al.*, C.A. No. 3022-VCS (Del. Ch. 2008).

80 *Katz v. Oak Industries, Inc.*, 508 A.2d 873 (Del. Ch. 1986); *Kass v. Eastern Air Lines, Inc.*, 12 DEL. J. CORP. L. 1074 (Del. Ch. 1986).

81 *GPC XLI L.L.C., et al. v. Loral Space & Communications Inc.*, *et al*., C.A. No. 3022-VCS (Del. Ch. 2008) (finding payment of an exit consent fee only to consenting holders permissible where the parties to the

relevant indenture had specifically considered, and rejected, a contractual provision that would have required that consent fees be paid to all holders).

82 *Assénagon Asset Management SA v Irish Bank Resolution Corporation Limited* [2012] EWHC (Ch) 2090 (Eng.).

83 *Marblegate Asset Management v. Education Management Corp.*, 111 F. Supp. 3d 542 (S.D.N.Y. 2015).

83.1 *Marblegate Asset Management v. Education Management Corp.*, 846 F.3d 1 (2d Cir. 2017).

84 *BOKF, N.A. v. Caesars Entertainment Corp.*, 144 F. Supp. 3d 459 (S.D.N.Y. 2015).

85 Opinion White Paper dated Apr. 25, 2016.

86 *See* Bryant B. Edwards & Jon J. Bancone, *Modifying Debt Securities: The Search for the Elusive "New Security" Doctrine*, 47 BUS. LAW. 571 (1992).

87 *See, e.g.*, *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 905 (1978); *Rathborne v. Rathborne*, 683 F.2d 914 (5th Cir. 1982); *Sheraton Corp.* (avail. Nov. 24, 1978); and *Allied-Carson Corporation* (avail. Mar. 12, 1976).

88 *See* § 9.02[1].

89 Excluding a *de minimis* (representing up to 2% of the subject securities outstanding) increase in the percentage of securities accepted for purchase. *See* § 9.02[2].

90 The short-dated tender offer relief letter notes that it supersedes the letters issued to *Goldman, Sachs & Co.* (avail. Mar. 26, 1986), *Salomon Brothers Inc* (avail. Mar. 12, 1986) and *Salomon Brothers Inc* (avail. Oct. 1, 1990), as well as "any similar letters relating to abbreviated offering periods in non-convertible debt tender offers."

91 *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Tender Offers and Schedules Sections, § 162.01 (Nov. 18, 2016).

92 In contrast, Regulations 13E and 14D require that a single "best price" be paid to all holders that accept a tender offer in respect of equity securities to which those regulations apply. *See* § 9.03[2] and § 9.05[1].

93 *See The Times Mirror Company* (avail. Nov. 15, 1994) (the no-action letter provides for pricing one business day prior to expiration, but the staff now requires two business days).

94 *See also UBS AG* (avail. July 29, 2009).

95 In contrast, Regulations 13E and 14D require withdrawal rights in tender offers for equity securities to which they apply. *See* § 9.03[2] and § 9.05[1].

96 *See, e.g.*, *Pepsi-Gemex, S.A. de C.V.* (avail. June 1, 2001).

97 *See, e.g.*, *SunTrust Banks, Inc.* (avail. July 16, 1999); *Dean Witter & Co., Inc.* (avail. Dec. 23, 1974); *Klabin S.A.* (avail. July 14, 2014).

98 *See Mortgage Investors of Washington* (avail. Oct. 8, 1980) and *Petroleum Geo-Services* (avail. June 8, 1999).

99 *See, e.g.*, *Klabin S.A.* (avail. July 14, 2014).

100 *See, e.g.*, *SunTrust Banks, Inc.* (avail. July 16, 1999); *Seaman Furniture Co., Inc.* (avail. Oct. 10, 1989); *Exxon Mobil Corp.* (avail. June 28, 2002).

101 The exemptions to Trust Indenture Act qualification requirements set forth in § 304 of the Trust Indenture Act include offerings exempt from Securities Act registration pursuant to § 4(a)(2) of the Securities Act and Rule 144A under the Securities Act, but do not include offerings exempt from Securities Act registration pursuant to § 3(a)(9) of the Securities Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 9.05, TENDER AND EXCHANGE OFFERS FOR EQUITY SECURITIES; BUSINESS COMBINATION TRANSACTIONS

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 § 9.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

[1] Tender Offers for Registered Equity Securities

A tender offer where the bidder, after consummation of the offer, would be the direct or indirect beneficial owner of more than 5% of any class [102] of equity securities (whether or not entitled to vote) registered under § 12 of the Exchange Act is subject to the tender offer provisions of § 14(d) of the Exchange Act and Regulation 14D thereunder, as well as the provisions of § 14(e) and Regulation 14E, as discussed in § 9.02 above and § 9.05[2] below. [103] A tender offer formally commences on the date on which the bidder first publishes, sends or gives securityholders the means to tender (normally called a "letter of transmittal"). [104] A bidder can express an intention to launch an offer, but there is no prescribed time period by which the offer must commence following the announcement. [105] All communications to securityholders by bidders and by targets are permitted prior to formal commencement of the tender offer. All pre-commencement written communications [106] by bidders or targets must be filed with the SEC on the

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date of first use [107] and must include a prominent legend-advising shareholder to read the tender offer statement when it becomes available because it will contain important information. [108]

A bidder is prohibited from announcing an offer without an intention to commence and complete it, as a means to manipulate stock prices, or without a reasonable belief that it will have the necessary cash to consummate the offer. [109] Normally, a commitment letter should be sufficient to satisfy this last requirement, although even that is not always required. [110]

The bidder must also file with the SEC, as soon as practicable on the day its tender offer formally commences, a statement on Schedule TO making detailed disclosure as to, *inter alia*:

- the identity of the target and the securities sought in the offer;
- the identity of the bidder, and its management, directors and controlling entities;
- the source and amount of funds to be used to purchase securities in the tender offer, including the specific sources of financing, all conditions to the financing and the bidder's ability to finance the offer if the primary source of financing falls through;

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- the purpose of the offer, including any plans or proposals of the bidder for any major corporate transaction affecting control of the target;
- the background of the offer, including a description of any discussions between the parties with respect to any extraordinary transaction during the current year or the two previous years;
- the amount and percentage of target securities held by the bidder and details about transactions in such securities during the 60 days prior to commencement of the offer; and

- if material to a selling shareholder, current and adequate financial information concerning the bidder.

In addition, in a negotiated two-step transaction (a first-step cash tender offer for less than 100% of the outstanding target shares, to be followed by a second-step statutory merger), if the acquisition will be "significant" to the bidder at or above the 20% level, *pro forma* financial information must be included in the first-step tender offer materials. [111]

The bidder in a cash tender offer is not required to provide financial statements if (i) there is no financing or funding condition to the tender offer *and* (ii) either (a) the bidder files reports with the SEC under § 13(a) or § 15(d) of the Exchange Act *or* (b) the offer is for all outstanding target shares. If financial statements are required, only two years' statements need be provided. [112]

In a cash tender offer, the bidder must also provide a so-called "Offer to Purchase," which must begin on the first or second page of the offer document. The Offer to Purchase must include a bullet-point, cross-referenced "plain English" summary term sheet highlighting the most important aspects of the transaction. [113] The Offer to Purchase also sets forth the information expressly called for by Schedule TO, as well as all material conditions to the offer and various procedural and timing provisions (*e.g.*, a description of withdrawal rights and the bidder's right to extend or amend the offer.) The Offer to Purchase also generally includes a summary of any material nonpublic information about the target (such as target management's projections) that were furnished by the target to the bidder. [114] An Offer to Purchase is *not* required in a stock-for-stock tender offer ("exchange offer"), but its offer document is required to be in plain English. [115]

Generally, a bidder has great flexibility in setting conditions on its obligation to consummate the tender offer. However, these conditions must be based on objective criteria and not be within the bidder's control. [116]

Any material change in the information previously disclosed to securityholders must be promptly disclosed in additional tender offer materials, filed as amendments to the bidder's Schedule TO. [117]

Management of the target company is required to notify its shareholders and file with the SEC a Schedule 14D-9 pursuant to which it must state whether or not it has taken a position with respect to the bid, and if so, what that position is and the reasons for that position (or the reasons for not taking a position). [118] Management must also disclose generally what steps it plans to take in response to the bid and any conflicts that management or the target's board of directors may have (including by reason of employment or severance agreements). [119] The Schedule 14D-9 must be filed on the date, on or after the formal commencement of the offer, that the target first publishes its recommendation, which must be within ten business days of such commencement. [120]

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Holders of equity securities registered under the Exchange Act also benefit from certain significant procedural rights under Regulation 14D, as well as those that apply to all tender offers under Regulation 14E. All tender offers, [121] including tender offers for registered equity securities, must be kept open for at least 20 business days and, under certain circumstances, must be extended from time to time, as discussed in § 9.02. [122] In the case of a tender offer for registered

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equity securities, any person who has tendered may withdraw his or her tendered shares at any time prior to the expiration of the offer and, accordingly, tendered shares may not be purchased before the offer expires. [123]

A tender offer must be open to all holders of the class of registered equity securities sought in the offer (the so-called "all-holders rule") and the same price must be paid in respect of all equity securities of that class that are purchased (the so-called "best-price rule"). [124] Tender offers can be made for less than 100% of the outstanding shares. [125] In such an offer, if more of the securities of the specified class are tendered than the bidder has offered to purchase, the securities must be accepted by the bidder on a *pro rata* basis. [126]

A bidder in a tender or exchange offer for all outstanding shares will sometimes want to extend the offer to allow for the tender of additional shares even after all conditions of the offer have been satisfied. This is particularly common

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where the bidder seeks to reach the 90% threshold of ownership required in most states to effect a short-form merger (a merger not requiring a shareholder meeting or shareholder vote). [127] To facilitate achieving this goal, a bidder conducting a tender or exchange offer for 100% of the outstanding shares of a class of equity securities registered under § 12 of the Exchange Act is permitted to allow shareholders to tender shares during a "subsequent offering period" [128] that *follows* the expiration of the initial offer (as it may have been extended) if the bidder concurrently accepts and promptly pays for all shares tendered during the initial offering period. [129] With respect to tender offers for the shares of non-U.S. companies whose shares trade in their home markets and are also registered under § 12 of the Exchange Act, a bidder may launch a subsequent offering period if it accepts and pays for all shares tendered during the subsequent offering period within 20 business days of the date of tender if payment may not be made on a more expedited basis under the home jurisdiction law or practice. [130] Withdrawal

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rights are not available during the subsequent offering period. [131] Tendered shares must promptly be accepted and purchased for the same form and amount of consideration as was offered in the initial offering period, except in tender offers for non-U.S. companies whose shares trade in their home markets and are also registered under § 12 of the Exchange Act, where separate offset and proration pools are permitted for securities tendered during the initial and subsequent offering periods. [132]

[2] Tender Offers for Any Equity Security

[a] Rule 14e-5

In addition to the provisions of § 14(e) and Regulation 14E discussed in § 9.02 above, a tender offer for any equity security (regardless of whether it is registered under the Exchange Act) is also subject to Rule 14e-5. Under Rule 14e-5, a bidder who makes such a tender offer is prohibited from directly or indirectly purchasing (or arranging to purchase) any of the equity securities for which the tender offer is being made, or any "related securities," except pursuant to the offer. [133] The prohibition extends from the first public announcement of the

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offer until the offer has expired. [134] Because of the "directly or indirectly" language, the rule is generally interpreted to apply to purchases by the bidder's dealer-manager or other financial advisor unless an exemption is available. [135]

Exceptions to Rule 14e-5 include the following:

- purchases pursuant to the exercise of previously owned options or convertible securities;
- certain purchases by employee benefit plans of the bidder;
- purchases in connection with certain "basket" transactions;
- purchases pursuant to unconditional contractual obligations entered into before the public announcement of the tender offer;
- unsolicited agency or riskless principal [136] purchases by or through the bidder's dealer-manager or affiliates of the dealer-manager made in the ordinary course of business; [137]
- purchases made by certain affiliates of the dealer-manager [138] that have appropriate firewalls in place to prevent the sharing of nonpublic information with

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the dealer-manager and that are not made for the purpose of facilitating the tender offer (this exception is most relevant for the investment management affiliates of the dealer-manager);

- certain purchases by U.K. market makers; [139]
- purchases in cross-border tender offers qualifying as Tier I offerings; [140]
- purchases of securities of a foreign private issuer pursuant to a foreign tender offer made in accordance with home country requirements where there are separate, concurrent or substantially concurrent U.S. and non-U.S. offers; [141] and
- in the case of a tender offer that the bidder reasonably expects to meet the conditions for reliance on the Tier II exemption, [142] purchases of securities of a foreign private issuer by an offeror or its affiliates or by an affiliate of a

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financial advisor [143] outside a tender offer, and conducted in accordance with the foreign private issuer's home jurisdiction laws. [144]

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If no exemption applies, Rule 14e-5's restrictions can be unduly burdensome to transaction participants as a result of their extraterritorial reach. The rule applies to tender offers containing a U.S. component even when neither the bidder nor the target are registered under the Exchange Act or maintain ADR programs, despite the fact that such bids would otherwise be fully regulated by non-U.S. law. French law, for example, permits a number of trading activities by the

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financial advisors to a bidder that would be impermissible under Rule 14e-5. [145] In a bid by one French company for another where the bidder decides to include U.S. shareholders (even limiting participation to qualified institutional buyers) in order to avoid discrimination against them and to encourage maximum acceptance of the offer, Rule 14e-5 would cover the trading activities of such advisors in France. The relief that might otherwise be afforded by virtue of the Tier I exemption is often unavailable with respect to French targets, because of the difficulty of determining beneficial ownership under the Tier I rules within the French ownership system.

[b] Rule 13e-1

Under Rule 13e-1, before an issuer may purchase, by way of tender offer or otherwise, any of its equity securities (whether or not registered under the Exchange Act) while a third-party's tender offer for equity securities of the issuer that are registered under the Exchange Act is outstanding, the issuer must file certain additional information with the SEC. The additional information includes, among other things, the title and number of securities to be purchased, the names of the persons from whom the securities will be purchased, the purpose of the purchase, the source and amount of consideration to be used, and whether the issuer will retire the purchased securities, hold them in its treasury or dispose of them. [146]

[3] Business Combination Transactions and Exchange Offers

[a] Introduction

In many jurisdictions, a business combination can be effected through a statutory transaction involving a shareholder vote, instead of utilizing a tender offer or an exchange offer. In general, such a "business combination transaction" involves a combination of companies, effected pursuant to the requirements of local law, in which the shares of the acquired company are cancelled as a matter of law and then represent only the right to receive the specified consideration—whether stock, cash or a mix of stock and cash—or to exercise dissenters' appraisal rights, if provided for by such law. Examples of business combination transactions include mergers under U.S. and German law, amalgamations and plans of arrangement under Canadian law and schemes of arrangement under English law. A business combination generally requires approval by both

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constituent companies' boards of directors and shareholders (and may also require regulatory or court approval, as do schemes of arrangement in the United Kingdom and plans of arrangement in Canada). In the United States, the required vote is established by the corporate law of the state of the company's incorporation unless the company's certificate of incorporation requires a higher vote. Under Delaware corporate law (and the law of most other states), a merger requires board approval and the affirmative vote of a majority of the outstanding shares. [147] The tender offer provisions of the Exchange Act are not applicable to mergers or other business combination transactions because no purchase offer is being made directly to individual shareholders.

In the United States, a merger may be structured in various ways: for example, as a "direct" merger of the target into the acquiror (which is generally not feasible for foreign acquirors of U.S. companies), a "forward subsidiary merger" in which the target is merged into a new wholly owned subsidiary of the acquiror, or a "reverse subsidiary merger" in which a new wholly owned subsidiary of the acquiror merges into the target (with the target's outstanding shares being cancelled in exchange for the specified consideration, even though the target is the "surviving" company in the merger). Both subsidiary merger structures can be utilized by foreign acquirors through the establishment of a U.S. subsidiary. As discussed below, in most cases the shareholders of a U.S. target must vote to approve a merger; whether the acquiror needs shareholder approval will generally be a question of its home country law and stock exchange rules, and may depend on the structure of the transaction and the size of the acquisition compared to the acquiror's size. In many cases, if the acquiror is a U.S. company, it will not need shareholder approval for a merger. [148] The selection of a merger structure is generally determined based on tax considerations and the terms of existing target (and sometimes acquiror) contracts and licenses.

[b] One-Step Mergers and Two-Step Tender Offer and Short-Form Mergers

Mergers of the types described above are often referred to as one-step mergers. But mergers are also often utilized as the second step following a

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successful cash tender offer or exchange offer for a U.S. target to acquire any shares not tendered. [149] This is because an acquiror generally finds it undesirable to leave even a small minority of target shares outstanding after a tender offer due to the fiduciary duties to minority shareholders imposed on the target's board. Furthermore, in a friendly acquisition, the parties' merger agreement generally obligates the acquiror to effectuate a second-step merger after completion of a tender or exchange offer and specifies that the merger consideration will be equivalent to the consideration offered in the tender or exchange offer. If the remaining shares represent a sufficiently small percentage of the outstanding shares of each class (usually less than 10%), the second-step merger can often be accomplished as a "short-form" merger without a shareholder vote.

Under Delaware law, the affirmative vote of the holders of a simple majority of the target's outstanding shares is required to approve a merger. [150] Prior to 2013 amendments to the Delaware General Corporation Law (the "DGCL"), acquirors that acquired a simple majority but less than 90% of the target's outstanding shares in a tender offer were required to go through the process of holding a shareholder vote to approve the second-step merger, even though the result of the vote was assured.

To simplify this process, in 2014, Delaware adopted a new § 251(h) of the DGCL ("DGCL § 251(h)") that, subject to certain exceptions, allows the parties to an acquisition agreement to forgo the vote of the target's shareholders to approve a "short-form" merger if the following conditions are met:

- The target's shares are listed on a U.S. national securities exchange or held of record by more than

2,000 holders immediately prior to the execution of the acquisition agreement;

- The target's certificate of incorporation does not expressly require a shareholder vote in order to approve a "short-form" merger;
- The acquisition agreement expressly permits or requires the "short-form" merger to be effected under DGCL § 251(h) and shall be effected as soon as practicable following the consummation of the tender offer if such merger is effected under DGCL § 251(h);
- The acquiror consummates the applicable tender or exchange offer for any and all of the outstanding stock of the target that, but for DGCL § 251(h),

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would otherwise be entitled to vote on the adoption or rejection of the merger, which offer may exclude outstanding stock of the target that, at the commencement of such tender or exchange offer, is owned by (i) the target, (ii) the acquiror, (iii) any person or parent entity that directly or indirectly owns all of the outstanding stock of the acquiror, or (iv) any direct or indirect wholly owned subsidiary of any of the foregoing;

- Following the consummation of the tender or exchange offer, the stock irrevocably accepted for purchase or exchange pursuant to such offer and received by the depository appointed to facilitate consummation of the offer prior to such offer's expiration, plus the stock otherwise owned by the acquiror equals at least such percentage of the stock, and of each class or series thereof, in the target that would otherwise be required to approve the merger pursuant to Delaware law and the target's certificate of incorporation;
- The acquiror merges with or into the target pursuant to the acquisition agreement; and
- Each outstanding share of each class or series of stock of the target that is the subject of but not irrevocably accepted for purchase or exchange in the tender or exchange offer is to be converted into the same amount and kind of consideration to be paid for the shares of such class or series of stock of the target irrevocably accepted for purchase or exchange in the tender or exchange offer. [151]

The overall effect of DGCL § 251(h) is to reduce the minimum number of shares required to be purchased in a tender offer in order for an acquiror of a Delaware corporation to avail itself of a statutory "short-form" merger (thereby avoiding the time delay of a shareholder vote to approve the second-step merger) from 90% of the target's outstanding shares to a simple majority.

As a general matter, the tender offer and "short-form" merger structure has the advantage of speed as compared to the one-step merger. Since the second-step merger can be accomplished very quickly after the consummation of the tender offer, acquirors can plan on an interim period between signing of the acquisition agreement and closing of the acquisition of approximately five to six weeks, [152] whereas a one-step merger can only be completed after a shareholder

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vote. [153] Both parties to a merger are likely to favor the timing advantages that a two-step transaction structure can provide since the acquiror benefits by reducing the period during which the deal is subject to interloper risk, while the target reduces market risk and the period during which it could suffer a material adverse effect. [154]

DGCL § 251(h) also makes the tender offer and short-form merger structure more attractive to acquirors that finance the purchase price of the acquisition with third-party financing secured by the target's stock and assets. Before DGCL § 251(h), acquirors did not have sufficient certainty that they would receive the minimum number of shares in the tender offer to permit a short-form merger. As a result, there was a substantial risk that the acquiror would have voting control but not sole ownership of the target. As sole ownership of the target would be required for an acquiror to obtain secured third-party financing, the acquiror using third-party financing risked having to obtain unsecured bridge financing in order to purchase the shares, thereby increasing the cost of borrowing to the acquiror. Such bridge financing would remain in place until the target could hold a shareholder vote and close the acquisition. As DGCL § 251(h) makes it easier for an acquiror to purchase sufficient shares to force a statutory short-form merger with the target, the risk of third-party lenders not providing permanent, secured financing at the closing of the tender offer is in turn reduced. [155]

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However, the SEC still takes the view that a financing condition to the offer exists even if such condition to the offer relates to the eventual funding of an otherwise committed financing. Thus, acquirors are required to provide five business days' notice of the funding of the financing before closing the offer. [156] Acquirors either have to require their potential lenders to fund into escrow five business days prior to the closing of the offer or waive the funding condition five business days in advance of the offer's expiration and accept the risk of the financing not being available to close the transaction even though the conditions to the offer were satisfied.

[c] Exchange Offers

Substantially all negotiated acquisitions in the United States in which Company A acquires the shares of Company B in exchange for shares of Company A have been accomplished through statutory mergers, not exchange offers in which a bidder's securities are directly offered in exchange for those of a target. Exchange offers have generally been used only in the relatively rare hostile stock-for-stock bids. As a result of changes to the SEC rules to facilitate and accelerate exchange offers, and the elimination of pooling of interest accounting under U.S. GAAP in 2001, [157] it was expected that exchange offers would begin to be used more often in negotiated stock-for-stock acquisitions. Such a trend, however, has not materialized, and exchange offers in negotiated transactions involving U.S. companies remain rare.

Exchange offers for U.S. target companies or non-U.S. target companies with U.S. shareholders are extensively regulated under both the tender offer rules described above [158] and the registration requirements for offerings of securities described below. [159]

[4] Registration of Securities in Business Combination Transactions and Exchange Offers

[a] Introduction

A business combination or exchange offer involving the issuance of acquiror securities to the target's shareholders constitutes an offer and sale of

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those securities and is subject to the registration requirements of the Securities Act unless an exemption is available. [160]

The same exemptions from registration under the Securities Act available generally are also available for business combinations and exchange offers. For example, in the context of a closely held target whose shares are not publicly traded, the private placement exemption under § 4(a)(2) of the Securities Act or Regulation D thereunder may be available. [161] Similarly, the exemption under Regulation S may be available if the target shareholders receiving acquiror securities are outside the United States. [162]

In addition, as discussed below, Rule 802 under the Securities Act provides an exemption from the registration requirements for securities issued in business combinations or exchange offers to shareholders of non-U.S. companies where U.S. ownership is 10% or less (computed in accordance with the SEC's rules). [163]

Section 3(a)(10) of the Securities Act provides an exemption from the registration requirements of the Securities Act for an exchange of securities approved by a court after a hearing on the fairness of the exchange open to all parties to whom securities will be issued in the exchange. This exemption would be available, for example, for shares issued in a scheme of arrangement under U.K. company law, as well as under similar mechanisms in other countries. [164]

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Finally, a vendor placement may be possible with respect to U.S. target shareholders. [165]

Because of the cost of registration and the delay inherent in the registration process, Securities Act registration would, in many circumstances, be burdensome if not wholly impracticable for a foreign company that was not already registered and reporting under the Exchange Act [166] or substantially ready to

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register. [167] Thus, in many cases it will not be feasible for such a foreign company to use stock consideration in an acquisition of a U.S. company or, unless an exemption is available or U.S. shareholders are excluded, [168] of a non-U.S. company with shares registered under the Exchange Act.

If registration is required in connection with a business combination transaction or exchange offer, typically the registration statement must be publicly filed [169] and is subject to SEC review. [170] However, the Jumpstart Our Business Startups Act (the "JOBS Act") may entitle the acquiror to confidential treatment of a registration statement in certain limited circumstances. In guidance relating to the application of the JOBS Act to mergers and exchange offers, the SEC staff acknowledges that emerging growth companies (or "EGCs") may use the confidential submission process set forth in § 6(e) of the Securities Act to submit draft registration statements for an exchange offer or merger that is its initial public offering of common equity securities. [171] Still, even when using the confidential treatment process, the registration statement must eventually be made publicly available. [172]

Once the registration statement becomes effective, the prospectus (in the case of an exchange offer) or proxy statement/prospectus (in the case of a business combination transaction), which is the principal part of the registration

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statement, is mailed to the target's shareholders. [173] In most mergers, this must be done at least 20 business days prior to the shareholder meeting at which shareholders vote on the transaction. [174]

[b] Registration of Securities of Foreign Issuers

Securities of foreign issuers offered in connection with the acquisition of a U.S. publicly traded company must be registered on Form F-4. [175] The key information that must be provided in the registration statement on Form F-4 [176] includes a business description of both companies, a description of the securities offered by the acquiror (and a comparison of the rights of holders of those securities with the securities of the target) and audited financial statements of the acquiror (reconciled to U.S. GAAP, except that such reconciliation is not required in the case of financial statements prepared in accordance with International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB") [177]) [178] and, in most cases, the target, in

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each case for the three most recent fiscal years. [179] If either the acquiror or the target company qualifies to use short-form registration statements (Form F-3 or, for domestic issuers, Form S-3), which permit incorporation of information by reference to previously filed documents, [180] the Form F-4 may likewise incorporate by reference with respect to the qualifying company. Otherwise, all required information must be set forth in the registration statement. In the context of a hostile exchange offer, the SEC is generally accommodating with respect to information on the target's business (even if incorporation by reference is not

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available) and the requirement (if otherwise applicable) that a reconciliation be provided of target financials to U.S. GAAP. If financial statements for the target are required, a *pro forma* income statement of the acquiror for the most recent fiscal year (and for any interim period for which the acquiror is required to include financial statements), [181] giving effect to the acquisition, must also be included, together with a *pro forma* balance sheet as of the year end (and the end of any such interim period). [182]

An exchange offer subject to Regulation 14D under the Exchange Act may be commenced upon the filing of the registration statement (or such later time as selected by the acquiror). [183] In order to so commence prior to the effectiveness of the registration statement, the preliminary prospectus must include all material information, including pricing information (which can be formula pricing), and must be disseminated to all shareholders. The acquiror is not permitted actually to purchase any shares until the registration statement is declared effective. The SEC has committed that the staff will review registration statements on an expedited basis during the pendency of an exchange offer, but the staff notes that offerings involving novel or unusually complex issues may result in a somewhat longer review period. In certain circumstances, there will be a need to supplement the prospectus and extend the offer. [184]

The SEC takes the view that a merger or acquisition transaction is a continuous offering requiring the acquiror to update its (and the target's) financial

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statements until shareholder approval has occurred. [185] However, if the acquiror or target, as the case may be, is a reporting company eligible for full incorporation by reference on Form F-3 or Form S-3, the Form F-4 or Form S-4 can state that it incorporates in advance future filings. In that event, the updating requirement can be satisfied by the relevant company filing the new financial statements on a Form 10-K, Form 10-Q or Form 8-K (for domestic companies) or a Form 20-F or Form 6-K (for foreign private issuers). [186] Normally no additional mailing will be required.

In the case of a merger transaction in which the target's shareholders have a right to elect between forms of consideration (*e.g.*, the right to elect shares or cash subject to an overall limit), the parties should not have to update their proxy statement/prospectus following the shareholder vote even if the election period has not expired (which may be months later, after all regulatory approvals have been received); however, the SEC has not given any specific guidance on this issue and the matter is not free from doubt. [187]

Lock-up agreements given by major target shareholders to the acquiror committing to vote in favor of a merger (or other business combination) and entered into prior to the registration of the securities to be issued in the merger may raise issues under § 5 of the Securities Act because such shareholders have arguably made their investment decisions regarding the merger prior to registration. Despite this general presumption, and recognizing the legitimate business reasons for seeking lock-up agreements in the course of business combination

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transactions, the SEC staff has indicated that so long as the lock-up agreements (i) involve executive officers, directors, affiliates, founders or their family members, or shareholders owning 5% or more of the target shares, (ii) the shares subject to the lock-up agreements do not represent in the aggregate 100% of the outstanding target shares, and (iii) votes will be solicited from holders of the securities who are not locked up, the staff will not view such lock-up commitments as "gun jumping" and will allow the acquiror securities to be issued to such shareholders to be included in the subsequently filed registration statement. [188] However, where such shareholders also delivered written consents at the time of the lock-up agreements, approving the merger or other business combination transaction, the SEC staff has objected to the subsequent registration on Form S-4 or F-4 of the securities to be issued because the staff takes the position that offers and sales have already commenced privately, and thus the exchange must end privately. [189]

[c] Proxy Solicitation Rules

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As noted above, an acquisition of a publicly traded U.S. target corporation through a merger will require a vote of the shareholders of the target. The SEC's proxy solicitation rules will apply if the U.S. target's shares are registered under the Exchange Act. (A foreign target company with shares registered under the Exchange Act that does not qualify as a foreign private issuer [190] is also subject to the proxy rules in connection with a business combination.)

Pursuant to Regulation 14A under the Exchange Act, if the U.S. target company's shares are registered under § 12 of the Exchange Act and the target is soliciting proxies, it may not begin actual solicitation [191] of proxies until it mails shareholders a written proxy statement containing specified types of information. [192] This requirement applies to mergers in which target shareholders will receive acquiror shares or other securities for their shares (where the Securities Act registration requirements will apply), as well as to mergers where target shareholders will receive only cash (where such registration requirements will not apply).

The proxy statement must be filed with the SEC by the target company in advance of its use and is subject to prior SEC review, and generally must be mailed to target shareholders at least 20 business days prior to the shareholder meeting. [193] In an all-cash merger, very little information concerning the acquiror is required in the proxy statement; acquiror financial statements are required only if such information "is material to an informed voting decision," such as where the acquiror's financing is not assured. [194] By contrast, in a merger involving the acquiror issuing stock or other securities, the acquiror must file a registration statement under the Securities Act, and the same document will constitute both the target's proxy statement and the acquiror's prospectus.

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In both all-cash and mergers involving stock (or other securities) as some or all of the consideration, detailed financial and business information about the target company is required to be disclosed to the shareholders of the target company voting on the transaction, but substantially all of this disclosure can often be incorporated by reference from existing annual and quarterly reports rather than repeated in the proxy statement. As in the case of cash tender offers, proxy statements for cash mergers must include a summary term sheet in plain English, [195] and as in the case of exchange offers, proxy statements for stock-for-stock mergers need not include such a term sheet but must be in plain English. [196]

The proxy statement must also describe the background of the negotiations, the terms of the merger agreement and any related agreement, [197] reasons for the target board of directors' recommendation of the merger, a description of

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any severance, employment or similar arrangements that will affect the target's executive officers or directors in connection with the merger, a description of any fairness opinion obtained by the target board of directors from its investment bankers (including a detailed description of the underlying analysis), [198] a description of dissenters' appraisal rights (if any), a description of any required regulatory approvals, and a description of the tax consequences to shareholders resulting from the merger. [199] If, in the course of negotiations of the merger, the target furnished material projections or similar nonpublic information to the acquiror, the SEC staff will often take the position that such projections must be summarized, even if the acquiror chose not to rely on them. [200]

[5] Communications Issues

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[a] Gun Jumping and Proxy Solicitation Safe Harbors

When companies announce a business combination or exchange offer there has historically been a significant tension between the desire to avoid "gun jumping" [201] violations of § 5 of the Securities Act (in stock-for-stock mergers and in exchange offers) and to avoid premature solicitation of proxies in violation of the proxy rules (in mergers or other business combinations subject to the proxy rules [202]), on the one hand, and the need promptly to explain an important and potentially complex transaction to the market and to both companies' existing shareholders, on the other hand. [203]

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The SEC has provided a safe harbor under the Securities Act and under the Exchange Act's proxy rules to permit free communications in the context of exchange offers and business combinations *before* the filing of a registration statement or proxy statement that exempts such communications from "gun jumping" and premature proxy solicitation restrictions. [204] This safe harbor applies to both oral and written communications. All written communications [205] relating to the transaction, however, must be filed on the day first used [206] in order to assure equality of information to all investors. [207] Investor slides and electronic, computer and video communications generally must also be filed. [208] This filing requirement applies from the first public announcement of the proposed

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transaction [209] and continues at least until the vote is taken or the exchange offer is consummated or terminated. [210]

Under the JOBS Act, new Securities Act § 5(d) allows an acquiror to make confidential "test-the-waters" communications to "qualified institutional buyers" or institutional accredited investors prior to the filing of the registration statement in connection with an exchange offer or merger. However, the acquiror must make any required filings under the Exchange Act for any written communications made in connection with or relating to the exchange offer or merger. [211]

Written materials must contain a prominent legend urging recipients to read the full proxy statement or exchange offer circular when available. [212] New

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materials that are substantially identical to prior materials need not be filed. These same filing and legending requirements apply after the registration statement is filed and after it is declared effective. [213]

In the context of mergers involving acquiror securities and exchange offers, the written materials filed are considered pre-filing prospectuses subject to § 12(a)(2) liability. Such written communications will not be subject to § 11 liability because they are not required to be incorporated by reference in the subsequent registration statement. [214] The SEC staff sometimes insists, however, that potentially material information (*e.g.*, figures relating to synergies and other projections) included in a pre-filing prospectus also be included (or incorporated by reference) in the registration statement before the registration statement is declared effective. [215]

Notwithstanding the safe harbor for free communications, in the context of a merger involving a target shareholder vote, a proxy card (by which shareholders can vote) cannot be furnished to shareholders prior to delivery of the definitive proxy statement. [216] In addition, in the context of mergers, if the proxy statement incorporates by reference other SEC filings, [217] there is a 20-business day minimum solicitation period. [218] Moreover, unlike exchange offers for equity securities, which generally can be commenced prior to SEC review, [219] the minimum time period for a proxy solicitation for a stock-for-stock merger subject to the proxy rules cannot begin until the registration statement is declared effective.

[b] Non-GAAP Financial Measures in the Business Combination Context

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The Sarbanes-Oxley Act directed the SEC to adopt rules covering the disclosure of "*pro forma*" financial information by public companies. [220] Despite the wording of this mandate, the legislative history of the act indicated that the provision aims to cure the use of misleading non-GAAP information and not the use of *pro forma* GAAP financial information in a business combination context. [221] Accordingly, the SEC's final rules on the use of non-GAAP financial measures exclude presentations of financial measures where they are subject to the SEC's communications rules on business combinations. [222] These rules cover communications such as certain public announcements made in a merger context, as well as disclosure relating to independent appraisals and fairness opinions received by issuers in self-tender offers. Without such protection, acquirors would be prevented from presenting measures that assume cost savings or other synergies that cannot be calculated in accordance with GAAP in any meaningful way. Acquirors also would be unable to use historical non-GAAP measures to argue that target management is underperforming, an ability that can be particularly important in the hostile tender context.

[6] Regulation M Issues

Acquirors in an exchange offer or business combination in which securities will be offered in the United States are subject to the antimanipulation provisions of Regulation M under the Exchange Act. [223] Whereas Rule 14e-5 under the Exchange Act generally prohibits bidders in a tender or exchange offer from purchasing securities of the *target* outside the offer, Rules 101 and 102 of Regulation M are designed to prevent interested parties from engaging in activities that could raise artificially the price of the securities of the *acquiror* (the "subject securities") proposed to be distributed to target shareholders in an exchange

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offer or business combination. Under Rule 102, it is unlawful for issuers and "affiliated purchasers" [224] to engage in any activities involving, directly or indirectly, bidding for, purchasing or inducing others to bid for or purchase any subject security or any other covered security [225] during the applicable restricted period. [226]

In the context of business combinations or exchange offers, there can be two restricted periods. The first restricted period begins on the day of mailing of the proxy solicitation materials or the formal commencement of the exchange offer and continues through the end of the period in which the target shareholders can vote on the merger or tender their shares for exchange. [227] There will be a separate second restricted period during any time period in which (i) the market price of the acquiror's security is used to determine the consideration to be paid to securityholders in connection with the merger or exchange offer (*e.g.*, each target share is to be exchanged for acquiror stock having a market value of $20, as so determined) or (ii) target shareholders in a business combination may make an election as to the consideration to be received (*e.g.*, the right to elect to receive cash or shares, whether or not subject to an overall limit, and *pro rata* or other allocation procedures). The prohibitions of Regulation M begin to apply one or five [228] business days prior to the commencement of each restricted period. [229]

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Rule 102 should not be construed to prohibit an acquiror's shareholder communications in the ordinary course of business (such as normal quarterly earnings calls or routine presentations to investors consistent with past practice) or its communications with target shareholders. However, nonordinary course presentations to the acquiror's existing shareholders or other investors (for example, to try to prop up a falling share price) could be subject to this prohibition. [230] In addition, programs implemented prior to closing to facilitate expected flowback of shares issued to target shareholders to the issuer's home market should be feasible, but consultation with the SEC staff may be advisable. Violations of Regulation M could delay the timing of the proposed transaction or require violating issuers to supplement their proxy solicitation materials or prospectus to reflect the information disseminated in violation of Regulation M and distribute the supplement to the shareholders.

The parties' financial advisors are also subject to the provisions of Regulation M. Unlike the acquirors (and their affiliated purchasers), however, who are subject to Rule 102, financial advisors should be eligible for the exemptions [231] in Rule 101 from the restrictions of Regulation M applicable to distribution participants. [232]

[7] Exempt Offshore Transactions

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[a] Introduction

As discussed above, tender offers or exchange offers made to U.S. holders of a foreign target generally must comply with the U.S. rules, even if those rules are different from or conflict with the rules applied to the bidder by the foreign target's regulators. Although bidders in friendly or agreed bids have negotiated compromises with the SEC to minimize or eliminate such conflicts, [233] bidders in hostile bids have tended to structure offers so that they cannot be accepted from the United States, thereby effectively excluding U.S. holders. [234] Despite the initial acquiescence of the courts and the SEC in this practice, the SEC subsequently expressed concern about the effects of this exclusion on the large number

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of U.S. shareholders who own shares in foreign targets. In 1999, the SEC adopted a number of exemptions to the tender offer rules and registration requirements of the U.S. securities laws to encourage bidders to extend their tender and exchange offers and offers of securities in connection with business combinations to the U.S. securityholders of non-U.S. companies. This section discusses how bids have been structured in the past (and continue to be structured when these exemptions are not available or are considered inadequate) to exclude U.S. holders; the subsequent section discusses the 2008 Cross-Border Amendments [235] and related rules.

[b] Historical Context

Because the most active takeover market outside the United States is in the United Kingdom, efforts by U.K. bidders to arrange bids for U.K. targets with U.S. shareholders so that the U.S. rules would not apply have provided the backdrop for development of much of the law in this area. The theory that U.K. bidders have relied on is that the registration requirements of the Securities Act and the tender offer rules under the Exchange Act should not apply if the bidder avoids, to the extent possible, making use of U.S. jurisdictional means. This avoidance is accomplished by not making the offer documentation relating to the offer available in the United States, rejecting acceptances mailed from the United States and minimizing any other direct communication of the offer into the United States. [236]

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In the bid by the General Electric Company plc ("GEC") in 1985 for the Plessey Company plc ("Plessey"), a U.S. District Court held that the bidder did not have to comply with the tender offer rules under the Exchange Act. [237] That case involved a request by Plessey for a preliminary injunction to require GEC to comply with Regulations 14D and 14E under the Exchange Act. The court noted that 98.4% of Plessey's shares were held outside the United States. However, Plessey had 1.2 million ADRs held by approximately 3,000 persons in the United States that traded on the NYSE. The offer by GEC was made to all holders of Plessey ordinary shares but certain restrictions were imposed to avoid the application of U.S. rules. The court found it doubtful that GEC had used U.S. jurisdictional means to make its tender offer and noted that to find use of jurisdictional means would raise serious questions of comity. The court concluded

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that "it would be a perversion of the principles of the [Exchange] Act to delay the processes of a quintessentially British takeover when American investors and interests are but barely touched." [238]

In 1986, when it adopted a rule requiring equal treatment of shareholders, [239] the SEC commented on the *Plessey* case as follows:

> As a result of the decision in *The Plessey Company plc v. The General Electric Company plc*, a decision with which the [SEC] concurs, the [SEC] believes the law is clear with respect to the application of § 14(d) of the Exchange Act to tender offers by bidders who are not citizens or residents of the United States and who do not employ the jurisdictional means of the United States. Accordingly, the [SEC] reiterates its position that the all-holders requirement is not intended to affect tender offers not otherwise subject to the [Exchange] Act.… [240]

In an unsuccessful bid by Hoylake Investments Ltd. ("Hoylake") in 1989 for B.A.T. Industries plc ("B.A.T."), the bid was made only for B.A.T.'s ordinary shares, and not for its ADRs; the offer documents were not made available in the United States; the bid could not be accepted by anyone from the United States; and the cash and securities offered in the bid would not be sent into the United States. In order to avoid the registration requirements of § 5 of the Securities Act, restrictions also would have been imposed on subsequent transfers into the United States of the securities being offered ("flowback") for a six-month period running from the last date shares were issued in the offer. [241]

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The SEC asked the U.K. Panel on Takeovers and Mergers whether the effective exclusion of U.S. shareholders was consistent with the requirement of the U.K. City Code on Takeovers and Mergers that the offer be made to all shareholders, and was given assurances that the offer was in compliance. Subsequently, questions were raised by the U.S. Congress as to whether the U.S. rules were applicable, and David Ruder, then-Chairman of the SEC, sent a letter to the Congress to the effect that the structure of the bid was such that the U.S. rules could not be applied on behalf of the U.S. holders.

Subsequently, the SEC issued a concept release (the "Concept Release") concerning the conflicts involved in tender offers with a multijurisdictional dimension. [242] In the Concept Release, the SEC took the position that use of jurisdictional means occurs whenever it is reasonably foreseeable that U.S. shareholders of a foreign issuer that have been excluded from an offshore offer will sell their shares into the secondary market in response to that offer. Clearly, the SEC's position in the Concept Release, confirmed by statements made by the SEC staff subsequently, was inconsistent with the statements made in former Chairman Ruder's letter and the SEC's prior statements regarding the *Plessey* case cited above. Notwithstanding the SEC's position in the Concept Release, if an offer for equity securities that are not registered under the Exchange Act is made on the basis of the restrictions imposed in the Hoylake bid [243] and that offer is challenged by the target company, its shareholders, holders of its ADRs or the SEC, a U.S. court would likely hold that the registration requirements of the Securities Act and the rules under the Exchange Act are not applicable because of insufficient use of jurisdictional means.

The Adopting Release for the 2008 Cross-Border Amendments provides additional guidance on how acquirors in cross-border business combination transactions legitimately may avoid the application of U.S. registration and tender offer rules. Whether U.S. tender offer rules apply in the context of a cross-border tender offer depends on whether the bidder uses U.S. jurisdictional means in making a tender offer. The SEC has provided guidance on measures acquirors may take to avoid using U.S. jurisdictional means through previously issued

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releases. [244] The SEC reiterated that a legend or disclaimer stating that the offer is not being made into the United States, or that the offer materials may not be distributed there, is not likely to be sufficient in itself, because if the acquiror wants to support a claim that the offer has no jurisdictional connection to the United States, it also will need to take special precautions to prevent sales to or tenders from U.S. target holders.

The SEC also pointed out that bidders may require a representation or certification from tendering holders that they are not U.S. holders to avoid application of U.S. law. The SEC recognized the possibility that target securityholders could misrepresent their status in order to be permitted to tender into an exclusionary offer. The SEC has previously stated that where this occurs, bidders will not be viewed as having targeted U.S. investors, thereby invoking U.S. jurisdictional means. However, the SEC clarified that this position is premised on the bidder's having taken adequate measures reasonably designed to guard against purchases from and sales to U.S. holders. It is also premised on the absence of indicia, such as payment drawn on a U.S. bank or provision of a U.S. taxpayer identification number that would or should put the bidder on notice that the tendering holder is a U.S. investor.

[c] The Problem of Flowback

Where, as discussed above, a foreign acquiror offers to exchange its securities for target shares in an exchange offer or business combination not subject to Securities Act registration in reliance on Regulation S, [245] the question can arise as to when those target shareholders may resell the acquiror securities into the United States. The principal issue is whether, in making these resales, target shareholders are entitled to rely on the registration exemption in § 4(a)(1) of the Securities Act for transactions "by any person other than an issuer, underwriter or dealer." [246] The only uncertainty regarding the availability of the exemption for target shareholders (assuming they are not securities dealers) is whether, having received the acquiror securities directly from the acquiror, the target shareholders should be treated as underwriters and thus not eligible to rely on § 4(a)(1).

Target shareholders that are neither securities dealers nor affiliates of the acquiror should be able to rely on § 4(a)(1) of the Securities Act for resales in the United States of acquiror securities received in Regulation S exchange offers

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or business combinations. [247] For Category 1 and Category 2 offers, [248] the Regulation S safe harbor provides an exemption from Securities Act registration of the exchange offer without imposing resale restrictions on investors receiving securities in the offer, [249] so long as the issuer (and its affiliates and distributors, if any) conduct the exchange offer through "offshore transactions" without "directed selling efforts" in the United States. [250] The additional Category 2 offering restrictions, 40-day distribution compliance period and notice requirements do not apply to resales of securities received by such investors unless the recipient is deemed to be a distributor (or an affiliate of either the issuer or a distributor). [251] In the exchange offer or business combination context, there is often no party, other than the issuer, acting as a distributor of the securities. In cases where an investment bank or other agent acts to solicit acceptances, such an agent of the issuer should generally be treated as a distributor, in which case it should not sell into the United States or to U.S. persons any securities it receives from the issuer pursuant to the exchange offer and it should observe the Category 2 offering restrictions and notice requirements during the 40-day distribution compliance period (measured, in this context, from the close of the exchange offer or business combination) with respect to any securities issued in the offer. [252]

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In contrast, Category 3 offerings under Regulation S, including, among others, [253] all offers of U.S. equity securities, do not permit subsequent unrestricted resales by recipients of securities because the Category 3 resale restrictions [254] apply to all investors during the applicable distribution compliance period. [255] As a result, except in the case of exchange offers and business combinations qualifying for an exemption under Rule 802 under the Securities Act, U.S. issuers of equity securities and other Category 3 issuers are effectively forced to file with the SEC a registration statement covering either the initial exchange offer or the possible flowback into the United States of the securities issued in the offer or business combination. [256]

A flowback registration statement [257] would theoretically offer a considerable advantage over registering the initial exchange offer or business combination because it may be filed on Form S-3 or Form F-3 rather than on Form S-4 or Form F-4, and, as a result, in most cases information with respect to the target would not be required. [258] The SEC, however, has to date been unwilling to accept a flowback registration statement in this context unless each selling securityholder is listed in the prospectus, which is not likely to be practical.

[d] Compulsory Acquisition

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In the United Kingdom, if the bidder receives acceptances in respect of 90% of the shares that are the subject of the tender offer, it can acquire the balance of the shares that are the subject of the offer in a compulsory acquisition pursuant to which the shares are acquired without the consent of the holders. The bidder should not be required to register under the Securities Act the securities issued as part of the compulsory acquisition. [259]

[8] Resales of Securities Acquired in an Exchange Offer or Business Combination

The resale of securities received in an exchange offer or business combination is (like the offer and sale of any securities) subject to the registration requirements of the Securities Act unless an exemption is available.

[a] Resales by Recipients of Registered Securities

In a registered exchange offer or business combination, unless the recipient of the acquiror securities is an affiliate of the acquiror, the recipient receives freely tradable securities (*i.e.*, those eligible for resale under the exemptions from Securities Act registration provided by § 4(a)(1) or § 4(a)(3) of the Securities

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Act), even if it was an affiliate of the target or held restricted securities in the target prior to the transaction.

[b] Resales by Recipients of Unregistered Securities

If the target is closely held and the issuance of acquiror securities pursuant to the business combination transaction is structured as a private placement exempt from registration under § 4(a)(2) of the Securities Act or Regulation D thereunder, the recipient will receive restricted securities that it may resell only pursuant to another exemption. [260] In negotiating the transaction, the shareholders of a closely held target will often request resale registration rights that obligate the acquiror to register such securities for resale. [261]

[c] Resales by Affiliates of the Acquiror

In any exchange offer or business combination, if the recipient of the acquiror securities is an affiliate [262] of the acquiror, or becomes an affiliate of the acquiror in connection with the exchange offer or business combination, the acquiror securities held by the recipient will be "control securities" subject to the resale restrictions of Rule 144. [263]

[d] Resales of Securities Received in Exempt Offshore Transactions and the Problem of Flowback

For a discussion of the resale into the United States of acquiror securities received by target shareholders in an exchange offer or business combination not subject to Securities Act registration in reliance on Regulation S, *see* § 9.05[7][c].

[e] Registration Rights Agreements in the Business Combination Context

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If the acquiror securities issued in an exchange offer or business combination are unregistered, substantial shareholders of the target sometimes negotiate in order to obtain specific contractual rights with respect to registration of the shareholders' securities in order to permit their public sale. Such registration rights may take the form of the issuer's commitment either to register the shares within a specified period, upon demand (generally referred to as "demand rights"), or to include the shareholder's shares as one portion of any contemplated sale involving the filing of a registration statement within a specified period. The latter category is usually referred to as "piggyback rights" because the shareholder's offering is, in a sense, carried along as part of the primary offering contemplated by the issuer.

[9] Exemptions for Certain Tender and Exchange Offers and Business Combinations

As noted above, in late 2008 the SEC adopted amendments to the tender offer and Securities Act exemptive rules adopted in 1999 for cross-border tender offers, business combinations and rights offerings (the "1999 Rules"). [264] The 1999 Rules established two tiers of exemptions. As described below, Tier I provides an exemption from most SEC tender offer rules, while Tier II provides limited relief from certain provisions that may be inconsistent with rules or practices outside the United States. [265]

[a] Tier I Exemption for Tender Offers

The "Tier I exemption" [266] provides that tender offers for the securities of foreign private issuers, [267] whatever the consideration, are exempt from the U.S. tender offer rules (other than general antifraud rules) if 10% or less of the class of securities subject to the tender offer is owned by U.S. persons and certain conditions are satisfied. In making this computation, the securities held by the

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bidder are excluded from the outstanding securities of the class (*i.e.*, such securities are excluded from both the numerator and the denominator). [268]

In determining U.S. ownership, the bidder is required to "look through" the record ownership of certain brokers, dealers, banks or nominees appearing on the books of the issuer or transfer agents, depositaries or others acting on the issuer's behalf. [269] Securities underlying ADRs must be included in determining the amount of securities outstanding of the class subject to the offer. [270] However, other types of securities that are convertible into or exchangeable for subject securities, such as warrants, options and convertible securities, should not be taken into account in calculating U.S. ownership. The bidder's calculation of U.S. ownership must generally be made as of a date no more than 60 days before and no later than 30 days after the "public announcement" [271] of the transaction. [272]

If an acquiror is "unable to conduct" the look-through analysis described above, the SEC rules provide an alternative eligibility test based in part on a comparison of the ADTV of the subject securities in the United States to the worldwide ADTV. [273] The SEC does not define what "unable to conduct" entails,

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leaving such inability to be assessed based on the facts and circumstances of the particular transaction. The SEC has noted, however, that the need to dedicate time and resources to the look-through process would be an insufficient reason, and stated that concerns about completeness or accuracy of available information would not be sufficient reasons without additional hindering circumstances. In each instance, the acquiror must make a good faith effort to conduct a reasonable inquiry into ascertaining the level of U.S. beneficial ownership.

The alternate eligibility test consists of three prongs. First, ADTV for the subject securities in the United States over a 12-month period ending no more than 60 days before the announcement of the transaction must be no more than 10% (or 40% for Tier II) of ADTV on a worldwide basis. [274] In the case of negotiated transactions, there also must be a "primary trading market" for the subject securities in order for the acquiror to rely on the alternate test. [275] "Primary trading market" means that at least 55% of the trading volume in the subject securities takes place in a single foreign jurisdiction, or no more than two foreign jurisdictions, during a 12-month period ending no more than 60 days before the announcement of the transaction. [276] In addition, if the trading of the subject securities occurs in two foreign markets, the trading in at least one of the two must be larger than the trading in the United States for that class of securities. [277]

Second, the acquiror must consider information about U.S. ownership levels that appears in the most recent annual report or other annual information filed by the issuer with the SEC or with the regulator in its home jurisdiction [278] or any jurisdiction in which the subject securities trade before the public announcement of the offer. [279] If those reports indicate U.S. ownership in excess of the allowed limits, the cross-border exemption may not be permitted.

Third, if the acquiror "knows or has reason to know" that U.S. beneficial ownership exceeds the permitted percentages, the exemption is unavailable, even where all other elements of the alternate test are met. An acquiror is deemed to have reason to know information about U.S. ownership of the subject class that

appears in any filing [280] with the SEC or any regulatory authority in the issuer's home country or (if different) the jurisdiction in which its primary trading market is located. [281] If the acquiror and the target enter into an agreement pursuant to which the acquiror has the right to obtain information from the target, including information about U.S. ownership, it will be deemed to know any such information known to the target. [282] An acquiror is required to take into account only that information it has reason to know before public announcement of the transaction. Knowledge or reason to know acquired after public announcement will not disqualify the acquiror from relying on the exemption.

To level the playing field for competing offers, if a subsequent bidder commences a tender or exchange offer during an ongoing offer for securities of the same class, the subsequent bidder will be eligible to use the same exemption as the first bidder (Tier I, or as described below, Tier II or Rule 802) even if U.S. ownership thresholds are exceeded at the time of the subsequent bid. [283] The subsequent bidder will not, however, be entitled to rely on any exemption not also relied upon by the first bidder unless all conditions of such exemption are satisfied.

If, but for the Tier I exemption, the tender offer would have been subject to Regulation 14D under the Exchange Act, in order to utilize the exemption the bidder must submit to the SEC an English translation of the offering materials on Form CB. [284] Form CB, which consists of a cover page, the attached offering

materials and exhibits containing any information provided to the home jurisdiction or incorporated by reference in the home jurisdiction documents, must be received by the SEC no later than the first business day after the publication or dissemination of such informational document by the bidder in the home jurisdiction. Any subsequent offering materials must be similarly filed. If the acquiror is a foreign company, it must also appoint a process agent in the United States on Form F-X for six years from the date of filing. Form F-X requires the non-U.S. acquiror to appoint an agent upon whom process, pleadings, subpoenas or other papers can be served in connection with any SEC investigation or administrative proceeding (whether or not arising out of the offering) and any civil action predicated on an offering of securities covered by Form CB. [285]

In any Tier I offer, offering materials must be disseminated to U.S. holders, in English, on a comparable basis to that provided to shareholders in the issuer's home jurisdiction and in a manner reasonably calculated to inform U.S. holders of the offer. [286] The offering materials disseminated to U.S. holders must include all of the information included in the materials disseminated to holders in the issuer's home jurisdiction, including responsibility statements, such as "lead manager statements" setting forth representations about due diligence, even though such statements are usually excluded from U.S. offering documents in the context of conventional equity offerings.

The bidder in a Tier I-exempt tender offer is required to give U.S. holders the right to participate on terms at least as favorable as those offered non-U.S. holders of the same class, [287] subject to the following exceptions for exchange offers:

- bidders may offer cash in the United States while offering securities offshore without violating the equal treatment requirements so long as they have a reasonable basis to believe that the cash being offered to U.S. securities holders is substantially equivalent to the value of the consideration being offered to non-U.S. holders; [288]

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- with respect to U.S. holders residing in a state where "blue sky" laws do not provide an exemption from registration requirements, [289] a bidder may offer a cash alternative or, if it does not offer a pure cash alternative in any other jurisdiction, exclude such holders; [290] and
- a bidder is not required to offer U.S. holders "loan notes" offered to non-U.S. holders in jurisdictions where those securities afford certain tax advantages under non-U.S. tax laws and the loan notes are not listed on an organized securities market or registered under the Securities Act. [291]

The SEC's specific tender offer disclosure requirements and the numerous U.S. procedural rules (relating principally to timing, withdrawal rights and, in the case of partial offers, pro-rationing) do not apply to a tender offer qualifying for the Tier I exemption. Moreover, subject to certain conditions, Rule 14e-5 under the Exchange Act does not apply. Rule 14e-5 prohibits, in connection with a tender offer for equity securities, a covered person from purchasing or arranging to purchase any subject securities or any related securities except as part of the tender offer. [292] The conditions to the exemption from Rule 14e-5 [293] include that:

- the offering documents furnished to U.S. holders prominently disclose the possibility that purchases or arrangements to purchase may be made outside the tender offer;
- the offering documents disclose the manner in which any information about any such purchases or arrangements to purchase will be disclosed;

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- the purchases or arrangements to purchase are disclosed in the United States in the same manner as in the target's home country; and
- the rules of the target's home country permit such purchases.

The SEC has not exempted Tier I transactions (or transactions qualifying for the Tier II exemption or exemptions under Rule 802) from Regulation M under the Exchange Act. [294] Regulation M restricts certain bids and purchases and solicitations of offers to purchase a security that is the subject of a distribution. The SEC has stated that it will continue to evaluate the need for exemptions from Regulation M in these transactions, having received very few requests for such relief in the past. [295]

[b] Tier II Exemption for Tender Offers

The "Tier II exemption" [296] provides more limited relief from the U.S. tender offer rules than that provided by the Tier I exemption, to accommodate practices outside the United States. The Tier II exemption applies in circumstances where the target company is a foreign private issuer and 40% or less of the class of securities subject to the tender is owned by U.S. holders. [297] Although the Tier II exemption is not available where U.S. ownership exceeds 40% of the target, the SEC has expressed its willingness to consider on a case-by-case basis applications for exemption from the tender offer rules where there is a direct conflict between U.S. and foreign laws or practice. [298] By delegating this authority to the

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Directors of the Divisions of Corporation Finance and Trading and Markets, the SEC has also provided for more expedited review of such cases.

The 2008 Cross-Border Amendments codify certain exemptions that were provided through no-action letters under the 1999 Rules. The amendments provide for "multiple" rather than "dual" offers, as were provided for in the 1999 Rules. [299] This allows multiple offers in multiple jurisdictions and for securityholders located both in the United States and outside the United States, as well as to offer "loan notes" or similar securities to non-U.S. holders only. [300] The 2008 Cross-Border Amendments also codify the commonly used structure of (i) an offer to securityholders resident in the United States and to all holders of ADRs, wherever resident, and (ii) a simultaneous offer to securityholders outside the United States. Some multiple offers are structured to allow U.S. holders to tender in both the U.S. offer and the non-U.S. offer in order to comply with home jurisdiction rules prohibiting the exclusion of U.S. holders from the non-U.S. offer. [301]

The rules continue to allow the announcement of an extension of an offer in accordance with home-country practice rather than the U.S. rules, [302] allow a bidder to provide a subsequent offering period, if the bidder announces the results of the offer and pays for the tendered securities in accordance with the requirements of home country law or practice, and provide a relaxation of the prompt payment rules to permit a bidder to pay for securities in accordance with the requirements of the target's home country. [303]

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In addition to the exemptions codified in Rule 14d-1(d), in the adopting release for the 1999 Rules, the SEC stated that it would allow a bidder meeting the requirements of the Tier II exemption to reduce or waive the minimum tender condition "without extending withdrawal rights during the remainder of the offer" if certain disclosure, procedural and timing requirements are met. [304] In the 2008 Cross-Border Amendments, the SEC limited this interpretation further noting that there must exist "a requirement of law or practice in the home country justifying a bidder's inability to extend the offer after a waiver or reduction in the minimum offer condition" as long as the minimum offer condition is not reduced beyond a majority or percentage threshold required for control in the home jurisdiction. [305]

Bidders relying on the Tier II exemption in offers for equity securities registered under § 12 of the Exchange Act remain subject to the SEC's disclosure and filing obligations, certain other procedural obligations and, if applicable, the "going-private" disclosure and procedural requirements of Rule 13e-3 under the Exchange Act. [306] For example, such bidders are still required to keep an offer

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open for 20 business days; to file a Schedule TO; to disseminate the offering documents; and to provide holders withdrawal rights until the offer becomes wholly unconditional, except in certain situations. [307] So-called "back-end" withdrawal rights, [308] however, may be suspended while tendered securities are counted where (i) the Tier II exemption is available, (ii) there is an offering period, which includes withdrawal rights, of at least 20 U.S. business days, (iii) all offer conditions have been suspended when the withdrawal rights are suspended, and (iv) withdrawal rights are only suspended during the necessary counting process period and are reinstated immediately thereafter, to the extent they are not terminated by the acceptance of tendered securities. [309]

[c] Securities Act Exemption for Exchange Offers and Business Combinations

Rule 802 provides an exemption from Securities Act registration for securities issued in cross-border exchange offers or business combinations (*e.g.*, mergers, amalgamations, schemes of arrangement and consolidations) to holders

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of securities in foreign private issuers with limited U.S. ownership. [310] This Rule 802 exemption may be relied on by any acquiror, whether a U.S. or a non-U.S. issuer. [311]

Under Rule 802, the securities issued in an exchange offer or business combination are exempt from registration under the Securities Act if 10% or less of the target securities are owned by U.S. holders, calculated as described above with respect to the Tier I exemption from the tender offer rules. [312] The offer must generally be made available to U.S. holders on the same basis as to other securityholders, except that the acquiror may offer a cash alternative. If it does not offer a cash alternative in any other jurisdiction, an acquiror may exclude U.S. holders in a state where the "blue sky" laws do not provide a corresponding exemption from registration. [313] If the target securities are "restricted securities" within the meaning of Rule 144 under the Securities Act in the hands of a U.S. investor (*e.g.*, because they were acquired in a private placement), then the securities acquired by that investor in the Rule 802 transaction are restricted securities; otherwise, they are freely tradable. [314]

Rule 802 does not require that any specific disclosure be sent to U.S. holders, except that they must be provided contemporaneously the same information that is made available to non-U.S. holders (translated into English). [315] If the issuer (acquiror) disseminates information solely by publication in its home

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country, publication of the exchange offer or business combination is also sufficient in the United States if the information is published in a manner reasonably calculated to inform U.S. holders of the offer. [316] In addition, an issuer (acquiror) is required to provide the disclosure documents to the SEC on Form CB and, if it is a foreign company, to appoint an agent for service of process in the United States on Form F-X. [317] A legend must be included in the U.S. offer document advising U.S. offerees that the offer is being conducted in accordance with foreign disclosure and accounting requirements, that those requirements may differ from requirements applicable in the United States and that investors may have difficulties enforcing rights against the issuer and its officers and directors. [318]

The securities issued under Rule 802 may be debt or equity securities, convertible or nonconvertible. In the case of debt securities, the SEC adopted a corresponding exemption from the provisions of the Trust Indenture Act of 1939, which requires that, absent an exemption, debt securities sold to U.S. holders be issued pursuant to a trust indenture qualified under that Act. [319]

Rule 802 greatly simplified the requirements for all qualifying exchange offers and business combination transactions, but its efficacy in promoting inclusion of U.S. shareholders in acquisitions of foreign targets has been limited by the difficulty in determining the beneficial ownership of those shareholders in the manner required by the Rule. The exemption, if applicable, applies to all offers of securities, whether inside or outside the United States, so long as there are at least some U.S. shareholders of the target company and U.S. shareholders are not excluded. [320] Such offers inside the United States would therefore not need to comply with the requirement that the acquiror file a registration statement on Form S-4 (or Form F-4 in the case of a foreign acquiror) or obtain financial information about the target company reconciled to U.S. GAAP. Such offers outside the United States also would not need to comply with the requirements of Regulation S under the Securities Act, which imposes burdensome restrictions upon the ability of U.S. issuers to offer equity securities outside the United States consistent with the Regulation, including the treatment of those securities as "restricted securities." [321]

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Despite its many advantages, acquirors contemplating reliance on Rule 802 to purchase Exchange Act-registered securities of a target using securities that are not so registered should note that they will be required to succeed to the target's Exchange Act registration obligations (including compliance with the Sarbanes-Oxley Act) unless (i) the acquiror securities are (a) exempt from registration *other than* pursuant to Rule 12g3-2 (which provides certain exemptions from Exchange Act registration) or (b) held of record by fewer than 300 persons or (ii) the successor issuer is a Canadian corporation meeting certain additional requirements. [322] Despite the requirement that an acquiror succeed to the target's Exchange Act registration obligations, the successor issuer may benefit from the de-registration rules applicable to foreign private issuers. A foreign private issuer is permitted under Rule 12h-6(d)(2) under the Exchange Act to take into account the reporting history of the issuer whose reporting obligations it assumed pursuant to Rule 12g-3 for purposes of determining whether it is eligible to deregister pursuant to Rule 12h-6(a) under the Exchange Act. [323]

[10] The Internet

The SEC has articulated certain guidance regarding disclosure over the Internet of information about tender and exchange offers conducted outside, and not including or directed to any persons resident in, the United States without triggering U.S. tender offer and securities registration requirements. [324] The SEC provided this guidance to increase the information available to U.S. investors about offshore offerings, as U.S. securityholders may benefit from timely and reliable information about foreign corporate activities even if they are not able to participate in the transactions.

The SEC has expressed concern that, in tender and exchange offers, U.S. holders of the securities subject to the offer are likely to be familiar with the issuer in question and are apt to be alerted to internet disclosure relating to such offer. In addition, the SEC has indicated that U.S. investors in such cases have a particular incentive to find indirect means to participate in the offer, even if the offer is not being made in the United States. Consequently, the SEC has advised bidders using a website to publicize a tender or exchange offer or rights offering otherwise conducted outside the United States to take "special care" that the site is not used as a means to induce indirect participation by U.S. holders of subject securities.

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The SEC has noted two (nonexclusive) ways in which a bidder may take such "special care." First, in responding to inquiries and processing letters of transmittal, bidders may seek to obtain adequate information to determine whether the holder is a person in the United States or a U.S. person. Second, bidders may obtain representations by the investor, or anyone tendering or exchanging on the investor's behalf, that the investor is not a person in the United States or a U.S. person. In addition, in disseminating the cash or securities consideration to tendering or exchanging investors, bidders should avoid mailing such consideration into the United States. Furthermore, even with these precautions, bidders should take care that the web page is not clearly designed to induce U.S. investors to find an indirect means to participate in the offer through offshore nominees or by other means.

In the context of an offshore exchange offer over the Internet concurrent with an exempt private offering in the United States, the SEC has given additional specific guidance. In such cases, special precautions should be instituted to ensure that the internet offering is not used as general solicitation [325] to find qualified investors in the private offering. [326] The nonexclusive list of recommended measures includes:

- not including U.S. investors who respond to the offshore internet offering in the U.S. private offering;
- extending the U.S. offer only to U.S. investors who were solicited before, or independently from, the posting of offering materials on the Internet;
- using separate contact persons for the Internet solicitation and the U.S. offering; and
- not referring to the private U.S. offering in the website materials, except to the extent mandated by foreign law. [327]

[11] Federal Margin Regulations

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If a tender offer (or other proposed acquisition of stock of a U.S. publicly traded company) is financed through borrowings, the loan transactions [327.1] may be subject to the margin regulations promulgated by the Federal Reserve Board under the Exchange Act. The margin regulations are designed to restrict the use of credit in financing positions in securities.

There are three margin regulations, Regulations T, U and X. [328] Regulation T applies to U.S. broker-dealers. [329] Regulation U applies to U.S. banks (including U.S. agencies or branches of foreign banks) and U.S. lenders [330] other than

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banks and broker-dealers. Regulation X applies to borrowers that are U.S. persons or foreign persons controlled by or acting on behalf of or in conjunction with U.S. persons. Regulation X precludes the borrower from obtaining financing outside the United States for the acquisition of a U.S. company if the financing would violate the Federal Reserve Board's margin rules were it obtained within the United States. Unless covered by Regulation X, foreign persons that obtain financing outside the United States are not themselves subject to the margin regulations but their lenders may be.

Regulation U limits the amount of loans that are (i) used for the purpose of purchasing or carrying any margin stock (which includes most equity securities publicly traded in the United States [331]) and (ii) directly or indirectly secured by margin stock. [332] These loans are permissible only if the loan value of the collateral is not less than the amount of the loan at the time the loan is made. Because the loan value of margin stock is limited to 50% of its market value, lenders in transactions subject to Regulation U generally may not finance more than 50% of the cost of an acquisition unless they do so on an unsecured basis or on the basis of sufficient [333] additional collateral other than the margin stock, such as the operating assets or the stock of wholly owned subsidiaries of the acquiring company.

A loan is directly secured by margin stock, and therefore subject to Regulation U, if a security interest is granted to the lender. However, even if a security interest is not granted to the lender, a loan may be indirectly secured by margin stock, and thus subject to Regulation U, if, as a legal or practical matter, the margin stock assets of the borrower are more readily available to the lender than to the borrower's other creditors or if the borrower's right to dispose of the margin stock assets is restricted during the term of the loan, for example through a standard negative pledge clause. Moreover, in 1986, the Federal Reserve Board adopted an interpretation of Regulation U stating that a nominally unsecured loan made to a shell company that is used to finance the shell company's acquisition of margin stock is presumed to be indirectly secured by the acquired margin

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stock, with the result that such a loan is subject to Regulation U. [334] The scope of this interpretation is somewhat unclear. The interpretation addressed a shell company that had substantially no assets other than margin stock and no significant business function other than the holding of such stock. At least one subsequent staff opinion suggests that whether the presumption of indirect security applies may depend not only on the amount of the borrower's assets in addition to margin stock and on the extent of the borrower's other business operations, but also on whether such assets and operations can reasonably support the loan in light of the borrower's other liabilities and its financial condition. [335] Consistent with this view, the Federal Reserve Board's interpretation regarding loans to shell companies provides that such loans are generally not presumed to be indirectly secured where the lenders could in good faith rely on assets other than the margin stock as collateral (*e.g.*, where there is a guaranty from the shell company's parent or another company with substantial non-margin stock assets or cash flow) or where lenders could rely on the assets of the target because the merger will take place promptly (*e.g.*, where the loans are contingent on the acquisition of sufficient shares to effect a merger without the approval of the target's shareholders or directors or where the loans are contingent on the existence of a binding merger agreement with the target and the tender of a sufficient number of shares to guarantee approval of the second-step merger). [336]

[12] Interaction of Federal and State Law

[a] State Takeover Statutes

If the target of a bid is a foreign corporation with U.S. shareholders, the only relevant U.S. laws will normally be the federal securities laws and SEC rules discussed above. [337] However, if the target is a U.S. corporation, the bidder will have to contend with federal and state law, and the uneasy tension that exists between the two. [338] As indicated in the discussion above, the federal rules affecting takeover bids are limited principally to procedural and disclosure rules that the SEC believes are designed neither to encourage nor discourage bids but to

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enhance shareholder protection. The SEC characterizes its policy as one of neutrality. The U.S. courts have, however, held that the federal system, as embodied in the Exchange Act and the tender offer rules adopted under it (the "Federal Rules"), does not preempt state activity, even if that activity seeks to inhibit hostile offers, so long as there is no material interference with a bidder's ability to comply with the Federal Rules. Thus, states are free to amend their corporate statutes to correct any perceived imperfections in the federal system, subject to certain constitutional considerations. [339] Some of these statutes are discussed below.

Hostile takeovers were quite rare prior to the late 1970s. In the latter part of that decade and the early 1980s, however, bidders began to be more aggressive in attempting to exploit the gap between the "private market" value of a target and the public trading price for its securities. In an effort to capture as much of this "value gap" for themselves as possible, bidders sought to acquire control of targets as rapidly as possible. Bidders often tried to stampede shareholders into accepting hostile offers by, among other techniques, leaving offers open for a very short period of time, making partial offers with a very limited proration period and limiting withdrawal rights to the maximum extent possible. By the middle of the decade, however, most of these practices had been limited by SEC rules designed to give all shareholders an adequate opportunity to evaluate and, if desired, to participate in tender offers. [340]

The Federal Rules, even as amended, do not, however, place any substantive limits on takeovers, and at the end of the 1980s, there were an increasing number of leveraged takeovers by financial bidders whose goal was to break up the target and sell it in pieces in order to fund acquisition costs. These bids, often launched before financing was even in place, [341] put well-known and respected companies "in play," and led to new outcries at the state and, to a lesser extent,

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the federal level. There were different and conflicting responses to this activity. The U.S. Congress was unable to agree about any change to the federal structure despite the introduction of numerous legislative alternatives. The SEC continued to take the position that its role was to promote neutrality, not to frustrate hostile activity, whatever the results of that hostile activity might be for certain companies. The action the SEC did take in the form of new rules or amendments to existing rules was justified as necessary for shareholder protection and informed shareholder choice in the corporate control market. [342] Its primary thrust was to achieve fair and equal treatment of shareholders and to provide a measured time for shareholders to respond.

State legislatures were not altogether comfortable with the response of the Congress or the SEC, and felt compelled to respond to the fears expressed by local corporations, which often were significant employers in the states involved. Thus, state legislation was enacted, both restricting bidder action and investing directors with broader discretion to fight unwanted suitors. The primary types of statutes that developed as a result of these efforts were "control share statutes" and "business combination statutes." Approximately 40 states (including Delaware and New York) have adopted one or both types of statutes. [343] Most of these statutes apply to any corporation incorporated under the laws of such state. Some of these statutes, however, do not apply unless the corporation chooses to "opt in" to their coverage, while others apply unless and until the corporation chooses to "opt out" of their coverage.

The typical control share statute allows a target company that meets the statute's jurisdictional nexus requirements to deny voting rights to certain of its shares that are classified as "control shares," unless such voting rights are "restored" by the vote of a majority of disinterested shares. "Control shares" are generally defined as shares owned by an acquiring person, which exceed specified percentage thresholds, usually 20%, 33% or 50%. These statutes, intended to help targets, arguably benefit bidders more because, in an era where most public companies have adopted or can adopt a poison pill (discussed below), the statute gives the bidder the ability to force a shareholder vote that target management will likely lose, thereby increasing the pressure on the target board of directors to negotiate with the bidder or put the target up for sale to the highest bidder. Accordingly, if relevant state law permits, a company resisting a hostile takeover will often "opt out" of such statutes.

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Business combination statutes restrict mergers and other "business combinations" (usually defined extremely broadly) with a person who has made a substantial (usually 10%, 15% or 20%) share acquisition without prior board approval. If a hostile bidder does not get such approval, it is typically forced to wait for three to five years before it can engage in a second-step merger, other business combination with the target company or certain other types of transactions. Also, following the expiration of the specified waiting period, many business combination statutes require the acquiror to comply with complex "fair price" provisions when engaging in a cash-out merger.

In addition to these types of statutes, about 30 states have also adopted provisions permitting directors to consider various factors and constituencies in addition to shareholders in making takeover-related decisions. These provisions are typically referred to as "expanded constituency" statutes. Although the substance of these statutes varies somewhat from state to state, all are primarily designed to provide added protection for corporate directors who choose to oppose a takeover.

Most of these statutes authorize directors making takeover-related decisions (and in some states, other types of decisions) to consider both the long-term and short-term interests of the corporation and its shareholders, including the benefits from long-term plans and the possibility that these interests may best be served by the corporation's continued independence. Most of these statutes also contain a list of constituencies (in addition to shareholders) that directors may consider the interests of, or the effects of actions on, in evaluating a potential change in control of the corporation. The constituencies listed in many of these statutes include current employees, retired employees, suppliers, the corporation's customers, and the communities in which the corporation is located. Corporate statutes also were amended to permit corporations to eliminate director liability to disgruntled shareholders frustrated in their attempts to realize the highest price for their shares, unless the directors are found to have breached their duty of loyalty.

Statutes have also been adopted in Pennsylvania, South Dakota and Maine requiring persons acquiring 20% (a simple majority in the case of South Dakota, 25% in the case of Maine) or more of the voting power of a target corporation to offer to purchase the remaining shares for the "fair value" of those shares as determined by a court. [344] There is substantial question about the validity of these statutes under the U.S. Constitution, but there have been no court decisions to date addressing their constitutionality. Ohio and Pennsylvania have also adopted "profit recapture" statutes, which permit the target company to recover profits

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from a bidder who makes an acquisition offer and then disposes of its holdings within a specified time. [345]

[b] Poison Pills

During the 1980s, management was not content to rely entirely upon state action. Most members of management view hostile bids for their companies as anathema. They and their advisors also do not view compliance with the Federal Rules as a deterrent to a bidder. Thus, management was constantly looking for defensive measures that could either block unwelcome bidders outright or force bidders to deal directly with them. Shareholder rights plans (or so-called "poison pills") are an effective mechanism to achieve these objectives.

Poison pills are, in effect, warrants or rights that are issued as a dividend on existing shares and that trade as a unit with the shares. In the absence of a takeover attempt, the rights have no economic significance. Typical poison pills are designed to penalize severely (and thereby, as a practical matter, prevent) bidders acquiring more than a specified percentage of the issuer's shares without target board approval. They provide that, upon the acquisition of beneficial ownership of a specified percentage of an issuer's stock, all shareholders (other than the acquiror and its affiliates and transferees) receive the right to purchase additional shares of the issuer's stock at half the market price. This would significantly dilute both the acquiror's percentage ownership and the value of the investment. Over time, issuers have become increasingly aggressive at setting the percentage of ownership that will cause the rights to "flip-in"; and while the first "flip-in" pills had triggers of 50%, now most rights plans have triggers in the range of 10 to 15%. [346] In addition, it has become common for rights plans to define "beneficial ownership" more broadly than the definition under § 13(d) of the Exchange Act, [347] so as to effectively prevent multiple activists from teaming up and potentially obtaining at least negative control. [348]

For many years, a significant majority of major public companies had poison pills in effect. However, in recent years, because of criticism by institutional investors, proxy voting services and governance professionals, most companies

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have terminated their poison pills or allowed them to expire. [349] In most cases, however, a company can adopt a poison pill quickly by board action, without shareholder approval, if and when faced with a takeover attempt that the board of directors considers coercive or at an inadequate price.

Once a poison pill has been implemented, a takeover is, as a practical matter, impossible without board approval. As a result, unless the board is removed after a proxy solicitation by the bidder [350] or a court orders the redemption of the rights (which they are generally unwilling to do), the board can "just say no" to an unsolicited offer. [351] Accordingly, the usual tactic of bidders to get around a poison pill is to run a proxy contest to replace the target's board of directors. If the target has a staggered board, with only one-third of the directors up for election each year and directors not being removable in the absence of good "cause" (which is extremely difficult to demonstrate), a proxy contest can generally only change one-third of the directors in a given year.

[c] Litigation

The desire by both management and state legislators to curb hostile takeovers placed the courts in a difficult dilemma. One of the characteristics of the U.S. system is the involvement of the courts in takeovers. Confronted with both parties claiming numerous violations of law in order to obtain a tactical advantage, courts had a choice: take a hands-off approach and let the market and shareholders discipline the participants, or intervene and set certain ground rules.

In the early days of hostile takeovers, courts usually dismissed claims that defensive actions by targets in hostile takeovers violated the target directors'

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fiduciary duties. Courts generally viewed defensive tactics as a normal exercise of directors' business judgment and thus refused to hear claims challenging such tactics unless an absence of good faith could be established. [352]

This somewhat cavalier approach was rejected in 1985 by the Delaware Supreme Court. [353] Under its decision in the *Unocal* case, a board of directors' adoption of defensive measures will be protected only if the board can establish that it has reasonable grounds for believing that a danger or a threat to corporate policy and effectiveness exists, and that the defensive measures adopted were reasonable in relation to the threat posed. [354] This is generally the test that boards try to meet today in responding to bids. Despite this shift in the burden of proof, however, the key point remains that directors continue to enjoy considerable discretion to adopt poison pills and implement other structural defenses against hostile takeovers, including "lock-up" provisions, "break-up" fees and "no-shop" clauses in agreements with successful bidders. [355] However, any lock-up or similar provision must not preclude other bids and must be reasonable. [356] Furthermore, in approving an acquisition of the company in which shareholders receive cash for all or many of their shares (or receive stock of a company that has a

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controlling shareholder [357]), the board of directors has additional duties under *Revlon*, a 1986 Delaware Supreme Court case. Once a takeover becomes inevitable, Revlon requires directors to take steps reasonably designed to attempt to maximize short-term shareholder value. [358]

[13] Vendor Placements

Another method of using securities of a foreign company to purchase a U.S. company is a so-called "vendor placement." In a vendor placement, the bidder typically employs a third party to sell in offshore transactions the securities to which tendering U.S. target holders would be entitled in the offer. The bidder or third party then remits the proceeds of the resale to the U.S. target holders. In several no-action letters, the staff of the SEC took the position that if a foreign company offers and issues to U.S. persons securities that are immediately resold outside the United States for the account of the U.S. person, no offer or sale (as those terms are defined in the Securities Act) to the U.S. person occurs. [359] Accordingly, the securities issued to and sold on behalf of the U.S. persons need not be registered under the Securities Act.

The no-action letters and other guidance provided by the SEC include a number of factors that the SEC looks to in deciding whether a vendor placement structure triggers the registration requirements under the Securities Act. These factors include:

- the level of U.S. ownership in the target company;
- the number of bidder securities to be issued in the business combination transaction as a whole compared to the amount of bidder securities outstanding before the offer;

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- the amount of bidder securities to be issued to tendering U.S. holders and subject to the vendor placement, compared to the amount of bidder securities outstanding before the offer;
- the liquidity and general trading market of the bidder's securities;
- the likelihood that the vendor placement can be effected within a very short period of time (*i.e.*, within a few business days) after the termination of the offer and the bidder's acceptance of shares tendered in the offer;
- the likelihood that the bidder plans to disclose material information, such as earnings results, forecasts or other financial or operating information, around the time of the vendor placement sales; and
- the process used to effect the vendor placement sales, such as whether the vendor placement involves special selling efforts by brokers or others acting on behalf of the bidder.

The SEC has indicated that it will no longer issue no-action letters for vendor placements, but reiterated that vendor placements may be used, provided bidders follow the guidance in previous no-action letters. [360] The SEC indicated that the two most important factors in the analysis are the liquidity of the market for the securities and the relative amount of securities going to U.S. holders. [361]

Footnotes

102 For purposes of calculating beneficial ownership of securities to determine whether the tender rules are applicable, ADRs are not considered a separate class of equity securities. SEC Release No. 33-6894 (May 23, 1991).

103 Tender offers by an issuer with a class of equity securities registered under § 12 of the Exchange Act for its

own equity securities are separately regulated. *See* § 9.03.

104 Rule 14d-2 under the Exchange Act. The bidder must deliver to the target, and any other bidder, a copy of the first such communication. Rule 14d-3(a) under the Exchange Act.

105 In contrast with the U.S. approach, a U.K. offer document must be mailed to target shareholders within 28 days of the public announcement of a firm intention to make an offer. (However, the U.K. Panel on Takeovers and Mergers may grant extensions to this period, which are sometimes required to accommodate the needs of bidders registering securities under the Securities Act.) *See* U.K. City Code on Takeovers and Mergers, Rules 24.1 and 30.2.

106 "Written communications" include all information disseminated other than orally, including electronic communications and other future applications of changing technology. For example, video, audio and other electronic presentations made available for replay on a website, through a dial-in telephone number or otherwise constitute written communications and must be filed with the SEC by means of a transcript. Newspaper articles about a transaction that are disseminated by one of the parties (*e.g.*, on a company website) or arranged or paid for by one of the parties must also be filed with the SEC. In addition, a script for a speech about the transaction that is disseminated publicly (*e.g.*, given to an audience or attached to a press release) or widely distributed throughout the company so that the speech can be given many times (analogous to a "proxy solicitation script") must also be filed with the SEC. *See* SEC Release No. 33-7760 (Oct. 22, 1999), 64 Fed. Reg. 61,408, 61,412 n.37 (Nov. 10, 1999); SEC, Division of Corporation Finance, Manual of Publicly Available Telephone Interpretations, Third Supplement (July 2001) (hereinafter, " Regulation M-A and Cross-Border Release Interpretations"); and § 9.05[5][a] for further discussion of this issue.

107 Rules 14d-2(b)(2) and 14d-9(a)(2) under the Exchange Act. These filings are made on Schedules TO and 14D-9, respectively, on which the "preliminary communications" box is checked. When used for pre-commencement communications, however, only the cover page of the respective schedule is filed with the attached communication; the complete schedules are filed only on (in the case of Schedule TO) or after (in the case of Schedule 14D-9) formal commencement of the offer as described below. "Stop-look-and-listen" communications, which are communications by the target board to its shareholders that merely identify the bidder, state that the tender offer is under consideration, state that the board will advise the shareholders of its recommendation regarding the offer and request that shareholders defer their decision to accept or reject the tender offer until the board publishes its recommendation, do not have to be filed or include a legend. Rule 14d-9(f) under the Exchange Act.

108 Instruction 3 to Rule 14d-2(b)(2) and Instruction 3 to Rule 14d-9(a)(2) under the Exchange Act.

109 Rule 14e-8 under the Exchange Act; *see also* § 9.02[2].

110 By contrast with the SEC, the U.K. Panel on Takeovers and Mergers and the takeover regulators in each other European Economic Area state require that a bidder should only announce a firm intention to make an offer once it has arranged its financing. *See* U.K. City Code on Takeovers and Mergers, General Principle 5 and Rule 2.7; the EU's Directive of the European Parliament and of the Council on Takeover Bids of Apr. 21, 2004 (Directive 2004/25/EC), Art. 3(1)(e).

111 *See* Schedule TO, Instruction 5 to Item 10; *see also* § 9.05[3][b] for a discussion of second-step mergers and § 4.05[5][a] for a discussion of significance tests, which reflect the "significance" of an acquired business by comparing to the acquiror's most recent audited financial statements (i) the amount of the acquiror's proposed investment in the business to be acquired, (ii) the total assets of the business to be acquired and (iii) the pre-tax income of the business to be acquired. This *pro forma* information must be included because the effective investment decision is being made at the time shareholders decide whether to tender or to wait for the second-step merger and remain as shareholders in the combined business. This requirement does not apply to hostile two-step transactions. The stated reason for its inapplicability in hostile transactions is that the bidder may not have adequate access to target information to prepare reliable *pro forma* financial statements. *See* SEC Release No. 33-7760 (Oct. 22, 1999). Nonetheless, subject to Rule 409 under the Securities Act, which provides that a registrant need only include information

in its registration statement insofar as it is known or reasonably available to the registrant, the SEC has long required *pro forma* financial statements in hostile exchange offers, and bidders have managed to prepare them.

112 Such financial information may be included or, if the bidder is eligible, incorporated by reference in Schedule TO; if, however, the financial information is incorporated by reference, at least summarized financial information must be disseminated to securityholders. *See* Schedule TO, Instruction 6 to Item 10; Regulation M-A and Cross-Border Release Interpretations, Question I.H.7.

113 *See* Item 1001 of Regulation M-A under the Securities Act.

114 In the context of reviewing a Schedule TO (utilized in the context of an offer for registered equity securities), the SEC staff is likely to inquire as to whether target management provided its projections to the bidder and, if so, require them to be disclosed. *See infra* Note 200 and accompanying text.

115 *See* SEC Release No. 33-7760 (Oct. 22, 1999). The plain English requirement also applies to proxy statements/prospectuses for stock-for-stock mergers.

116 *See* SEC Release No. 34-43069 (July 24, 2000). If the conditions are not objective or are within the bidder's control (*e.g.*, the offer may be terminated for any reason or may be extended indefinitely), in the SEC's view, the offer would be illusory and may constitute a "fraudulent, deceptive or manipulative" practice within the meaning of § 14(e) of the Exchange Act.

117 Rule 14d-3(b) under the Exchange Act.

118 Rules 14e-2 and 14d-9 under the Exchange Act; Schedule 14D-9, Item 4.

119 Rules 14e-2 and 14d-9 under the Exchange Act; Schedule 14D-9, Items 3 and 7.

120 Rules 14e-2 and 14d-9 under the Exchange Act; Schedule 14D-9. Prior to the time when a full Schedule 14D-9 is filed, all management's pre-commencement communications must generally be filed on Schedule 14D-9 no later than the date of their first use, except "stop-look-and-listen" communications, which are exempt from filing. *See supra* Note 107.

121 *See* § 9.02 for a description of procedural rules applicable to all tender offers.

122 Rule 14e-1 under the Exchange Act. The SEC interprets Rule 14d-4(d)(2) under the Exchange Act, which sets forth minimum time periods necessary for dissemination of material changes in a registered securities offer (*i.e.*, a tender offer in which the consideration consists solely or partially of securities registered under the Securities Act) that commences early, as applying to all tender offers, including those subject only to Regulation 14E. *See* SEC Release No. 33-7760 (Oct. 22, 1999). The SEC has stated that if a bidder intends to reduce the offer price by any cash or other distributions to securityholders by the target, the bidder should disclose this prospective offer price reduction in its description of the offer price and that if a distribution occurs and the offer price is reduced, the bidder must extend the tender offer, if required under Rule 14e-1(b), so that the offer remains open for at least ten business days following the date of the notice of the change in the offer price. *See* SEC Release No. 34-43069 (July 24, 2000).

Prior to the 2008 Cross-Border Amendments, the staff of the SEC granted exemptive relief from Rule 14e-1(b) to permit a material change to the offer to be made by the bidder even if the offer would not remain open for at least ten business days from the date that notice of such change was first published, sent or given to securityholders. For example, in January 2006, the SEC staff issued exemptive relief from Rule 14e-1(b) in a cross-border offer for a Danish company, listed on the NYSE with securities registered under § 12 of the Exchange Act, to permit the offer price to potentially decrease as a result of a dividend payment or other distribution made by the target without the tender offer remaining open for at least ten days from the date of notice of any such potential decrease. *See Nordic Telephone Company ApS* (avail. Jan. 3, 2006); *see also Axel Springer AG* (avail. Sept. 12, 2005) and *BCP Crystal Acquisition GmbH & Co.* (avail. Feb. 3, 2004), in which the SEC granted relief from Rule 14e-1(b) to allow the bidders to extend the initial offering period for only the maximum two-week period required under German law in the event of a material change to the terms of the offer during the last two weeks of the offer; and *Bayer Entities* (avail. June 29, 2006), in which the SEC granted relief from Rule 14e-1(b) to allow the bidder to rely on a mandatory two-week subsequent offering period rather than extend the offer if market purchases at a price higher than the offer price resulted in a mandatory increase of the offer price under German law. The offer in *Nordic Telephone* was eligible for the Tier II exemption; the offer in *Axel Springer* could have been eligible for the Tier II exemption but for the fact that the target was not a foreign private issuer; and the offer in *BCP Crystal* was not eligible for the Tier II exemption. *See* § 9.05[9][b] for a discussion of the Tier II exemption.

The SEC has also provided no-action relief from Rule 14e-1(b) to permit an increase in the offer price in the event a certain percentage of target securities are tendered as an incentive to target securityholders. *See STATS ChipPAC Ltd.* (avail. Mar. 15, 2007) (permitting an incentive payment if 90% tender threshold was reached if, among other things, a subsequent offering period is provided or extended so that the offer including the subsequent offering period remains open for ten U.S. business days after the announcement of the increase in the offer consideration); *Alcan, Inc.* (avail. Oct. 7, 2003) (permitting an incentive payment if 95% tender threshold was reached without an extension of the offering period or a subsequent offering period).

The SEC has also granted no-action relief from Rule 14e-1(b) where the exact number of shares and the offer price were not disclosed in the tender offer, but the terms of a pricing methodology to determine the number of shares and offer price were fully disclosed at the time of the commencement, despite the fluctuation in share price that could result from using a pricing methodology rather than a set offer price. *See Lloyds Banking Group plc* (avail. May 28, 2010); *see also Towers Watson & Co.* (avail. May 17, 2010).

123 Rule 14d-7 under the Exchange Act. For these purposes, a "subsequent offering period," described below, is not an extension of the expiration of the offer and is disregarded. Thus, shares tendered during the original offer can, and (subject to the offer's conditions) must, be purchased at the end of the main offer and prior to the commencement of a "subsequent offering period."

124 Rule 14d-10 under the Exchange Act. Following its adoption in 1986, the best-price rule required that "the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during the tender offer." SEC Release No. 34-23421 (July 17, 1986), 51 Fed. Reg. 25,873, 25,878 (July 17, 1986). This language resulted in a significant number of shareholder class actions, claiming that amounts paid to target executives as retention bonuses or pursuant to golden parachutes or similar arrangements actually constituted additional payments for the executive's shares, to which all of the target company's public shareholders were entitled. In 2006, the SEC unanimously approved amendments that modified the basic language of the best-price rule to require that "[t]he consideration paid to any security holder *for securities tendered in* the tender offer is the highest consideration paid to any other security holder *for securities tendered in* the tender offer." Rule 14d-10 under the Exchange Act (emphasis added). By eliminating the previous references to consideration paid "pursuant to the tender offer" and "during the tender offer," the SEC clarified that the best-price rule applies only with respect to the consideration offered and paid for securities tendered in a tender offer. SEC Release No. 34-54684 (Nov. 1, 2006), 71 Fed. Reg. 65,393, 65,407 (Nov. 8, 2006). The adopting release also explicitly confirmed the SEC's view that the best-price rule is not applicable to arrangements between a bidder (or the target) and target shareholders where the shareholders do not tender their shares in the tender offer. SEC Release No. 34-54684 (Nov. 1, 2006).

125 A bidder for ADRs or the underlying shares will be required under the all-holder provision of Rule 14d-10 under the Exchange Act to make a tender offer for both the ADRs and the underlying shares, unless the SEC provides exemptive relief.

126 Rule 14d-8 under the Exchange Act. The SEC staff has granted relief from this requirement where certain non-pro rata purchases are required under local law. *See Advanced Semiconductor Engineering, Inc.* (avail. Dec. 28, 2015) (granting relief where Taiwanese law required the tender offer to include an odd-lot provision).

127 *See* § 9.05[3][b].

128 Rule 14d-11 under the Exchange Act. Prior to the 2008 Cross-Border Amendments, the subsequent offering period was between 3 and 20 business days. The amendments now permit the period to be longer

than 20 business days.

129 Rule 14d-11 under the Exchange Act. Following the effectiveness of Rule 14d-11, the SEC staff initially took the position that a decision to have a subsequent offering period is itself a material change requiring disclosure five business days before expiration of the initial offering period. The result was that most bidders chose not to use a subsequent offering period because announcing this intention five business days before the close of the initial offering period created a risk of holdouts to the initial offer. In 2001, the SEC staff stated that a subsequent offering period does not require the five-business day advance notice if the bidder announces in its initial offer (or during the course of the offer but at least five business days before the expiration) that it may include a subsequent offering period, explains what a subsequent offering period is and announces the commencement of the subsequent offering period in the required notice announcing the results of the initial offer (by 9:00 A.M. Eastern time on the business day after the expiration date). Rule 14d-11(d) under the Exchange Act; Regulation M-A and Cross-Border Release Interpretations, Question I.J.1.

130 Rule 14d-1(d)(2)(iv) under the Exchange Act. In particular, the SEC staff has granted exemptions from Rule 14d-11(d) under the Exchange Act where such a tender offer is not a Tier II offer (and thus ineligible for the codified relief under the 2008 Cross-Border Amendments) but applicable laws in the home jurisdiction would allow the bidder to delay the commencement of the subsequent offering period. *See China National Chemical Corporation and CNAC Saturn (NL) B.V.* (avail. Mar. 21, 2016) (granting no-action relief where Swiss law permitted bidders to pay for shares tendered in the subsequent offering period after the expiration of that period, even if more than 20 business days after the date of tender); *Acorda Therapeutics, Inc.* (avail. Mar. 8, 2016) (granting no-action relief where, in accordance with customary Finnish market practice, bidders were permitted to accept shares tendered in the subsequent offering period on a periodic basis (approximately every week) and make payment for such shares up to five Finnish banking days after acceptance); *Oak Leaf B.V., Acorn B.V and Acorn Holdings B.V.* (avail. May 21, 2013) (granting no-action relief where Dutch law permitted bidders to determine within three Dutch trading days whether to declare the conditions to the tender offer satisfied or to instead commence a subsequent offering period); and *Echo Pharma Acquisition Limited* (avail. May 1, 2013) (granting no-action relief where Irish law permitted bidders to pay for shares tendered within 14 calendar days from the end of the initial offering period or from the date of tender in the subsequent offering period).

131 Rule 14d-7(a)(2) under the Exchange Act. Even before the introduction of subsequent offering periods in the United States, the SEC had allowed withdrawal rights to be terminated in tender offers for non-U.S. companies whose shares trade in their home markets and are also registered under § 12 of the Exchange Act in order to allow compliance with U.K. rules. The SEC has codified its practice of granting exemptions from the withdrawal rights provisions of Rule 14d-7 in connection with certain tender offers for foreign private issuer targets. *See* § 9.05[9].

132 Exchange Act Rule 14d-1(d)(2)(viii) under the Exchange Act. Prior to the 2008 Cross-Border Amendments, the staff of the SEC had granted exemptions from Rule 14d-11(f) in the cross-border context where Brazilian law required an incremental interest payment for shares tendered during the subsequent offering period (also granting relief from the requirement in Rule 14e-1(b) under the Exchange Act that an offer be extended in the event of an increase in the offer price). *See Telemar Participaçöes S.A.* (avail. Oct. 9, 2007). After the adoption of the 2008 Cross-Border Amendments, the staff of the SEC has continued to grant exemptions from compliance with Rule 14d-11(f) on a case-by-case basis where the tender offer in question is not a Tier II offer (and thus ineligible for the codified relief) but where the conflict between foreign law and U.S. tender offer rules still remains. *See Empresa Brasileira de Telecommunicacoes* (avail. Oct. 15, 2010) and *GTIS Partners LP and GP Capital Partners IV, L.P.* (avail. Mar. 27, 2015). *See also Kraft Foods, Inc.* (avail. Dec. 9, 2009) (granting no-action relief where U.K. law required a "mix and match facility" allowing shareholders to receive either additional shares or a cash payment in Kraft's tender offer for Cadbury). *See also Alamos Gold Inc*. (avail. Mar. 7, 2013) (granting no-action relief where Canadian law required that the bidder be permitted to use a proration mechanism during its subsequent offering period).

133 The term "related securities" is defined as "securities that are immediately convertible into, exchangeable

for, or exercisable for" securities of the same class as securities for which the tender offer is being made. Rule 14e-5(c)(6) under the Exchange Act.

134 Rule 14e-5 under the Exchange Act. The prohibition does not apply to purchases or arrangements to purchase during a subsequent offering period as provided in Exchange Act Rule 14d-11 so long as the form and amount of consideration for such purchases are the same as that offered in the tender offer. For a discussion of subsequent offering periods, *see supra* Note 123.

135 In the context of a friendly offer, the SEC has clarified that the target company is considered to be "acting in concert" with the bidder and, accordingly, is a "covered person" falling within the Rule 14e-5 prohibition on purchases outside a tender offer. *See* SEC Release No. 33-7760 (Oct. 22, 1999). Because the definition of "covered person" includes "any person acting, directly or indirectly, in concert with any … other covered persons," SEC Release No. 33-7760 (Oct. 22, 1999), 64 Fed. Reg. 61,408, 61,431 at n.242 (Nov. 10, 1999), Rule 14e-5 may also extend to the target company's financial advisors in this context.

136 The exemption does not apply to all riskless principal purchases, but rather only to purchases "[a]s principal for its own account if the dealer-manager or its affiliate is not a market maker, and the purchase is made to offset a contemporaneous sale after having received an unsolicited order to buy from a customer who is not a covered person." Rule 14e-5(b)(4)(ii) under the Exchange Act.

137 Rule 14e-5 applies to any financial advisor to a bidder if the advisor's compensation is dependent on completion of the offer, even if it is not acting as dealer-manager for the tender offer. However, as drafted, this exception is only available to the dealer-manager. Nonetheless, the SEC staff has informally indicated that it is willing to read the term "dealer-manager" broadly to pick up entities performing similar functions but denominated "financial advisors" or the like.

138 As drafted, this exemption does not cover affiliates of a financial advisor not acting as dealer-manager. Rule 14e-5(b)(8) under the Exchange Act. *But see supra* Note 135. Although Rule 14e-5(b)(8) provides a potentially broad exemption for purchases made by certain affiliates of the dealer-manager that have appropriate firewalls in place to prevent the sharing of nonpublic information with the dealer-manager and that are not made for the purpose of facilitating the tender offer, this exemption has proved of limited use in cross-border tender offers, because the staff of the SEC has interpreted the requirements of this exemption to mean that the dealer-manager relying on the exemption must be an SEC-registered broker-dealer, a requirement that many non-U.S. financial advisors do not meet, and that all dealer-managers in the transaction or persons performing similar roles be broker-dealers registered under § 15 of the Exchange Act. *See* Regulation M-A and Cross-Border Release Interpretations, Question I.L.7; § 9.05[9][a].

139 Rule 14e-5(b)(9) exempts purchases or arrangements to purchase if (i) the tender offer is for the securities of a foreign private issuer, (ii) the tender offer is subject to the U.K. City Code on Takeovers and Mergers, (iii) the purchases or arrangements to purchase are effected by a connected exempt market maker or a connected exempt principal trader (as those terms are used in the City Code), (iv) such market maker or trader complies with the applicable provisions of the City Code and (v) certain required disclosure is included in the tender offer documents.

140 *See* Rule 14e-5(b)(10) under the Exchange Act. *See* § 9.05[9][a] for a discussion of the Tier I exemption.

141 *See* Rule 14e-5(b)(11) under the Exchange Act, codifying the class-wide no-action relief granted to Mittal in its acquisition of Arcelor. *See Mittal Steel* (avail. June 22, 2006). *See* § 9.05[9][b] for a discussion of the Tier II exemption. For exemption under Rule 14e-5(b)(11), (i) the tender offer must qualify as a Tier II tender offer under Rule 14d-1(d), (ii) the economic terms and consideration in the U.S. tender offer and foreign tender offer(s) must be the same, provided that any cash consideration to be paid to U.S. securityholders may be converted from the currency to be paid in the foreign tender offer(s) to U.S. dollars at an exchange rate disclosed in the U.S. offering documents, (iii) the procedural terms of the U.S. tender offer must be at least as favorable as the terms of the foreign tender offer(s), (iv) the intention of the offeror to make purchases pursuant to the foreign tender offer(s) must be disclosed in the U.S. offering documents, and (v) purchases must be made solely pursuant to the foreign tender offer(s) and not pursuant to an open market transaction(s), a private transaction(s) or other transaction(s). The SEC has issued no-action letters

granting exemptive relief for tender offers under Rules 14e-5(b)(11) and (12) despite the nonavailability of Tier II exemptive relief. *See America Movil* (avail. Apr. 23, 2010); *VimpelCom Ltd.* (avail. Feb. 5, 2010). In both cases, Tier II exemptive relief was unavailable solely because the percentage of outstanding shares held by U.S. residents was greater than 40%. *See also Enersis Americas S.A. and Endesa Americas S.A.* (avail. Aug. 24, 2016) (granting relief for the solicitation of shareholder approval for a merger involving a target company, the shares of which were then subject to a pending tender offer).

142 *See* § 9.05[9][b] for a discussion of the Tier II exemption.

143 For purchases by an affiliate of a financial advisor, (i) the financial advisor and the affiliate must maintain and enforce written policies and procedures reasonably designed to prevent the transfer of information between the financial advisor and affiliate that might result in a violation of U.S. federal securities laws and regulations through the establishment of information barriers, (ii) the financial advisor must have an affiliate that is registered as a broker or dealer under § 15(a) of the Exchange Act, (iii) the affiliate must have no officers (or persons performing similar functions) or employees (other than clerical, ministerial or support personnel) in common with the financial advisor that direct, effect or recommend transactions in the subject securities or related securities who also will be involved in providing the offeror or subject company with financial advisory services or dealer-manager services, and (iv) the purchases or arrangements to purchase must not be made to facilitate the tender offer.

The SEC acknowledged in the Adopting Release for the 2008 Cross-Border Amendments that the level of normal business activity may fluctuate once a tender offer is announced, but noted that if purchasing activity after the announcement of a tender offer far exceeds the usual or expected level of activity, it could potentially be a red flag of improper facilitation. In so noting, it acknowledged potential implications of a focus in the 2008 Cross-Border Amendments on the level of activity rather than the nature of activity, where the prior focus was on the nature of the activity. *See* Adopting Release for the 2008 Cross-Border Amendments, Section II.C.7.b, 73 Fed. Reg. 60,050, 60,069 (Oct. 9, 2008).

Prior to the 2008 Cross-Border Amendments and the adoption of Rule 14e-5(b)(12), the SEC staff informally indicated that it did not view the then-available exemptive relief covering trading activities of financial advisors and their affiliates as encompassing risk arbitrage activities, and the SEC's initial proposal for the 2008 Cross-Border Amendments included specific language to expressly exclude risk arbitrage from Rule 14e-5(b)(12)'s scope. *See* SEC Release No. 33-8917 (May 6, 1998). Although this language was not included in the final version of the rules, the SEC stated directly in the Adopting Release for the 2008 Cross-Border Amendments that purchasing activity by an affiliate of a financial advisor, including risk arbitrage, made to facilitate the tender offer will not be eligible for the exception. *See* Adopting Release for the 2008 Cross-Border Amendments, Section II.C.7.b, 73 Fed. Reg. 60,050, 60,069 (Oct. 9, 2008). Regarding the exemptive relief available prior to the 2008 Cross-Border Amendments, *see the Cleary Gottlieb Letter* (*see infra* Note 144).

Financial advisors to the bidder or target may be subject to Rule 14e-5 under the Exchange Act because they are acting in the capacity of "dealer-manager" to the bidder, because their compensation is dependent on the completion of the offer or because they are considered to be acting directly or indirectly in concert with a covered person (*e.g.*, the target in a friendly transaction). The exemptions described above are meant to allow a financial advisor's ordinary course trading activities to continue notwithstanding the restrictions imposed by Rule 14e-5 under the Exchange Act during a tender offer in which the financial advisor is involved.

The SEC staff has previously provided relief where the bidder, target or an affiliate of the bidder or target is in the banking or financial services sector to permit trading activities involving target securities by such entities on both a proprietary basis and on behalf of their customers, notwithstanding the fact that the rule would otherwise preclude such trading activities. *See*, *e.g.*, *Barclays PLC and ABN Amro Holdings N.V.* (avail. Apr. 24, 2007).

144 *See* Rule 14e-5(b)(12) under the Exchange Act, codifying the class-wide relief granted to Sulzer AG in its acquisition of Bodycote International plc and to Goldman Sachs International and similarly situated financial

advisors (and their affiliates and separately identifiable departments). *See Sulzer AG* (avail. Mar. 2, 2007); *see also the Cleary Gottlieb Letter*.

For this exemption to be available, (i) the covered person must reasonably expect that the tender offer meets the conditions for reliance on the Tier II cross-border exemptions of Rule 14d-1(d) (*see* paragraph 3 and 4 of this Note for further discussion), (ii) no purchases or arrangements to purchase outside the tender offer may be made in the United States, (iii) the U.S. offering materials must prominently disclose the possibility of, or the intention to make, purchases or arrangements to purchase subject securities or related securities outside the tender offer, and if there will be public disclosure of purchases of subject or related securities, the manner in which information regarding such purchases will be disseminated, and (iv) there is public disclosure made in the United States, to the extent that such information is made public in the subject company's home jurisdiction, of information regarding all purchases of subject securities and related securities otherwise than pursuant to the tender offer from the time of public announcement of the tender offer until the tender offer expires. For purchases by an offeror or its affiliates, there is a requirement that the tender offer price will be increased to match any consideration paid outside the tender offer that is greater than the tender offer price. This condition is satisfied if the laws of the relevant home jurisdiction or the terms of the tender offer provide for matching the higher consideration and the offeror complies with such provision. *See* Adopting Release for the 2008 Cross-Border Amendments, Section II.C.7.b, 73 Fed. Reg. 60,050, 60,069 (Oct. 9, 2008).

See § 9.05[9][b] for a discussion of the Tier II exemption. The SEC, since the 2008 Cross-Border Amendments went into effect, has granted no-action letters for companies that have complied with all the conditions of Rule 14e-5(b)(12)(i) except for the requirement that the financial advisor reasonably expects the tender offer to meet the requirements of the Tier II cross-border exemption. In these cases, the SEC has granted no-action relief, subject to a number of trading restrictions and disclosure requirements. *See Braas Monier Building Group* (avail. Oct. 25, 2016); *Songbird Estates PLC* (avail. Dec. 19, 2014); *VimpelCom Ltd.* (avail. Feb. 5, 2010); *Kraft Foods, Inc.* (avail. Dec. 9, 2009).

Prior to the 2008 Cross-Border Amendments and the changes to Rule 14d-1 under the Exchange Act, a letter from Cleary Gottlieb included the following note regarding the financial advisors' reasonable belief that an offering would be Tier II eligible: "[I]n many jurisdictions it may be difficult or impossible to 'look through' record ownership to determine beneficial ownership or to 'look back' to determine ownership percentages as of the date 30 days before the commencement of the tender offer, tests contained in Rule 14d-1 to ascertain the availability of the Tier II exemption. … Financial [a]dvisors and other transaction participants will make a determination of the percentage of the target held by U.S. shareholders … based upon information to the extent known or which can be obtained without unreasonable effort or expense, and will exclude the bidder and greater than 10% holders from such calculations as prescribed in the instructions to Rule 14d-1, notwithstanding the lack of literal compliance with the counting rules of Rule 14d-1 to ascertain Tier II eligibility." *Cleary Gottlieb Steen & Hamilton LLP* (avail. Apr. 4, 2007) (the "*Cleary Gottlieb Letter*"). This may serve as useful guidance in assessing whether the requirements of Rule 14e-5(b)(12) are satisfied, though the rule has been modified, as discussed. Note that the reference to 10% holders no longer applies, as such holders no longer must be excluded from calculations of U.S. ownership.

145 A separate issue is whether the non-U.S. financial advisor is acting in the same capacity as a "dealer-manager," the term used in Rule 14e-5(b)(8).

146 Rule 13e-1 under the Exchange Act.

147 *See* DEL. CODE ANN. tit. 8 § 251 (2016).

148 Generally in an acquisition for cash, a U.S. acquiror does not need shareholder approval. In an acquisition for stock, a U.S. acquiror will need shareholder approval if it lacks sufficient authorized-but-unissued shares under its certificate of incorporation or if such approval is required by applicable stock exchange requirements. Both Nasdaq and NYSE-listed U.S. companies generally need shareholder approval to issue more than 20% of their outstanding shares in connection with an acquisition. Both Nasdaq and NYSE, however, generally waive the requirement for foreign private issuers. *See* § 5.05[6] for a discussion of the

NYSE's corporate governance requirements and waiver policy and § 5.05 for a discussion of Nasdaq's requirements and policies.

149 As a general matter, U.S. corporate law does not have a compulsory acquisition provision following a successful tender offer. However, as discussed in greater detail below, an acquiror may be required to consummate a second-step merger following successful completion of a tender offer effected pursuant to an acquisition agreement that contemplated such a merger under § 251(h) of the Delaware General Corporation Law.

150 *See* DEL. CODE ANN. tit. 8 § 251(c) (2014).

151 *See* DEL. CODE ANN. tit. 8 § 251 (Supp. 2016).

152 This estimated timing between signing and closing assumes that the tender offer will be launched within one to two weeks after signing the acquisition agreement and that all regulatory approvals and conditions to closing in the merger agreement can be achieved while the tender offer remains outstanding. If consummation of the transaction will be subject to regulatory approval that is not likely to be received prior to the consummation of the tender offer (*e.g*., under applicable antitrust or competition laws), acquirors will typically prefer the one-step merger as the timing advantage afforded by a two-step tender offer and statutory merger cannot be realized and receipt of the shareholder approval required in a one-step merger may serve to deter interlopers during the period following the shareholder vote when the required clearances remain pending.

153 For U.S. public company targets, a shareholder vote requires preparing a proxy statement, filing it with the SEC and circulating it to shareholders, which process typically takes two to three months or longer if the SEC determines to review the "preliminary" proxy statement initially filed.

154 DCGL § 251(h) also eliminates the need for work-arounds developed by practitioners in the United States to manage the risk of failing to receive 90% of the target's shares in the tender offer. For example, in a typical non-§ 251(h) tender offer and second-step merger, the target will issue to the acquiror a "top-up option" to purchase the amount of the target's authorized but unissued shares that results in the acquiror owning one share more than 90% of the target's outstanding shares, which option is exercisable if the acquiror receives in the tender offer the minimum number of shares required to approve the transaction in a shareholder vote. However, the feasibility of using a top-up option depends on both the number of shares acquired in the tender offer and the number of authorized and unissued shares available for issuance upon exercise of the top-up option.

155 It should be noted, however, that in timing the tender offer and short-form merger, parties must take care to structure the transaction to avoid violating the Federal Reserve Board's margin rules that limit a lender's ability to lend money where such obligation is secured by margin stock, which includes any U.S. publicly traded equity security. Generally, the margin rules limit the amount of borrowing against margin stock to 50% of the value of such stock. Thus, parties must either limit the amount of debt financing used for the purchase or structure the transaction in such a way so that the debt financing is never secured, directly or indirectly, by margin stock. The margin rules are discussed in greater detail in § 9.05[11].

156 *See* § 9.02[2].

157 Pooling of interest accounting treatment for mergers under U.S. GAAP was eliminated in 2001 pursuant to the Financial Accounting Standards Board's Statement 141, Business Combinations. Since that time, mergers accounted for under U.S. GAAP must use purchase accounting treatment.

158 *See* § 9.02, § 9.05[1] and § 9.05[2].

159 *See* § 9.05[4].

160 *See* Rule 145 under the Securities Act with respect to Securities Act registration requirements in the context of a shareholder vote regarding a business combination and § 9.05[7][c] and § 9.05[8] with respect to Securities Act registration requirements relating to the resale of securities received originally in an offer exempt from registration; *see also* § 3.04[10], Note 81 (discussing Exchange Act current reporting obligations in the context of transactions, including business combinations, in which a shell company

reporting under the Exchange Act ceases to be a shell company).

161 *See* § 7.02[1] and [2] for a discussion of § 4(a)(2) of the Securities Act and Regulation D thereunder.

162 *See* § 8.02 for a discussion of Regulation S under the Securities Act. The use of the Regulation S exemption by acquirors that are U.S. issuers in this context may not be practical, however, as equity securities of U.S. issuers acquired pursuant to a Regulation S offering are "restricted securities" under Rule 144(a)(3) under the Securities Act. *See* § 7.03[2] for a discussion of restricted securities and Rule 144 under the Securities Act.

163 *See* § 9.05[9][c].

164 *See*, *e.g.*, *Flamel Technologies S.A.* (avail. July 14, 2016) (Ireland); *Nabi Biopharmaceuticals/Biota Holdings Limited* (avail. June 20, 2012) (Australia); *AngloGold Limited* (avail. Jan. 15, 2004) (Ghana); *Constellation Brands, Inc.* (avail. Jan. 29, 2003) (Australia); *Gilat Satellite Networks Ltd.* (avail. Dec. 19, 2002) (Israel); *Ashanti Goldfields Company Limited* (avail. June 19, 2002) (Cayman Islands); *Xyratex Group Limited* (avail. May 29, 2002) (England and Wales); *ICICI Bank Limited* (avail. Dec. 13, 2001) (India); *John Wood Group PLC* (avail. Mar. 1, 2001) (Scotland); *Galen Holdings PLC* (avail. Aug. 7, 2000) (Ireland); *The Development Bank of Singapore Ltd.* (avail. Aug. 12, 1999) (Singapore); *Source Media, Inc.* (avail. Dec. 3, 1996) (Ontario, Canada); *National-Oilwell, Inc*. (avail. July 30, 1997) (Alberta, Canada); *Buffelsfontein Gold Mining Co. Limited* (avail. Apr. 9, 1996) (South Africa). However, compulsory acquisition provisions that (as in the case of § 974 of the U.K. Companies Act 2006) only allow access to a court by a disgruntled minority holder would not satisfy the requirement of § 3(a)(10) of the Securities Act that a court rule on the fairness of the exchange. If an issuer submits a no-action request very close to the fairness hearing date, the Division of Corporation Finance may not have adequate time to consider the issues presented and respond before the hearing.

The SEC staff has issued guidance on the application of § 3(a)(10), clarifying a number of key practical and interpretive issues, including the following:

- The SEC's Division of Corporation Finance will not issue no-action relief after a § 3(a)(10) fairness hearing has been held.
- Although an issuer's solicitation of votes by securityholders on a transaction prior to a fairness hearing constitutes an offering, this should not prevent § 3(a)(10) from being available, so long as the issuer submits to the court or relevant government entity the disclosure materials pursuant to which the securities are offered before sending them to the offerees.
- When options, warrants or other convertible securities are issued in a § 3(a)(10) transaction, § 3(a)(10) does not exempt their later exercise or conversion.
- Following the amendments to § 18 of the Securities Act (*exempting* certain securities from state registration or qualification laws) effected by the Securities Litigation Uniform Standards Act of 1998 excluding securities issued in a § 3(a)(10) transaction from the coverage of the § 18 *exemption*, fairness hearings conducted under state securities law may now be relied upon for § 3(a)(10) purposes. (Conversely, securities issued in a § 3(a)(10) transaction are no longer exempt from state registration or qualification requirements.)
- Hearings held in foreign courts may suffice for § 3(a)(10) purposes, provided that they satisfy all the requirements applicable to exchanges approved by U.S. courts and the issuer provides the SEC's Division of Corporation Finance with an opinion of counsel licensed to practice in the relevant foreign jurisdiction stating that before the court can give its approval of the transaction, it must consider its fairness to the persons receiving the securities.
- Holders reselling securities received in § 3(a)(10) transactions must resell them in the manner permitted by clauses (c) and (d) of Rule 145 under the Securities Act (governing the sale of securities in connection with reclassifications of securities, mergers, consolidations and asset acquisitions). *See* § 9.05[8] and § 9.05[7][c]. Following amendments to Rule 145(c), which eliminated the presumptive underwriter provision except in transactions involving a shell company,

securities received in a Rule 145(a) transaction not involving a shell company and meeting the § 3(a)(10) exemption may generally be resold without regard to Rule 144 under the Securities Act if the sellers are (i) not affiliates of the issuer of the § 3(a)(10) securities and (ii) have not been affiliates within 90 days of the date of the exempt transaction.

See SEC, Division of Corporation Finance, Staff Legal Bulletin No. 3A (CF) (June 18, 2008), Fed. Sec. L. Rep. (CCH) ¶60,003.

165 *See* § 9.05[13] for a discussion of vendor placements.

166 Even if the acquiror is registered and reporting under the Exchange Act, if financial statements complying with Item 18 of Form 20-F have not been filed, it would be difficult to avoid delay. *See* § 4.07[11] for a discussion of Item 18 financial statements. In addition, financial information would have to be included for the target unless certain conditions are met. *See infra* Note 179; *see also* Rule 3-05(b)(2) of Regulation S - X.

167 Of course, in a friendly context, the target company may be willing to allow the bidder sufficient time to complete the registration process. For example, in Stora Enso Oyj's acquisition of Consolidated Paper, Inc. in 2000, Stora Enso's registration statement on Form F-4 also served as its initial U.S. public offering document.

168 For a discussion of the exclusion of U.S. shareholders, *see* § 9.05[7].

169 It is likely, however, that the SEC would be willing to afford a foreign issuer's Form F-4 registration statement confidential treatment if it contains the issuer's initial public offering prospectus.

170 *See* § 3.02[3] for a general discussion of the timing of the registration process.

171 SEC, Division of Corporate Finance, Generally Applicable Questions on Title I of the JOBS Act, Question 43 (Dec. 21, 2015).

172 In the context of an exchange offer, if an EGC uses the confidential submission process to submit a draft registration statement and does not commence its exchange offer before the effectiveness of the registration statement, it must publicly file the registration statement (including the initial confidential submission and all amendments) at least 15 days before the earlier of the road show, if any, or the anticipated date of effectiveness of the registration statement. An EGC that commences its exchange offer before the effectiveness of the registration statement pursuant to Rule 162 under the Securities Act must publicly file the registration statement (including the initial confidential submission and all amendments thereto) at least 15 days before the earlier of the road show, if any, or the anticipated date of effectiveness, but in no event later than the date of commencement of the exchange offer. SEC, Division of Corporate Finance, Generally Applicable Questions on Title I of the JOBS Act, Question 44 (Dec. 21, 2015).

173 In a merger involving the acquiror issuing stock or other securities, the target's proxy statement also constitutes the prospectus that is part of the acquiror's registration statement under the Securities Act. Issuers that file proxy statements for business combination transactions are no longer permitted to do so on a confidential basis, unless the participants do not avail themselves of the free communications safe harbor discussed in § 9.05[5][a] and disclose *only* the very limited information permitted by Rule 135 under the Securities Act. This Rule 135 standard applies even for cash merger proxy statements.

174 *See* Form F-4, General Instruction A.2. This 20-business day requirement only applies if the proxy statement is incorporating other SEC filings by reference, as is generally the case. The requirement is designed to afford the securityholders time to retrieve the information incorporated by reference. In cases where this option is not chosen by the registrant, the timing requirements in respect of delivering proxy statements are governed purely by state law, the registrant's charter and bylaws and applicable stock exchange requirements. *See*, *e.g.*, NYSE LISTED COMPANY MANUAL § 401.03, which recommends that a minimum of 30 days be allowed between the record date and meeting date for a shareholders' meeting to give ample time for the solicitation of proxies.

175 In rare circumstances, registration may also be required under applicable state securities (or "blue sky") laws in connection with a merger. *See* § 3.02[8] for a discussion of "blue sky" laws. Section 18 of the

Securities Act contains an exclusion for "covered securities," which include securities traded on a major U.S. securities exchange. Also, many states' "blue sky" laws provide that registration of a merger is not required if the shareholders have voted as a class to approve the merger because a "sale" for purposes of such laws has not occurred or it is a merger transaction exempt from registration.

176 Additional information is required to be included in order to comply, in the case of an exchange offer, with the tender offer rules described in § 9.02 and § 9.05[1] and, in the case of a business combination, with the proxy solicitation rules described in § 9.05[4][c].

177 For a discussion concerning IFRS relief, *see* § 4.05[1].

178 Registrants that do not report financial statements in accordance with U.S. GAAP (or IFRS, as issued by the IASB) may use the "pooling of interest" (or "merger") method of accounting for business combinations in circumstances where it would not be permitted under U.S. GAAP (or IFRS, as issued by the IASB), provided that its use is permitted by the accounting principles under which the registrant's financial statements are prepared and certain other conditions are met. SEC Release No. 33-7119 (Dec. 13, 1994).

179 Form F-4 requires that financial information be included for the target unless the *acquiror's* shareholders are not voting on the transaction, the target is not significant to the acquiror at the 20% level and the target is not a reporting issuer. Form F-4, Item 17(b)(5). For a discussion of the significance tests, *see* § 4.05[5][a]. Form F-4 also provides that the target company's financial statements for the latest fiscal year need be audited only to the extent practicable and that the financial statements for the fiscal years before the latest fiscal year need not be audited if they were not previously audited. *See* Form F-4, Item 17(b) and Instruction 1 to Item 17(b)(6). The target's financial statements generally must be reconciled to U.S. GAAP unless they are IASB IFRS financial statements or unobtainable without unreasonable cost or expense and, at a minimum, a narrative description of all material differences between U.S. GAAP and the relevant non-U.S. GAAP (other than IASB IFRS) is disclosed. If the target is a nonreporting company and the acquiror's shareholders are not voting on the transaction, only the most recent fiscal year financial statements need be provided. It is likely to be impossible to obtain the consent of a hostile target's auditors to the use of their audit opinion, but such consent need not be obtained if it is impracticable to do so and application to this effect is made to the SEC pursuant to Rule 437 under the Securities Act.

Although the SEC considers the inclusion of reconciled financial information of the target to be necessary to allow target shareholders to compare what they get in an exchange offer to what they give up, this requirement is onerous if the target is not a U.S. company, and it has led to U.S. holders being excluded from some offers to avoid registration of those offers. Nevertheless, the requirement that financials be included and reconciled as to nonreporting issuers only when the target is significant at the 20% level or the acquiror's shareholders are voting on the transaction is an improvement over the prior rule requiring inclusion and reconciliation irrespective of the target's materiality with respect to the acquiror. Where the target does not report in the United States, however, 20% may still be too low a significance threshold, leading, we suggest, to the unnecessary exclusion of U.S. holders in some offers. *See* § 9.05[7].

The disclosure requirements for a registered exchange offer are more onerous than the disclosure requirements applicable to registered securities offerings for cash to finance an acquisition, particularly with respect to the provision of target company financial information. For example, no financial statements of the target are required in a registration statement for an offering to raise cash to finance an acquisition of that target unless the acquisition is material to the acquiror at the 50% significance level, not the 20% significance level applicable to a registered exchange offer. Rule 3-05(b)(4) of Regulation S -X. Similarly, if the acquiror's shares are issued privately to shareholders of the target, and the acquiror registers such shares on Form F-3 for resale by such selling shareholders, no financial statements of the target are necessary unless the acquisition is material to the acquiror at the 50% significance level.

180 For a discussion of short-form registration statements, *see* § 3.02[1][b].

181 *See* § 4.05[2] for a discussion of requirements for interim period financial statements.

182 Such *pro forma* financial information must be reconciled to U.S. GAAP (unless prepared in accordance with IFRS, as issued by the IASB) whether or not the target's financials are so reconciled. *See supra* Note 179

as to when target financial statements are not required and thus *pro forma* information is not required. In such circumstances, the staff also will not object to the omission of comparative per share information and financial and related information required under certain Items of Regulation S -K. *See* Regulation M-A and Cross-Border Release Interpretations, Question I.H.2.

183 Rule 162(a) under the Securities Act. Such early commencement is also available in the context of an issuer tender offer under Rule 13e-4. In Rule 13e-3 "going-private" transactions and roll-up transactions, the offer cannot commence until the registration statement is declared effective by the SEC. "Going-private" transactions are transactions in which the public shareholders are being asked to (or forced to) exchange their shares for something other than full-voting common shares, instituted by controlling shareholders of a public company with the aim of eliminating its outstanding equity and thereby returning it to private ownership. A roll-up transaction is a transaction involving the combination of one or more partnerships in which some or all of the partners receive new securities or securities in another entity. *See* § 9.03[2] for a discussion of Rules 13e-3 and 13e-4 under the Exchange Act.

184 Rule 14d-4(d) under the Exchange Act. Following effectiveness, a comprehensive final prospectus reflecting all supplements must be filed. However, unless the preliminary prospectus was materially deficient, a comprehensive final prospectus does not need to be delivered to shareholders so long as a preliminary prospectus and prospectus supplements have been delivered in accordance with Rule 14d-4(b) under the Exchange Act. *See* Rule 162(b) under the Securities Act, which provides an exemption from the prospectus delivery requirements of § 5(b)(2) of the Securities Act.

185 *See* SEC, Division of Corporation Finance, Financial Reporting Manual, Topic 6230.1 (Mar. 17, 2016). For a discussion of delayed and continuous offerings, *see* § 3.02[2].

186 The JOBS Act also provides some additional relief to EGC acquirors in presenting financial statements of the acquiror and the target. If the acquiror is an EGC that is not a shell company and has presented only two years of financial statements in its registration statement for the exchange offer or merger, the SEC has indicated that it would not object if such an acquiror includes only two years of financial statements for the target company in the registration statement. *See* SEC, Division of Corporate Finance, Generally Applicable Questions on Title I of the JOBS Act, Question 45 (Dec. 21, 2015).

187 Following the shareholder vote, such updating should no longer be necessary, as there should be no "sale" triggering the applicability of the Securities Act's registration requirements, even where shareholders later make an election with respect to whether they will receive acquiror shares, cash or a combination of both. The SEC staff has taken the position, in the related context of the application of the registration requirements of the Securities Act to stock/cash dividend elections and dividend reinvestment and bonus plans providing for a dividend payable at the option of the shareholder in securities or cash, that no registration is required. This is because such election does not involve the surrender of "value," which, under § 2(3) of the Securities Act, is the principal characteristic of a "sale." *See*, *e.g.*, *JDN Realty Corporation* (avail. Oct. 26, 1999); *Greencore Group plc* (avail. July 3, 1996); *Medeva plc* (avail. Jan. 31, 1995); *Burns, Philp & Company Limited* (avail. Sept. 2, 1994). The same analysis should apply in the case of elections by target shareholders to receive merger consideration in the form of cash, acquiror shares or a combination of both, though there is no SEC guidance directly on point. If the companies qualify for incorporation by reference (and thus benefit from forward incorporation), however, this updating question often may not be significant.

188 *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, § 239.13 (Nov. 26, 2008).

189 *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Sections, § 239.13 (Nov. 26, 2008). Acquirors should consider carefully whether to obtain such written consents from the target shareholders given the interplay between disclosure requirements under the Exchange Act and existing Delaware case law. In *OmniCare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), the Delaware Supreme Court held that where shareholders holding the requisite number of shares needed to approve a deal have irrevocably committed to vote to approve such deal, the board may

not agree to other restrictions that prevent it from considering a superior proposal from another potential acquiror. There, the Delaware Supreme Court found that irrevocable consents obtained from target shareholders, when taken together with provisions in the acquisition agreement that prohibited the board from discussing superior proposals with other potential acquirors and that required the target to hold a shareholder vote (regardless of whether the board changed its recommendation to shareholders to approve the transaction) absolutely precluded other potential acquirors from coming forward with a superior proposal. In the court's view, consents that would absolutely "lock up" a transaction are therefore impermissible under Delaware law. *Omnicare*, 818 A.2d 914, 934–938. *See also* § 9.05[12][c] for a discussion of Delaware case law regarding defensive measures.

Despite the holding in *Omnicare*, in certain instances, it is still possible to effectively "lock up" a transaction by obtaining the requisite number of written consents from shareholders immediately after the board of directors approves the transaction. Since *Omnicare*, Delaware courts have held that there is no required minimum period of time between obtaining board approval for a transaction and the shareholder vote. *See Optima International v. WCI Steel*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008). By obtaining the shareholder approval at essentially the same time as the approval of the board of directors and closing the acquisition shortly thereafter, the period of time during which a superior proposal may emerge (and therefore the period of time during which the target's board of directors must be free to consider a superior proposal per *Omnicare*) is effectively eliminated.

190 *See* § 3.01[1], Note 1 for a discussion of the definition of a foreign private issuer.

191 The concept of solicitation is very broad and includes any oral or written statement intended to lead to the grant of a proxy. However, as discussed in § 9.05[5][a], SEC rules permit free communications to be made prior to the furnishing of a proxy statement, provided that a proxy card is not furnished and certain other requirements are met.

192 If fewer than ten shareholders hold the necessary number of votes to assure approval of the merger and the solicitation of proxies is done by the acquiror (not the target), a written proxy statement may not be necessary. Rule 14a-2(b)(2) under the Exchange Act. In those circumstances, however, Regulation 14C requires delivery of an "information statement" to any shareholders from whom proxies are not solicited at least 20 days prior to consummation of the merger. Rule 14c-2(b) under the Exchange Act. The information statement requires substantially the same information as a proxy statement and, in a stock-for-stock merger, can also constitute the acquiror's prospectus included in its registration statement.

193 Schedule 14A, Note D.3 (Rule 14a-101 under the Exchange Act); *see supra* Note 174 in respect of the 20-business day requirement.

194 Schedule 14A, Instruction 2.a. to Item 14.

195 *See* Item 1001 of Regulation M-A under the Securities Act; § 9.05[1].

196 *See* SEC Release No. 33-7760 (Oct. 22, 1999); § 9.05[1].

197 When describing the terms of a merger agreement or any related agreement in a disclosure document (or including such an agreement as an exhibit to a disclosure document), an issuer must consider whether additional disclosure is necessary to put into context the information contained in, or otherwise incorporated by reference into, the document so that the information is not false or misleading.

In 2005, in connection with settling a separate enforcement action against The Titan Corporation alleging violations of the Foreign Corrupt Practices Act of 1977 (the "FCPA"), the SEC issued a Report of Investigation on potential liability under §§ 10(b) and 14(a) of the Exchange Act. In Titan's proxy statement for its (subsequently abandoned) merger with Lockheed Martin Corporation, Titan had disclosed that the merger agreement contained representations and warranties by Titan expiring on completion of the merger "as to, among other things … Titan's compliance with the [FCPA]," and the merger agreement containing the unqualified FCPA representation was appended to the proxy statement filed with the SEC and distributed to Titan's shareholders. Although the report does not allege that Titan violated Rules 10b-5 and 14a-9 under the Exchange Act in respect of its merger proxy statement, the report highlights for issuers their responsibility to ensure the accuracy of disclosure of material contractual provisions, such as representations and covenants, contained in agreements disclosed in or appended to public filings, whether or not the agreements containing such provisions were themselves prepared as disclosure documents or the issuer intended public shareholders to rely on such provisions. *See* SEC Release No. 34-51283 (Mar. 1, 2005).

In 2010, Bank of America Corporation settled charges brought by the SEC that the proxy materials in connection with Bank of America's acquisition of Merrill Lynch & Co. represented that Merrill Lynch had agreed it would not pay bonuses to its executives prior to the closing of the merger without Bank of America's consent. The SEC's complaint alleged that the disclosure on bonuses was rendered materially false and misleading by the omission of disclosure of an exception permitting payments of certain bonuses that was reflected in a confidential disclosure schedule to the merger agreement, and that Bank of America was in violation of § 14(a) of the Exchange Act and Rule 14a-9 thereunder. In connection with the settlement, Bank of America acknowledged that an evidentiary basis existed for certain factual matters underlying the SEC's complaint but did not ultimately admit or deny any alleged wrongdoing. *SEC v. Bank of America Corp.*, SEC Litigation Release No. 21407 (Feb. 4, 2010).

Issuers filing agreements as exhibits to public SEC filings should consider including disclosure in their filings to the effect that (i) the representations and warranties in such agreements (a) were made solely for the benefit of the parties thereto, (b) may have been used for the purpose of allocating risk between the parties, rather than establishing matters of fact, and (c) may have been qualified by disclosure contained in separate disclosure schedules (which, in accordance with Item 601(b)(2) of Regulation S -K, may be omitted from the filing in the case of merger and similar agreements) or by materiality standards that differ from what may be viewed as material for securities law purposes, (ii) certain representations may have been made as of a specified date and may no longer continue to be true as of a later date, and (iii) the agreement is not intended to provide any other factual or financial information about the issuer other than the terms of such agreement and should be read in conjunction with the other information contained in the issuer's other SEC filings. At the same time, issuers should be sensitive to the need to disclose any material information about the transaction, including any condition that reasonably could be anticipated to be difficult to satisfy.

198 In 2008, the SEC approved a proposal by FINRA to adopt a rule on fairness opinion disclosures. SEC Release No. 34-58643 (Sept. 25, 2008); FINRA Rules, Rule 5150, FINRA MANUAL. The rule requires FINRA members, when rendering a fairness opinion that the member knows or has reason to know, at the time it issues the fairness opinion, will be provided or described to public shareholders, to make certain specified disclosures in the fairness opinion, including (i) whether the member has acted as a financial advisor to any party to the transaction and whether any compensation that the advisor will receive, for rendering the fairness opinion or serving as an advisor, is contingent upon the successful completion of the transaction, (ii) whether the member will receive any other significant payment or compensation contingent upon the successful completion of the transaction, (iii) any material relationship that existed between the advisor and any party to the transaction during the past two years or is mutually understood to be contemplated in which any compensation was received or intended to be received, (iv) any information that formed a substantial basis for the fairness opinion that was supplied to the member by the company requesting the opinion and whether any such information has been independently verified by the member, (v) whether or not the fairness opinion was approved or issued by a fairness committee and (vi) whether or not the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to any of the company's officers, directors or employees, or a class of such persons, relative to the compensation to the public shareholders of the company. In addition, the rule requires a FINRA member to adopt and maintain written procedures with respect to the composition of its fairness committee and the circumstances in which the member will use a fairness committee and a process to determine the appropriateness of the valuation analyses used FINRA Rules, Rule 5150, FINRA MANUAL.

199 *See* Schedule 14A, Item 14.

200 The Delaware courts as part of their review of a target board's compliance with Delaware judicial "full disclosure" requirements also appear to be moving toward requiring more disclosure of projections

provided to the acquiror or a target's investment banks and valuation methods used by the target's investment banks in preparing a fairness opinion where those methods are key to understanding the value of the target company; note, however, that this is a highly fact-specific inquiry. *See Koehler v. NetSpend Holdings, Inc.*, C.A. No. 8373-VCG, 2013 WL 2181518 (Del. Ch. May 21, 2013) (noting that where a board of directors elects to engage in a single-bidder process, the court will more closely scrutinize the quality of an investment bank's fairness opinion in order to determine whether the board engaged in "a process reasonably designed to maximize price" despite the absence of an external market check); *Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*, 11 A.3d 1175 (Del. Ch. 2010) (holding that exclusion of free cash flow estimates provided to the advisory investment bank by the target constituted a material omission because, in the context of a cash-out merger, the "value of stock should be premised on the expected future cash flows"); *In re Netsmart Technologies, Inc. Shareholders Litigation*, 924 A.2d 171 (Del. Ch. 2007) (failing to disclose projections used by financial advisors to perform a discounted cash flow evaluation establishes a probability that disclosure is materially incomplete). *But see In re BioClinica, Inc. Shareholder Litigation*, Consol. C.A. No. 8272-VCG, 2013 WL 5631233 (Del. Ch. Oct. 16, 2013) (holding that shareholders are entitled to "a 'fair summary' of the inputs and procedures used to construct the fairness opinion [but] are not entitled to the granular details of why certain inputs were selected or rejected"); *In re Micromet, Inc. Shareholders Litigation*, C.A. No. 7197-VCP, 2012 WL 681785 (Del. Ch. Feb. 29, 2012) (noting that a target is not obligated to disclose speculative information "which would tend to confuse shareholders or inundate them with an overload of information"); *In re Checkfree Corporation Shareholders Litigation*, C.A. No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007) (noting that even in a cash-out merger, a company is not required to provide all estimates of future results); *In re PNB Holding Co. Shareholders Litigation*, No. Civ. A. 28 N, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006) (same).

201 "Gun jumping" involves offers made prior to the filing of a registration statement, and written offers (other than by means of a preliminary prospectus) made after filing but before the registration statement is effective. *See* § 3.02[3].

202 Foreign private issuers are exempt from the proxy rules. Rule 3a12-3 under the Exchange Act. However, as discussed in § 9.05[4][c], if a U.S. issuer (or a foreign company that does not qualify as a foreign private issuer) is being acquired in a merger (or other business combination requiring shareholder approval), the proxy rules will be applicable.

203 For further discussion of communications issues arising in the merger context, *see* §§ 4.07[7] (discussing disclosure of preliminary merger negotiations) and 4.10 (discussing communications with financial analysts).

204 *See* Rules 165 and 425 under the Securities Act and Rule 14a-12 under the Exchange Act.

205 *See supra* Note 106.

206 Although communications released after 5:30 P.M. Eastern time can be filed on the next business day as early as practicable, the filing requirement creates difficulties for press releases issued late in the afternoon. Unintentional or immaterial delays will not, however, preclude reliance on the exemption.

207 Even if the acquiror were to limit its public statements to what is permitted under Rule 135 under the Securities Act as not constituting an offer, a copy of the Rule 135 notice must be filed under Rule 425 under the Securities Act. Rule 425(b) under the Securities Act. Domestic issuers disclosing information relating to the business combination transaction on a Form 8-K may use the Form 8-K simultaneously to satisfy their reporting obligations under Rule 425, provided that the Form 8-K filing meets all the substantive requirements of Rule 425 (other than Rule 425(c)) and the issuer checks the appropriate box on the cover sheet of the Form 8-K. Information voluntarily filed on a Form 8-K by a domestic issuer or on a Form 6-K by a foreign private issuer does need to be filed under Rule 425 even if it relates to the business combination. *See* Regulation M-A and Cross-Border Release Interpretations, Question I.B.13.

Information that is required to be disclosed in an annual or other Exchange Act report need not be filed under Rule 425, so long as the information is being disclosed solely to satisfy the requirements of the report. The SEC staff has also clarified that "business information that is factual in nature and relates solely to ordinary business matters, and not the pending transaction, does not need to be filed." SEC Release No. 33-7760 (Oct. 22, 1999), 64 Fed. Reg. 61,408, 61,412 (Nov. 10, 1999). It also explained that it expected "that filing persons [would] apply traditional legal principles in determining whether a particular written communication is made in connection with or relating to a proposed business combination transaction." SEC Release No. 33-7760 (Oct. 22, 1999), 64 Fed. Reg. 61,408, 61,412 (Nov. 10, 1999); *see also* Regulation M-A and Cross-Border Release Interpretations, Question I.D.1.

208 Transcripts of oral presentations also need to be filed if the presentations are made available through audio or visual recordings after their initial live presentation, *e.g.*, through a website or a call-in telephone number. Similarly, scripts for presentations need to be filed if they were distributed to investors or widely distributed throughout the company so that the speech can be given many times. *See* Regulation M-A and Cross-Border Release Interpretations, Questions I.B.2-4; *see also supra* Note 106 and accompanying text.

209 Thus it appears that press releases announcing "bear hugs" or similar offers to a target board involving the proposed issuance of acquiror securities, and subsequent press releases by the potential acquiror, need to be filed even if no exchange offer is threatened or contemplated. *See* Regulation M-A and Cross-Border Release Interpretations, Question I.A.2. (A bear hug involves an offer to the target board that the potential acquiror publicly announces in order to put pressure on the target board to negotiate.)

210 The SEC Release adopting Rule 165 states that filings are required until "the close of the proposed transaction." SEC Release No. 33-7760 (Oct. 22, 1999), 64 Fed. Reg. 61,408, 61,413 (Nov. 10, 1999). This would be illogical in the context of a transaction subject to regulatory or other delays. Once shareholders have made their investment decision by voting, filings generally should not be required between the date of the meeting and receipt of regulatory approvals. The SEC staff has indicated that it agrees with this position, as evidenced by its statement that communications required by Rule 165 under the Securities Act must be filed only "until the offering period is over." *See* Regulation M-A and Cross-Border Release Interpretations, Question I.B.17.

211 *See* SEC, Division of Corporate Finance, Generally Applicable Questions on Title I of the JOBS Act, Question 42 (Dec. 21, 2015).

212 The SEC has provided guidance regarding the requirement of a legend for electronic communications made through platforms that limit the number of characters or amount of text that can be included in such communication, such as those made available through certain social media websites. The SEC has stated that it will not object to the use of an active hyperlink to a legend to satisfy the requirements of Rules 134(b) or 134(d) under the Securities Act in the following limited circumstances:

- The electronic communication is distributed through a platform that has technological limitations on the number of characters or amount of text that may be included in the communication;
- Including the required statements in their entirety, together with the other information, would cause the communication to exceed the limit on the number of characters or amount of text; and
- The communication contains an active hyperlink to the required statements and prominently conveys, through introductory language or otherwise, that important or required information is provided through the hyperlink.

Where an electronic communication is capable of including the required statements, along with the other information, without exceeding the applicable limit on the number of characters or amount of text, the use of a hyperlink is inappropriate. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, § 110.01 (Apr. 21, 2014).

In addition, where an electronic communication platform permits the user to re-transmit a posting or message received from another party, such re-transmission is not attributable to the issuer so long as the transmitting party is neither an offering participant nor acting on behalf of the issuer or an offering participant and the issuer has no involvement in the transmitting party's transmission beyond having initially prepared and distributed the communication in compliance with either Rules 134 or 433 under the Securities Act. *See* SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Rules, § 110.02 (Apr. 21, 2014).

213 *See* Rules 165 and 425 under the Securities Act and Rule 14a-6(b) under the Exchange Act; Regulation M-A and Cross-Border Release Interpretations, Question I.D.4.

214 Section 11 of the Securities Act imposes absolute liability on the registrant for materially misleading written disclosure in a registration statement at the time it becomes effective. Section 12 (a)(2) of the Securities Act incorporates a negligence standard to impose liability for materially misleading written or oral communications in connection with the public sale of a security. *See* § 11.03[1] and [2] for a detailed discussion of §§ 11 and 12(a)(2) of the Securities Act.

215 *See* SEC Release No. 33-7760 (Oct. 22, 1999), 64 Fed. Reg. 61,408, 61,413 n.57 (Nov. 10, 1999).

216 Rule 14a-12(a)(2) under the Exchange Act.

217 Material may generally be incorporated by reference in a proxy statement if (i) it is contained in an annual report or a previously filed statement and (ii) (a) that statement is delivered to securityholders with the proxy statement or (b) the proxy statement identifies the information incorporated by reference and the information is not otherwise required to be included in the proxy statement.

218 *See supra* Note 194.

219 Exchange offers for equity securities that are not registered under the Exchange Act may not commence prior to SEC review, unlike exchange offers for equity securities registered under the Exchange Act. *See* Rule 14d-4(b) under the Exchange Act; § 9.05[4][b].

220 § 401(b) of the Sarbanes-Oxley Act; *see* § 3.06[1] for a discussion of these rules.

221 *See* S. REP. NO. 107-205, at 28–29 (2002).

222 *See* SEC Release No. 33-8176 (Jan. 22, 2003). The business combination disclosure rules identified by the release are Rules 165 and 425 under the Securities Act and Item 1015 of Regulation M-A under the Securities Act and Rules 14a-12 and 14d-2(b)(2) under the Exchange Act. The SEC noted in a subsequent Compliance & Disclosure Interpretation that Rule 14d-9(a)(2) was also intended to be included therein. *See* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Non-GAAP Financial Measures, Question 101.01 (Jan. 11, 2010). *See also* § 4.09.

223 *See* § 3.02[9] for a discussion of Regulation M under the Exchange Act generally. However, if the exchange offer or business combination involves only Rule 144A-eligible securities and is open only to qualified institutional buyers, then there is an exemption from Regulation M. Rule 102(b)(7) of Regulation M under the Exchange Act.

224 *See* Rule 100 of Regulation M under the Exchange Act for the definition of "affiliated purchasers." The staff has stated that once a merger agreement has been signed between an acquiror and a target, the target should be viewed as an "affiliated purchaser" in connection with purchases of acquiror securities for purposes of applying Rule 102. SEC, Division of Market Regulation (now, Division of Trading and Markets), Staff Legal Bulletin No. 9, Fed. Sec. L. Rep. (CCH) ¶60,009 (Oct. 27, 1999); SEC, Division of Market Regulation, FAQ About Regulation M (Sept. 10, 2010) ("Staff Bulletin No. 9").

225 A covered security is any security that is the subject of a distribution (the "subject security") and any security into which a subject security may be converted, exchanged or exercised (whether immediately or not), or which, under the terms of the subject security, may in whole or significant part determine the value of the subject security. Rule 100 of Regulation M under the Exchange Act.

226 The staff has clarified the application of these restrictions in the context of concurrent distributions of the same securities by an issuer, *e.g.*, an offering of common stock for cash and an exchange offer for the shares of another company. Absent additional factors, *bona fide* offers to sell or the solicitation of offers to buy the securities being distributed in one distribution should not constitute impermissible inducements with respect to a concurrent distribution. Staff Bulletin No. 9.

227 Rule 100 of Regulation M under the Exchange Act; Staff Bulletin No. 9.

228 The restricted period commences one business day prior to pricing or such time that a person becomes a distribution participant if the subject security has an average daily trading volume of at least $100,000 and

the issuer had a public float value of at least $25 million. In all other cases, the restricted period commences five business days prior to pricing, unless the distribution involves a merger, acquisition or exchange offer, in which case the period commences on the day proxy solicitation or offering materials are first disseminated to securityholders. *See* Rule 100 of Regulation M under the Exchange Act.

229 Staff Bulletin No. 9. The SEC staff has updated Staff Bulletin No. 9 to clarify that when a third party seeking also to acquire a target company for its stock solicits proxies in opposition to the target's preferred merger, a restricted period may be triggered. Assuming that the third-party alternative bid is sufficiently specific so as to constitute an "offer" for purposes of the Securities Act, then a restricted period in respect of the third party's distribution would commence at the time its proxy materials are distributed and continue until the third party's bid is voted on or abandoned.

Target companies should exercise caution in connection with purchasing acquiror securities in the context of a friendly merger, even in advance of the commencement of applicable Regulation M restricted periods. *See supra* Note 44 and accompanying text.

230 Similarly, where a target has become an "affiliated purchaser" for purposes of Regulation M following the signing of a merger agreement with the acquiror, its ordinary course communications should not be prohibited (*see supra* Note 224). As is the case with the acquiror, however, nonordinary course communications by the target in the context of a falling acquiror stock price could raise questions under Regulation M.

231 *See* § 3.02[9] for a discussion of these exemptions, including the significant exemption applicable in the case of securities with an average daily trading volume at or above a specified level.

232 A financial advisor's ability to rely on these exemptions would depend on its being classified as a "distribution participant" within the meaning of Rule 100 of Regulation M. The term "distribution participant" includes "an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution." Financial advisors generally should be viewed as distribution participants eligible for the exemptions in Rule 101 rather than being subject to the more restrictive Rule 102 as affiliated purchasers (defined to include "a person acting, directly or indirectly, in concert with a distribution participant, issuer, or selling securityholder"), particularly when the financial advisor is participating in a proxy solicitation effort or is acting as a dealer-manager in an exchange offer.

In the context of an acquiror with an affiliated purchaser that is a broker-dealer, but not a distribution participant, the SEC has granted no-action relief allowing the affiliated purchaser to continue certain of its brokerage and related activities, subject to a number of restrictions. In connection with the merger of UBS AG ("UBS") with PaineWebber Group, Inc., the staff permitted UBS's brokerage arm, UBS Warburg ("Warburg"), to continue, among other activities, making a market in UBS shares on the Swiss Stock Exchange and elsewhere outside the United States, as well as to engage in certain market making and hedging activities in derivatives linked to UBS shares. In granting relief, the staff noted, among other things, the significance of UBS shares and derivatives to the Swiss market and the role of Warburg as the principal market maker in these shares and derivatives; the operation of Warburg behind a "Chinese wall" and the compliance of its activities with Swiss law; the harm that could befall the Swiss and U.S. markets in respect of the liquidity and volatility of UBS shares by the cessation of Warburg's activities during a restricted period of approximately eight to ten weeks; that UBS's U.S. brokerage activities were conducted by a separate U.S. subsidiary, registered as a broker-dealer with the SEC and a member of the NASD (now known as FINRA), which would engage only in unsolicited brokerage activities in the normal course of its business with customers; and that the merger consideration was fixed and not dependent on the market price of UBS shares. *UBS AG* (avail. Sept. 22, 2000); *see also Lloyds Banking Group plc* (avail. Nov. 2, 2009).

233 *See*, *e.g.*, SEC Release No. 34-38030 (Dec. 9, 1996) (relating to tender offers undertaken to combine the U.K. cable television and telecommunications businesses of Cable & Wireless plc, NYNEX Corporation and Bell Canada International Inc.); SEC Release No. 34-27425 (Nov. 7, 1989) (Exemption Order regarding Ford Motor Company's agreed offer for Jaguar plc); SEC Release No. 34-27671 (Feb. 2, 1990) (Exemption Order relating to exchange and cash tender offers by Procordia Aktiebolag and Aktiebolaget Volvo for the

securities of Pharmacia Aktiebolag).

234 In the business combination context, non-U.S. offerors may also structure their offers to preclude U.S. target shareholders from voting on a proposed merger, thereby attempting to avoid the burdens of complying with U.S. securities laws. Because the SEC has taken the view that the issuance of securities in short-form mergers— *i.e.*, mergers not requiring the consent or vote of the recipients of the securities—also would constitute an "offer," "offer to sell," "offer for sale" or "sale" within the meaning of § 2(3) of the Securities Act, thereby triggering an obligation to register such securities under the Securities Act or to find an exemption from registration, SEC Release No. 33-5316 (Oct. 6, 1972), it is not clear whether this attempt would be successful.

In the 1999 release adopting exemptions from registration in the cross-border business combination context, however, the SEC stated:

> Business combinations present different issues from tender or exchange offers because participation by U.S. holders is not voluntary. In order to attempt to avoid U.S. jurisdiction, offerors often do not provide U.S. investors an opportunity to vote on the transaction. It is neither practicable nor desirable to treat U.S. holders differently from other securityholders when their company is merged out of existence. No special precautions should be taken to prevent U.S. holders from receiving the merger consideration in a business combination involving a foreign company merely because the proxy statement/prospectus was posted on a web site available in the United States.

SEC Release No. 33-7759 (Oct. 22, 1999), 64 Fed. Reg. 61,382, 61,395 (Nov. 10, 1999).

Accordingly, in the context of a business combination involving the distribution of securities to U.S. shareholders of a non-U.S. target that have been precluded from voting, it should be reasonable for the acquiror to conclude that it need not register its securities under the Securities Act. *See also infra* Note 259; § 9.05[9][c]; Regulation M-A and Cross-Border Release Interpretations, Question II.F.1.

235 SEC Release No. 33-8957 (Sept. 19, 2008), referred to herein as the "2008 Cross-Border Amendments" or, in reference to the guidance provided therein, the "Adopting Release for the 2008 Cross-Border Amendments."

236 In a U.K. takeover offer, in order for the bidder to ensure that it can invoke statutory compulsory acquisition (or "squeeze-out") rights under § 974 of the U.K. Companies Act 2006, the bidder must make a takeover offer to all shareholders on the same terms. However, the bidder may modify its offer to take account of issues created by the existence of foreign shareholders if it qualifies for certain exemptions under both the U.K. Companies Act 2006 and the U.K. City Code on Takeovers and Mergers.

Under the squeeze-out provisions, the bidder may exclude a particular territory or country outside the United Kingdom if it is able to conclude that the exclusion was made in order "not to contravene" the laws of that territory or country. Although not a formal pre-condition to the exercise of compulsory acquisition rights, the requirements of the U.K. City Code on Takeovers and Mergers as to documents being made available to shareholders must be complied with as a matter of law. Under these requirements, a bidder must send offer documentation to all shareholders of the target company, including those located in other jurisdictions, unless there is "sufficient objective justification" for not doing so. The U.K. Panel on Takeovers and Mergers will not normally allow a bidder to avoid the requirement to post the offer documentation to a European Economic Area jurisdiction. However, it will permit the bidder to avoid the posting requirement in respect of a non-European Economic Area jurisdiction if, at the date of posting, less than 3% of the shares of the target are held by shareholders located in that jurisdiction and there is a significant risk of civil, regulatory or criminal exposure if the documentation is sent to shareholders in that jurisdiction. (It is expected that U.S.

registration requirements would meet this test.) If more than 3% of the target company shareholders are located in a particular non-European Economic Area jurisdiction, the U.K. Panel on Takeovers and Mergers has discretion to waive the posting requirement in respect of that jurisdiction (having regard to, for example, the cost involved, any potential delays to the transaction timetable and the number of target shareholders in that jurisdiction). *See* U.K. City Code on Takeovers and Mergers, Rule 30.4 and the note therein.

In addition, the compulsory acquisition provisions in the U.K. Companies Act 2006 also recognize the difficulties that bidders may face in making certain forms of non-cash consideration available to overseas shareholders (*e.g.*, because of foreign registration requirements relating to the distribution or admission to trading of non-cash consideration). The variation of an offer to exclude certain shareholders from participating in non-cash consideration alternatives on the grounds that it may be unduly onerous to make such alternatives available does not prevent a takeover offer from benefiting from the U.K. squeeze-out provisions. This is not explicitly recognized in the City Code on Takeovers and Mergers, although it is longstanding market practice and, as such, is tolerated by the U.K. Panel on Takeovers and Mergers despite being inconsistent with the fundamental requirement for equal treatment of shareholders.

As a technical matter, U.K. offers are made to all shareholders, including U.S. persons. However, because the offer precludes acceptance from the United States in order to avoid jurisdictional means, U.S. holders as a practical matter cannot accept the offer unless they arrange for an advisor in London to act on their behalf. *See* text accompanying *infra* Note 241.

237 *Plessey Co. plc v. General Electric Co. plc*, 628 F. Supp. 477 (D. Del. 1986).

238 *Plessey Co. plc v. General Electric Co. plc*, 628 F. Supp. 477, 497 (D. Del. 1986).

239 Rule 14d-10 under the Exchange Act.

240 SEC Release No. 33-6653 (July 11, 1986), 51 Fed. Reg. 25,873, 25,877–78 (July 17, 1986). The *Plessey* case did not involve a claim for breach of the antifraud provisions of the U.S. securities laws. It is generally thought that fewer contacts with the United States are required for a court to assert jurisdiction under the antifraud provisions, and there is always a risk that a claim will be made that an offer document is fraudulent in certain respects.

For example, Consolidated Gold Fields PLC sued Minorco S.A. in 1988 in a U.S. District Court on the basis that Minorco's offer violated the U.S. antitrust laws and the antifraud provisions of the U.S. securities laws. On the antifraud claim, the SEC, in an amicus brief, took the position that the court had subject matter jurisdiction over the dispute but nevertheless argued that the court should refuse to grant an injunction for reasons of international comity. The key factor influencing the SEC's position that U.S. jurisdictional means were used seemed to be that Minorco sent offering documents to U.K. nominees notwithstanding that "it was surely foreseeable" that the nominees would forward the offering documents to their U.S. principals. Brief for the SEC as *Amicus Curiae*, *Consolidated Gold Fields PLC v. Minorco, S.A.*, 871 F.2d 252 (2d Cir.), *cert. denied*, 492 U.S. 939 (1989).

241 For a further discussion of "flowback" restrictions, *see* § 9.05[7][c].

242 SEC Release No. 33-6866 (June 6, 1990).

243 It may not be necessary for all the restrictions imposed in the Hoylake bid to be applied. For example, the SEC issued a no-action letter to Reuters in 1990 making it clear that representatives of the U.S. press need not be excluded from press conferences abroad during which a bid is announced in a manner customary in the market. *Reuters Holding PLC* (avail. Mar. 6, 1990). In addition, the result should be the same if the restrictions to prevent flowback are modified as discussed in § 9.05[7][c]. Although the court might not apply the procedural requirements for tender offers in Regulation 14E under the Exchange Act, it might nevertheless be willing to review any claims alleging fraud. *See supra* Note 241 and accompanying text.

With respect to U.K. companies, the U.K. City Code on Takeovers and Mergers restricts target companies from taking any action that may result in an offer being frustrated (including instituting litigation) without the approval of a majority of the target shareholders in a general meeting.

244 *See generally* Statement of the SEC Regarding Use of Internet Web Sites to Offer Securities, Solicit

Securities Transactions or Advertise Investment Securities Offshore, SEC Release No. 33-7516 (Mar. 23, 1998); SEC Release No. 33-7759 (Oct. 22, 1999) (adopting the 1999 Rules (as defined below)).

245 For a detailed discussion of Regulation S under the Securities Act, *see* § 8.02.

246 For a discussion of § 4(a)(1) of the Securities Act, *see* § 7.02.

247 A target affiliate that is, or becomes, an acquiror affiliate on completion of the exchange offer cannot rely on § 4(a)(1) or § 4(a)(3).

Although Regulation S contemplates distributions of securities through underwriting syndicates, practitioners believe its safe harbor should be available for exchange offers if the requirements of Regulation S are followed.

248 Category 1 offerings include offerings by a foreign issuer if there is no "substantial U.S. market interest" in the type of security being offered. Category 2 offerings consist of all debt offerings of foreign issuers that do not fall into Category 1, all non-Category 1 equity offerings of foreign issuers that are subject to the periodic reporting requirements of the Exchange Act, and most debt offerings of U.S. issuers subject to the periodic reporting requirements of the Exchange Act. *See* § 8.02[1][c][i] and [ii] for detailed descriptions of Category 1 and Category 2 offerings.

249 Although Regulation S imposes no restrictions on resales by recipient investors, their ability to resell into the United States will effectively be limited by the unavailability of the dealer exemption in § 4(a)(3) of the Securities Act for the 40-day period following commencement of the exchange offer. To facilitate market compliance with this 40-day restriction, issuers with public ADR programs generally prohibit deposits into those programs during this 40-day period or require certification by depositors during this period that the securities being deposited were not issued in the exchange offer, or in the case of a business combination, proxy solicitation. *See* §§ 7.02 and 8.03[1] for further discussion of § 4(a)(3) of the Securities Act.

250 *See* Rules 902(g) and 903 under the Securities Act.

251 In the context of Regulation S, a "distributor" is defined as any underwriter, dealer or other person who participates, pursuant to a contractual arrangement, in the distribution of securities offered or sold in reliance on Regulation S. Rule 902(d) under the Securities Act. Recipients of securities in exchange offers should not, without more, be deemed to be "distributors" under Regulation S.

252 If other outstanding securities of the issuer are fungible with those issued in the exchange offer, a distributor may sell the fungible securities into the United States or to U.S. persons so long as the securities being distributed in connection with the exchange offer are held in a segregated identifiable account and the fungible securities are not borrowed from and will not be replaced by the securities being distributed in the exchange offer. *See* SEC Release No. 33-6863 (Apr. 24, 1990); § 8.02[1][c][ii].

253 In addition to U.S. equity securities, Category 3 offerings include (i) equity offerings by foreign issuers not subject to the periodic reporting requirements of the Exchange Act if there is a "substantial U.S. market interest" for the class of securities being offered and (ii) debt offerings by U.S. issuers not subject to such periodic reporting requirements. *See* Rule 903(b)(3) under the Securities Act.

254 For a detailed description of the Category 3 requirements, *see* § 8.02[1][c][iii].

255 In Category 3 offerings, debt securities are subject to a 40-day distribution compliance period and equity securities are subject to a one-year distribution compliance period (or a six-month distribution compliance period if the issuer is a reporting issuer). *See* Rule 903(b)(3) under the Securities Act; § 8.02[1][c][iii]. In addition, U.S. equity securities sold under Regulation S are designated "restricted securities" under Rule 144 and may only be sold in the United States in accordance with Rule 144 requirements until the end of a one-year restricted period (or until the end of a six-month restricted period for securities of reporting issuers). *See* § 7.04[2] for a discussion of Rule 144.

256 *See* § 9.05[9][c].

257 The registration statement would have to be effective for one year, in the case of U.S. equity securities and Category 3 foreign equity securities, and 40 days, in the case of Category 3 debt securities.

258 For a discussion of Securities Act registration procedures for the initial exchange offer, including problems

that can arise in hostile offers, *see* § 9.05[4]. For a discussion of when target financial statements are required in a registration statement in connection with an offering being used to raise cash to finance an acquisition, *see supra* Note 179.

259 *See supra* Note 234, which discusses analogous circumstances in the cross-border business combination context in which an acquiror should not be required to register under the Securities Act the securities issued as part of the business combination to target shareholders in the United States that have been precluded from voting on the transaction. In November 1979, Thorn Electrical Industries Ltd., a U.K. company ("Thorn"), offered to exchange its ordinary shares ("Thorn Ordinary Shares") and convertible preference shares ("Thorn Preference Shares") for outstanding ordinary stock units ("EMI Shares") of EMI Ltd., another U.K. company. ADRs representing EMI Shares ("EMI ADRs") were not subject to the offer, and U.S. holders of EMI Shares were not permitted to accept the offer. The Thorn Ordinary Shares and Thorn Preference Shares were not registered under the Securities Act. An investment bank, on behalf of Thorn, offered to acquire Thorn Ordinary Shares (but not Thorn Preference Shares) for cash for a limited period during the offer, thus providing a partial cash alternative. In January 1980, Thorn announced that the holders of more than 90% of the EMI Shares had accepted its offer and that it intended to compulsorily acquire the remaining EMI Shares pursuant to the applicable U.K. statutory procedure. In a no-action letter, the SEC permitted Thorn and the depositary for the EMI ADRs to make arrangements for the withdrawal of EMI Shares from the ADR program, the delivery of withdrawn EMI Shares to Thorn and the subsequent delivery of cash or Thorn Ordinary Shares plus Thorn Preference Shares to former holders of EMI ADRs. The SEC permitted these arrangements without registration of the Thorn Ordinary Shares or Thorn Preference Shares under the Securities Act, and despite the fact that U.S. holders of EMI ADRs would receive unregistered Thorn shares, in large part because the acquisition procedure was compulsory under U.K. law. *EMI Ltd*. (avail. Apr. 21, 1980).

260 For a discussion of the principal exemptions from registration for the resale of restricted securities, *see* § 8.02 for a discussion of Regulation S under the Securities Act, §§ 7.04[3] and [4] for a discussion of the private resale exemptions, § 4(a)(7) of the Securities Act and "Section 4(1 ½)," and § 7.04[2] for a discussion of the public resale exemption, Rule 144 under the Securities Act.

261 *See* § 9.05[8][e] for a discussion of registration rights.

262 For purposes of Rule 144, the term "affiliate" means "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with" the issuer. The term "control" is defined broadly as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." The SEC staff has also indicated that a person is generally presumed to "control" an issuer if such person is an executive officer or director or owns more than 10% of the voting securities of the issuer, but this presumption is not absolute and can be rebutted. Rule 405 under the Securities Act; *American Standard* (avail. Oct. 11, 1972).

263 *See* § 7.04[2].

264 For the 1999 Rules, *see* SEC Release No. 33-7759 (Oct. 22, 1999).

265 The Tier I exemption and the Tier II exemption are codified as part of Regulation 14D under the Exchange Act. The 2008 Cross-Border Amendments clarify that the exemptions also apply to offers subject only to § 14(e) of the Exchange Act and Regulation 14E thereunder.

266 Rule 14d-1(c) under the Exchange Act.

267 *See* § 3.01, Note 1 for a discussion of the definition of a foreign private issuer.

268 The various calculation rules discussed in this section apply to all the exemptions discussed in this § 9.05[9].

269 These "look through" requirements apply only to securities held of record (i) in the United States, (ii) in the issuer's home jurisdiction and (iii) in the primary trading market for the issuer's securities if different from the issuer's home jurisdiction. If after reasonable inquiry the bidder is unable to obtain information, the bidder may presume that the customer accounts are held in the nominee's principal place of business. It is also

clear that, especially if there is a large number of nominees in such jurisdictions, a bidder need not look through every last nominee, so long as it has conducted a diligent investigation at a minimum of all institutions believed reasonably likely to hold shares on behalf of U.S. persons.

As originally proposed, the SEC had based the exemption threshold calculations on the number of "U.S. record holders." The adopted approach, which grounds such calculations instead on the concept of "U.S. ownership" requiring bidders to "look through" to beneficial owners of shares, more closely reflects the approach adopted by the SEC in the current definition of a "foreign private issuer." SEC Release No. 34-41936 (Sept. 28, 1999). The SEC recognized that focusing on beneficial ownership rather than record ownership limits the applicability of the exemptions.

270 The SEC did not adopt a proposed rebuttable presumption that persons holding through ADR facilities are U.S. holders.

271 The SEC generally considers the "public announcement" to be any oral or written communication by the acquiror or any party acting on its behalf, which is reasonably designed to inform or has the effect of informing the public or securityholders in general about the transaction. *See generally* Instruction 5 to Rules 13e-4(c) and 14d-2(b)(2) under the Exchange Act.

272 *See* Rule 800(h) under the Securities Act. If an acquiror in a business combination is unable to accomplish the look-through analysis as of a date between 60 days prior to and 30 days after announcement, a date no more than 120 days before the public announcement may be used. *See* Instructions to Rules 14d-1(c) and 13e-4(h)(8) under the Exchange Act; *see also* Regulation M-A and Cross-Border Release Interpretations, Question I.L.2.

273 Rule 800(h)(7) under the Securities Act.

274 *See* Rule 800(h)(7)(i) under the Securities Act, Instruction 3.1 to Rules 13e-4(h)(8) and (i) under the Exchange Act and Instruction 3.1 to Rule 14d-1(c) and (d) under the Exchange Act.

275 The SEC considers the primary trading market important because it ensures there is a primary foreign regulator with oversight over the transaction.

276 *See* Rule 12h-6(f)(5)(i) under the Exchange Act.

277 *See* Rule 12h-6(f)(5)(ii) under the Exchange Act.

278 "Home jurisdiction" is defined as both the jurisdiction of the target company's organization and the principal foreign market where the target company's securities are listed or quoted. Rule 800(f) under the Securities Act.

279 *See* Rule 800(h)(7)(ii) under the Securities Act, Instruction 3.ii to Rule 13e-4(h)(8) and (i) under the Exchange Act and Instruction 3.ii to Rule 14d-1(c) and (d) under the Exchange Act.

280 This includes not only filings of the issuer, but also filings by third parties, such as beneficial ownership reports. It also picks up information "readily available" through other sources, such as advisors or third-party information providers that can provide the information at no or limited cost. The rule, however, does not require that the bidder or target engage third parties in order to qualify for eligibility.

281 *See* Rule 800(h)(7)(iii) under the Securities Act and Instruction 3.iii to Rules 14d-1(c) and (d) under the Exchange Act.

282 *See* Rule 800(h)(7)(iii) under the Securities Act and Instruction 3.iii to Rules 14d-1(c) and (d) under the Exchange Act. *See also* Rules 13e-4(h)(8) and (i) under the Exchange Act.

283 In the context of a two-step transaction (*e.g.*, a tender offer followed by a merger), the U.S. ownership calculation may be made for the first step only so long as (i) the disclosure document discloses the intent to conduct the second-step merger and (ii) the second step is completed within a reasonable time after the first step. *See* Regulation M-A and Cross-Border Release Interpretations, Question II.E.9.

284 The SEC staff has stated that a late filing of Form CB may result in a loss of a bidder's ability to seek relief under the Tier I exemption. Because Form CB is furnished to, rather than filed with, the SEC, the bidder has no potential liability for the offering materials under § 18 of the Exchange Act (although the bidder is potentially liable under the other antifraud provisions of the U.S. securities laws, including §§ 10(b) and

14(e) of the Exchange Act, and must comply with the informational requirements of Rule 12b-20 under the Exchange Act, which requires disclosure of any material information necessary to make the information expressly required to be included in the report, in the light of the circumstances under which it is made, not misleading).

285 Rule 14d-1(c)(3)(iii) under the Exchange Act.

286 Rule 14d-1(c)(3)(i) and (ii) under the Exchange Act; Form CB.

287 Rule 14d-1(c)(2) under the Exchange Act. Equal treatment requires not only equal consideration, but also that the procedural terms of the tender offer, such as duration, pro-rationing and withdrawal rights, be the same for all holders. SEC Release No. 33-7759 (Oct. 22, 1999).

288 Rule 14d-1(c)(2)(iii) under the Exchange Act. The determination of whether the cash consideration is "substantially equivalent" to consideration offered offshore should be made as of the commencement of the offer. The SEC has stated that the amount of cash consideration must be adjusted during the term of the offer only if the bidder no longer has a reasonable basis to believe the cash is substantially equivalent to the value of the consideration offered to non-U.S. holders, such as if the bidder increases the offer price to non-U.S. holders. SEC Release No. 33-7759 (Oct. 22, 1999), 64 Fed. Reg. 61,382, 61,385 n.26 (Nov. 10, 1999).

If the offered security is not a "margin security" within the meaning of Regulation T promulgated by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") under the Exchange Act, the bidder must provide upon the request of the SEC or a U.S. securityholder an opinion from an independent expert stating that the cash-only consideration is substantially equivalent to the consideration offered outside the United States. The opinion must address the relative value of consideration offered to U.S. and non-U.S. securityholders, but does not need to address the fairness of either form of consideration in relation to the value of the subject securities. *See* Rule 14d-1(c)(2)(iii)(B) under the Exchange Act.

289 In addition to the U.S. federal securities laws, which regulate U.S. securities offerings at the national level, "blue sky" laws regulate U.S. securities offerings at the state level. Under many such state laws, the registration procedure for a securities offering can be as onerous and time consuming as that under the Securities Act at the federal level. *See* § 3.02[8] for a detailed discussion of state "blue sky" laws.

290 Rule 14d-1(c)(2)(i) under the Exchange Act.

291 Rule 14d-1(c)(2)(iv) under the Exchange Act.

292 *See* § 9.05[2] for a detailed discussion of Rule 14e-5 under the Exchange Act.

293 Rule 14e-5(b)(10) under the Exchange Act.

294 *See* § 3.02[9] for further discussion of Regulation M under the Exchange Act.

295 *See* § 9.05[6] for a further discussion of Regulation M in the context of exchange offers and business combinations.

296 Rule 14d-1(d) under the Exchange Act.

297 *See* § 9.05[9][a] for a discussion of the method of calculating U.S. ownership.

298 *See* SEC Release No. 33-7759 (Oct. 22, 1999), 64 Fed. Reg. 61,382, 61,387 n.41 (Nov. 10, 1999). The staff has granted relief in a number of cases where the Tier II exemption was not available where U.S. ownership either exceeded 40% or was not calculable. *See*, *e.g.*, *Acorda Therapeutics, Inc.* (avail. Mar. 8, 2016); *Songbird Estates PLC* (avail. Dec. 19, 2014); *Gemalto S.A., Wavecom S.A*. (avail. Nov. 7, 2008); *AstraZeneca PLC* (avail. May 23, 2006); *Harmony Gold Mining Company Limited* (avail. Nov. 19, 2004). In addition to granting relief where U.S. ownership exceeds 40%, the staff may in some circumstances be willing to grant relief from the U.S. tender offer rules where the Tier II exemption is not available solely because the target is a foreign issuer that does not qualify as a "foreign private issuer" as defined in Rule 3b-4(c) under the Exchange Act. *See Axel Springer AG* (avail. Sept. 12, 2005) (extending Tier II-type relief from Rules 14e-1(b), (c) and (d) under the Exchange Act where the target, ProSiebenSat.1 Media AG, failed to qualify as a "foreign private issuer" because its controlling shareholders were several private equity investors resident in the United States, although its operations were located in Germany, its securities were

not registered under the Exchange Act or listed on a U.S. exchange and it did not file reports with the SEC under §§ 13(a) or 15(d) of, or furnish information to the SEC pursuant to Rule 12g3-2(b) under, the Exchange Act); *see also TMX Group Inc*. (avail. June 14, 2011); *Chemoil Energy Limited* (avail. Dec. 14, 2009).

299 Rules 13e-4(i)(2)(ii) and 14d-1(d)(2)(i) and (ii) under the Exchange Act.

300 Rules 13e-4(i)(2)(ii) and 14d-1(d)(2)(i) and (ii) under the Exchange Act provide that ADRs and underlying securities are treated as a single class for purposes of the tender offer, and a U.S. offer can be made to U.S. holders of the subject securities and all holders of ADRs, including foreign holders. However, unlike the Tier I exemption, the Tier II exemption does not grant relief to bidders seeking to offer cash-only alternatives to U.S. holders. Requests for such relief are treated on a case-by-case basis.

Under the 1999 Rules, the SEC resolved the mismatch between the exemption and the practical needs of issuers making dual offers by routinely granting no-action relief from the application of the all holders rule set forth in Rule 14d-10(a)(1) under the Exchange Act to permit dual offers structured in this way rather than as set forth in the Tier II exemption (including when bidders cannot demonstrate that the U.S. ownership levels are within the limits set forth in the Tier II exemption). *See*, *e.g*., *Harmony Gold Mining Company Limited* (avail. Nov. 19, 2004); *Sanofi-Synthelabo S.A*. (avail. June 10, 2004); *Alcan, Inc*. (avail. Oct. 8, 2003); *Serono S.A.* (avail. Sept. 12, 2002); *Saipem SpA* (avail. July 29, 2002).

301 Rules 13e-4(i)(2)(ii) and 14d-1(d)(2)(ii) under the Exchange Act. Prior to the 2008 Cross-Border Amendments, the SEC routinely granted no-action relief from Rule 14d-10(a)(1) under the Exchange Act to permit this structure. *See*, *e.g.*, *CANTV* (avail. Apr. 6, 2007) (Venezuela); *E.ON Aktiengesellschaft* (avail. Dec. 6, 2006) (Spain); *Gas Natural SDG, S.A.* (avail. Mar. 2, 2006) (Spain); *Koninklijke Ahold N.V.* (avail. Sept. 10, 2002) (Chile); *Telefonica S.A*. (avail. June 5, 2000) (Brazil and Peru).

302 Rule 14d-1(d)(2)(iii) under the Exchange Act.

303 Rule 14d-1(d)(2)(iv) and (v) under the Exchange Act; *see supra* Notes 128 to 132 and accompanying text.

304 SEC Release No. 33-7759 (Oct. 22, 1999), 64 Fed. Reg. 61,382, 61,387 (Nov. 10, 1999). As discussed above, *see supra* Note 122, the SEC interprets Rule 14d-4(d)(2) under the Exchange Act, which sets forth minimum time periods necessary for dissemination of material changes in a registered securities offer (*i.e.*, a tender offer in which the consideration consists solely or partially of securities registered under the Securities Act) that commences early, as applying to all tender offers, including those subject only to Regulation 14E under the Exchange Act. Thus, in tender offers for U.S. registered equity securities and those for non-U.S. registered equity securities, bidders are required to extend the offer in the event of a material change to the offer. The SEC considers the reduction or waiver of a minimum tender condition to be a material change for purposes of the dissemination requirements of Rule 14d-4(d)(2). SEC Release No. 34-24296 (Apr. 3, 1987). Thus, unless the bidder qualifies for the exception to this rule, if the bidder waives or reduces a minimum tender condition it must hold the offer open for a minimum of five U.S. business days following announcement of the reduction or waiver, or, if there are fewer than five U.S. business days remaining prior to expiration of the offer, the bidder must extend the offering period. Bidders will be required to disclose fully and discuss all implications of waiver or reduction in the offering materials.

However, under the interpretation of the 2008 Cross-Border Amendments set forth in the Adopting Release for the 2008 Cross-Border Amendments, certain changes to the minimum acceptance condition may be made without providing withdrawal rights in the time remaining for the tender offer. Section II.C.5 of the Adopting Release for the 2008 Cross-Border Amendments, 73 Fed. Reg. 60,050, 60,066 (Oct. 9, 2008). This relief requires that the bidder undertake not to waive or reduce the minimum acceptance condition below a majority or such percentage threshold required to control the target company under applicable foreign law, and the relief is limited to circumstances under the home jurisdiction law that justify the bidder's inability to extend the offer or afford withdrawal rights. This relief does not apply to extensions under U.S. law due to changes in offer consideration, the amount of securities sought in the offer or the dealer's soliciting fee.

305 Rule 14d-1(d)(2)(viii) under the Exchange Act; 2008 Cross-Border Amendments.

306 *See* § 9.03[2]. If the offer were subject only to § 14(e) of the Exchange Act and Regulation 14E thereunder, a bidder relying on the Tier II exemption would only need to comply with the requirements of Regulation 14E not modified by Tier II, since the disclosure and other requirements of Regulation 14D and Rule 13e-3 would not be applicable. *See supra* Note 265.

307 Rule 14d-7 under the Exchange Act requires that withdrawal rights be provided to tendering holders as long as the offer remains open, and § 14(d)(5) of the Exchange Act provides that securities tendered may be withdrawn at any time after 60 days from the date of the original offer. We understand that the staff of the SEC takes the position that all conditions to an offer must be satisfied or waived prior to the expiration date of the offer and the offer must be declared wholly unconditional before a bidder can terminate the withdrawal rights of tendering securityholders. *See* Regulation M-A and Cross-Border Release Interpretations, Question II.A.1. Thus, an offer that remains subject to a post-expiration condition may be deemed to remain open and securityholders may be entitled to withdrawal rights under Rule 14d-7. Prior to the 2008 Cross-Border Amendments, the staff of the SEC had granted no-action relief from Rule 14d-7 under the Exchange Act and § 14(d)(5) of the Exchange Act to allow termination of withdrawal rights prior to receipt of regulatory approval. *See Bayer AG* (avail. Apr. 28, 2006). In addition, non-U.S. jurisdictions do not always provide for the extended withdrawal periods that may result from § 14(d)(5) and Rule 14d-7. In some jurisdictions, withdrawals are prohibited after the expiration date of the tender offer. In addition, permitting withdrawals during the period specified by local law for tabulating the results of the offer might conflict with local tender offer procedures, as well as potentially frustrate any minimum tender condition. No-action relief must be sought in such cases. *See*, *e.g.*, *Grand Chip Investment GmbH* (avail. Aug. 17, 2016); *Top Alpha Capital S.M. Ltd.* (avail. Feb. 16, 2016); *Pepsi-Cola (Bermuda) Ltd.* (avail. Mar. 18, 2011); *Barclays PLC* (avail. Aug. 7, 2007); *Serono S.A.* (avail. Sept. 12, 2002); *TotalFina* (avail. Oct. 15, 1999).

308 Rule 13e-4(f)(2)(ii) under the Exchange Act and § 14(d)(5) of the Exchange Act require bidders to provide "back-end" withdrawal rights if tendered securities have not been accepted for payment within a certain date after the commencement of a tender offer (40 business days following commencement in the case of an issuer tender offer subject to Rule 13e-4 under the Exchange Act and 60 days following commencement in the case of a third-party tender offer subject to § 14(d)(5) of the Exchange Act).

309 § 14(d)(5) of the Exchange Act and Rules 13e-4(i)(2)(v) and 14d-1(d)(2)(viii) thereunder.

310 Even if the Rule 802 exemption is not available, a transaction approved as a scheme of arrangement in the United Kingdom would be exempt from Securities Act registration under § 3(a)(10) thereof. *See supra* Note 164 and accompanying text.

311 None of the exemptions from the tender offer rules and registration requirements is available for any securities transaction that technically qualifies under the rules but is part of a plan or scheme to evade the registration requirements of the Securities Act or the tender offer rules under the Exchange Act. An example of a sham, according to the SEC, would be if an initial offer were commenced solely as a pretext for making a subsequent offer automatically eligible for the exemptions. SEC Release No. 33-7759 (Oct. 22, 1999), 64 Fed. Reg. 61,382, 61,389 n.51 (Nov. 10, 1999).

312 *See* § 9.05[9][a] for a discussion of the method of calculating U.S. ownership.

313 *See* Rule 802(a)(2) under the Securities Act. "Blue sky" laws generally provide an exemption from registration for offers to certain qualified institutions and generally exempt offers of securities (and securities senior to them) listed on a U.S. national securities exchange. "Blue sky" laws do not, however, include general exemptions from state registration requirements analogous to Rule 802. Consequently, to avoid registration requirements at the state level, tender offers and business combinations exempt from registration at the federal level under Rule 802 must qualify for alternative state law exemptions. As a result, an issuer may be forced to offer shares only to certain qualified institutional investors and exclude or offer cash alternatives to other holders in certain states to avoid registration under "blue sky" laws.

314 General Note 8 to Rules 800, 801 and 802 under the Securities Act.

315 Rule 802(a)(3)(ii) under the Securities Act. In certain cases it may be possible to distribute an equivalent English-language document, such as a Form 20-F, instead of a translation of a home country document,

such as an annual report, so long as the documents provide similar information in all material aspects.

316 Rule 802(a)(3)(iii) under the Securities Act.

317 Rule 802(a)(3)(i) under the Securities Act.

318 Rule 802(b) under the Securities Act.

319 SEC Release No. 33-7759 (Oct. 22, 1999); *see* § 3.05[4] for a discussion of the Trust Indenture Act of 1939.

320 Regulation M-A and Cross-Border Release Interpretations, Question II.C.1.

321 *See* § 8.02[1][c][iii] for a discussion of Category 3 restrictions under Regulation S and the restrictions applicable to an offering of equity securities by a U.S. issuer, and § 9.05[7][c] for a discussion of the resale of securities offered pursuant to Category 3.

322 *See* Rule 12g-3 under the Exchange Act; § 4.02[3].

323 *See* § 4.11[2] for a discussion of the de-registration rules applicable to successor issuers.

324 Generally, with respect to offshore tender and exchange offers, the SEC has indicated that the guidance in its 1998 release relating to the Internet is applicable. *See* SEC Release No. 33-7516 (Mar. 23, 1998); SEC Release No. 33-7759 (Oct. 22, 1999).

325 *See* § 7.02[4] for a discussion of the prohibition on "general solicitation and general advertising" in private placements.

326 The SEC has stated that no special precautions need be taken to prevent U.S. holders from receiving the merger consideration in a business combination (other than a tender or exchange offer) involving a foreign company merely because the proxy statement/prospectus was posted on a website available in the United States. Because shareholder participation in business combinations is not voluntary, general solicitation restrictions that give rise to the need for special precautions in the private placement context generally are less relevant. *See supra* Note 234. Accordingly, in the context of a business combination, the ability to establish a private placement exemption should not depend on taking the kind of special precautions described above for private placements generally. SEC Release No. 33-7759 (Oct. 22, 1999); Regulation M-A and Cross-Border Release Interpretations, Question II.F.1.

327 *See* § 7.02[5].

327.1 The margin regulations would not apply to an acquisition financed by the issuance of debt securities in a *bona fide* public offering, including under Regulation S, though they may apply to privately offered debt securities. *See* Fed. Res. Serv. ¶5-606.56 (staff opinion, Dec. 20, 1993) (the Board and its staff does not regard the purchase of debt securities offered in a public offering as an extension of credit subject to the margin regulations, with the caveat that the public offering must not be structured "so that the sale in actual practice resembles a private placement"), *see also* 51 Fed. Reg. 1771, 1775 (Jan. 15, 1986) (describing a particular registered offering of debt securities with minimum denominations of $2.5 million as resembling a private placement). The Board and its staff have provided interpretive guidance that facilitates issuances of debt securities pursuant to Rule 144A in compliance with the margin regulations, including characterizing a broker-dealer's purchase of an unregistered debt security for resale under Rule 144A as "arranging" rather than extending credit, *see* Fed. Res. Reg. Serv. ¶5-470.1 (Board interp., July 16, 1990), and by providing some relief from the registration requirements of Regulation U that would otherwise be applicable to purchasers of Rule 144A securities that are secured by margin stock. *See* Fed. Res. Reg. Serv. ¶5-942.69 (staff opinion, Aug. 30, 1996). *See* §7.06 for a more detailed discussion of the application of Regulation T to broker-dealer intermediation of Rule 144A offerings. The extent to which regulations otherwise apply to private securities offerings (and public securities offerings that are subject to the margin regulations because the offering in actual practice resembles a private placement) are generally described in this §9.05[11].

328 12 C.F.R. Parts 220, 221 and 224.

329 Because of Regulation T and applicable regulatory capital requirements, broker-dealers generally do not serve as a source of financing for acquisition transactions, although they may, in an investment banking

capacity, arrange for such financing, including from affiliates that are not broker-dealers and thus may be subject to Regulation U. For a general description of the restrictions applicable to broker-dealers under Regulation T, *see* § 14.07[6] and § 7.06[1].

330 For this purpose, a U.S. lender is one that has a principal office in a Federal Reserve District. *See* Fed. Res. Reg. Serv. ¶5-942.65 (staff opinion, Mar. 24, 1989) (Regulation G, which is now incorporated into Regulation U, "does not apply unless the lender has a principal place of business in a Federal Reserve District"); *Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp.*, 303 F. Supp. 1354 (S.D.N.Y. 1969). Federal Reserve Districts cover the 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the U.S. Virgin Islands, American Samoa, Guam and the Commonwealth of the Northern Mariana Islands. Regulation U requires U.S. lenders other than broker-dealers and banks that have a principal office in a Federal Reserve District to register with the Federal Reserve Board if they extend or maintain credit secured, directly or indirectly, by any margin stock in the ordinary course of business and the amount of credit meets certain monetary thresholds. 12 C.F.R. § 221.3(b)(1).

331 "Margin stock" is (i) any equity security listed or traded on a U.S. securities exchange, (ii) any security underlying American Depositary Shares listed on a U.S. securities exchange, (iii) any debt security convertible into, or carrying warrants or rights to subscribe to or purchase, margin stock, (iv) any warrant or right to subscribe to or purchase margin stock and (v) shares in most U.S. mutual funds and other companies registered under the Investment Company Act. 12 C.F.R. § 221.2; Fed. Res. Reg. Serv. ¶5-919.14 (staff opinion, Mar. 18, 1998).

332 Regulation U thus permits a loan used for the purpose of purchasing or carrying margin stock so long as the loan is not directly or indirectly secured by margin stock.

333 The loan value for collateral that is not margin stock (and not puts, calls, or combinations of puts and calls) is the collateral's "good faith" value, which is the amount (not exceeding 100 percent) of the current market value of the collateral that the lender, exercising sound credit judgment, would lend to a customer, without regard to the customer's other assets held as collateral in connection with unrelated transactions. 12 C.F.R. § 221.2.

334 Fed. Res. Reg. Serv. ¶5-805.1, 72 Fed. Res. Bull. 195 (1986).

335 Fed. Res. Reg. Serv. ¶5-917.192 (staff opinion, Dec. 23, 1988).

336 Fed. Res. Reg. Serv. ¶5-805.1, 72 Fed. Res. Bull. 195 (1986).

337 Of course, U.S. antitrust laws and foreign investment laws may be applicable. *See* § 9.06 and § 9.07. If the target is in a regulated industry (such as banking, aviation and television/radio), federal or (in the case of insurance) state regulatory approval will generally be required.

338 The discussion in this § 9.05[12] is based on Edward F. Greene, *Regulatory and Legislative Responses to Takeover Activity in the 1980s: The United States and Europe*, 69 TEX. L. REV. 1539 (1991).

339 *See Edgar v. Mite Corp.*, 457 U.S. 624 (1982).

340 The SEC adopted (i) Rule 14e-1(a) under the Exchange Act in 1979, requiring tender offers to remain open for at least 20 business days, SEC Release No. 34-16384 (Nov. 29, 1979); (ii) Rule 14d-8 under the Exchange Act in 1982, requiring that all partial offers be prorated over the entire period the offer was open, thus eliminating any incentive to tender early in the offering period, SEC Release No. 34-19446 (Dec. 15, 1982); (iii) Rule 14d-7 under the Exchange Act in 1986, requiring withdrawal rights to be available during the entire period an offer was open, SEC Release No. 34-23421 (July 11, 1986); and (iv) Rules 14d-10 and 13e-4 under the Exchange Act in 1986, requiring that a bidder's or issuer's tender offer be open to all holders of the class of securities subject to the tender offer and that each securityholder be paid the highest consideration paid to any other securityholder during the tender offer, SEC Release No. 34-23421 (July 11, 1986).

341 Whereas the SEC permits a bidder to launch a bid that is subject to the condition that adequate financing be obtained, requiring only that there be a reasonable basis for the bidder to believe that there will be financing available, the U.K. Panel on Takeovers and Mergers does not permit financing conditions in U.K.

takeover bids (although, if the bidder is likely to require a significantly long period (*e.g.*, more than 12 months) to obtain a necessary, material regulatory clearance, the U.K. Panel on Takeovers and Mergers may permit a financing condition if it would be unreasonable for the bidder to maintain committed financing throughout the period). *See* U.K. City Code on Takeovers and Mergers, Rule 13.4; Rule 14e-8(c) under the Exchange Act; *see also supra* Note 110.

342 *See supra* Note 340.

343 *See*, *e.g.*, N.Y. BUS. CORP. LAW § 912 (McKinney 2003); DEL. CODE ANN. tit. 8 § 203 (2012).

344 15 PA. CONS. STAT. ANN. §§ 2541–2548; S .D. CODIFIED LAWS §§ 47-33-8 to 47-33-16; ME. REV. STAT. ANN. tit. 13-C, § 1110.

345 OHIO REV. CODE ANN. § 1707.043; 15 PA. CONS. STAT. ANN. §§ 2571–2576.

346 The Delaware Supreme Court has upheld a board's reduction of a pill trigger to 4.99%, and its subsequent implementation of a dilutive exchange provision under such pill, in a circumstance in which the pill was designed to preserve the availability of the company's net operating loss carryforwards. *See Selectica, Inc. v. Versata, Inc.*, C.A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010), *aff'd*, 5 A.3d 586 (Del. 2010). *But see Yucaipa American Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010), *aff'd*, 15 A.3d 218 (Del. 2011) (expressing concern about net operating loss pills with triggers of 4.99% and interpreting "preclusive" in a broader manner than *Selectica*).

347 *See* Rule 13d-3(d) under the Exchange Act.

348 *See generally Third Point LLC v. Ruprecht, et al.*, 2014 WL 1922029 (Del. Ch. 2014).

349 Institutional investors generally dislike poison pills, particularly because they are adopted without shareholder approval. Accordingly, they sometimes put informal pressure on boards to redeem them. Each year a number of companies also face shareholder resolutions (which are generally nonbinding) requesting the board to redeem the poison pill, which often receive a majority of support of the shares actually voted.

350 Poison pills cannot, in Delaware, contain provisions to prevent or delay newly elected directors from redeeming the poison pill. *See Quickturn Design Systems v. Shapiro*, 721 A.2d 1281 (Del. 1998); *Carmody v. Toll Brothers*, 723 A.2d 1180 (Del. Ch. 1998). In some other states, however, the courts have upheld such "dead hand" provisions. *See Invacare Corp. v. Healthdyne Technologies*, 968 F. Supp. 1578 (N.D. Ga. 1997); *AMP Inc. v. Allied Signal*, 1998 U.S. Dist. LEXIS 15617 (E.D. Pa. Oct. 8, 1998), *rev'd on other grounds*, 168 F.3d 649 (3d Cir. 1999).

351 The Delaware courts confirmed this principle in *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011). There, the board of the target (Airgas, Inc.) elected to keep the company's poison pill in place in the face of a tender offer by Air Products, despite several price increases and extensions of the offer. The *Air Products* court noted that, while a target board cannot blindly refuse to consider a tender offer for the company, if the board is properly informed and is found to be acting in good faith, it may reject such an offer in its business judgment, assuming that the defensive measures adopted by the board are found to be reasonable in relation to the threat posed by a hostile offer to purchase the company at an inadequate price.

352 This view was clearly expressed by the Seventh Circuit in *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). In *Panter*, the court considered a challenge to defensive tactics adopted by directors of Marshall Field in response to a hostile offer by Carter Hawley Hale. The court affirmed the district court's directed verdict in favor of Marshall Field, finding that "[i]n the absence of fraud, bad faith, gross overreaching or abuse of discretion" the courts should not interfere with directors' judgment. *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168, 1194 (N.D. Ill. 1980).

353 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *see also Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995). Delaware law is important because many large U.S. companies are Delaware corporations, and because much of the law concerning directors' obligations has been determined in proceedings in the Delaware courts.

354 The first part of the test can be satisfied by directors demonstrating that they acted in good faith and with

reasonable investigation.

355 "Lock-ups" are options granted to a bidder on target securities or assets that become exercisable if another bidder acquires the target at a higher price. "Break-up" fees are fees payable to the original bidder in the event another bidder acquires the target at a higher price. "No-shop" clauses are covenants that restrict a target from soliciting or accepting other offers to acquire the company.

356 *See OmniCare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003). *But see Orman v. Cullman*, Civ. Act. No. 18039, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004) (declining to apply the *Omnicare* decision to a case in which the shareholders that approved the merger were fully informed and the deal protection mechanisms at issue (principally an 18-month lock-up agreement with the majority shareholders requiring them to not sell their shares and to vote against any alternative transaction) were not tantamount to *a fait accompli* because the merger agreement provided the target's board with a meaningful and effective fiduciary out and required approval of a majority of the minority shareholders before the merger could be consummated).

357 If, following the acquisition, the combined company has a controlling shareholder, the target shareholders will have given up their opportunity to obtain a control premium.

358 *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*., 506 A.2d 173 (Del. 1986); *see also Paramount Communications, Inc. v. QVC Network Inc*., 637 A.2d 34 (Del. 1994); *Arnold v. Society for Savings Bancorp, Inc*., 650 A.2d 1270 (Del. 1994), *aff'd*, 678 A.2d 533 (Del. 1996). *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009) (*Revlon* duties are triggered when a company "embarks on a transaction … that will result in a change in control" not merely when the company is "in play.").

359 *See* the definitions of the terms "offer" and "sale" in § 2(3) of the Securities Act. For examples of vendor placement no-action letters, *see*, *e.g.*, *Singapore Telecommunications Limited* (avail. May 15, 2001), *Airline Industry Revitalization Co. Inc*. (avail. Sept. 9, 1999), *TABCORP Holdings Ltd.* (avail. Aug. 27, 1999), *Durban Roodepoort Deep, Ltd.* (avail. June 22, 1999), *AMP Ltd.* (avail. Sept. 17, 1998), *Oldcastle, Inc.* (avail. July 3, 1986), *Hudson Bay Mining and Smelting Co., Ltd.* (avail. June 19, 1985) and *Electrocomponents PLC* (avail. Sept. 23, 1982).

360 2008 Cross-Border Amendments.

361 2008 Cross-Border Amendments, 73 Fed. Reg. 60,050, 60,078 (Oct. 9, 2008) ("Unless the market for the bidder's securities to be sold through the vendor placement process is highly liquid and robust and the number of bidder securities to be issued for the benefit of U.S. target holders relatively small compared to the total number of bidder securities outstanding, a vendor placement arrangement in a cross-border exchange offer would in our view be subject to Securities Act registration under Section 5.") A vendor placement may be subject to the equal treatment provisions of Rules 13e-4(f)(8) and 14d-10 under the Exchange Act; however, the SEC has stated that it generally believes cross-border tender offers eligible to be conducted under the Tier I exemption, and therefore not subject to the equal treatment rules, are the appropriate situation for vendor placements. SEC Release No. 33-8957 (Sept. 19, 2008). In light of the SEC's position, if U.S. ownership exceeds the limits of the Tier I exemption, it would be advisable to approach the SEC staff for a no-action letter before proceeding with a vendor placement. *See TABCORP Holding Ltd.* (avail. Aug. 20, 1999) (granting no-action relief from the equal treatment provisions for an offer by an Australian company, approximately 17% of the ordinary shares of which was beneficially owned by U.S. holders).

U.S. Regulation of the International Securities and Derivatives Markets, § 9.06, REPORTING REQUIREMENTS UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT

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 § 9.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The HSR Act [362] and the rules promulgated under it (the "HSR Rules") [363] require parties contemplating most large mergers and acquisitions with a significant U.S. connection to notify the Federal Trade Commission (the "FTC") and the Department of Justice (the "DOJ") and to observe a waiting period before closing. [364] The purpose of the HSR Act is to enable the FTC and the DOJ to review transactions for antitrust issues before closing and, where necessary, to seek a federal court injunction to prevent them from closing. [365]

[1] Jurisdictional Tests

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Acquisitions of assets, voting securities, and non-corporate interests, as well as mergers, tender offers, or the formation of joint ventures are all potentially reportable if the value of any party's acquisition exceeds $78.2 million (as adjusted). [366] Acquisitions valued at $78.2 million or less are not reportable under the HSR Act under any circumstances, [367] although the DOJ or FTC can still challenge such a transaction on substantive grounds under § 7 of the Clayton Act. [368] Acquisitions of debt instruments or other securities that do not carry voting rights are also never reportable.

The value of a transaction for HSR Act purposes is generally the greatest of the stated acquisition price, the market price of any traded voting securities to be acquired, and the fair market value of the assets or any untraded voting securities to be acquired. [369] The acquiring person must generally aggregate all voting securities or non-corporate interests of the target company that it will hold after

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the transaction, including holdings from previous purchases (unless those previous purchases were reported under the HSR Act in the last five years and the acquiring person is not crossing a higher notification threshold), and it must generally aggregate any assets of the target that it has purchased (or has signed an agreement or letter of intent to purchase) within 180 days of the execution of the present transaction agreement (unless those previous acquisitions were reported under the HSR Act). [370]

Unlike the European Commission's Merger Regulation, an acquisition of voting securities may be reportable under the HSR Act if valued at more than $78.2 million even where the transaction would not confer control of the issuer of the voting securities. [371] Moreover, an acquisition of additional voting securities of the same issuer may require an additional HSR Act filing if the subsequent acquisition would cause the acquiring person's holdings to meet or exceed one of the following notification thresholds (as adjusted at the time of the subsequent acquisition): (i) $78.2 million, (ii) $156.3 million, (iii) $781.5 million, (iv) 25% of the issuer's outstanding voting securities if valued greater than $1.563 billion and (v) 50% of the issuer's outstanding voting securities. [372]

After the HSR Act waiting period expires, an acquiring person has one year from the date of expiration to consummate an acquisition at the reported notification threshold. If the acquiring person's holdings of the target's voting securities do not meet or exceed the notification threshold reported within that one-year period, then any further acquisition will again be subject to the HSR Act. [373] However, once the acquiring person does meet or exceed the reported notification threshold within a year of the date that the initial waiting period expired, it may then acquire additional voting securities of the target until five years after that initial expiration date—provided that it does not meet or exceed a higher notification threshold. [374] Any acquisitions following the end of this five-year period, even an acquisition of one additional share of the target's voting securities, may trigger a new notification requirement. [375]

Reportable acquisitions are subject to a multi-tiered filing fee structure. Acquisitions valued at more than $78.2 million but less than $156.3 million have a filing fee of $45,000. For transactions valued at $156.3 million or more but less

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than $781.5 million, the filing fee is $125,000. For transactions valued at $781.5 million or more, the filing fee is $280,000. The waiting period does not begin to run until the filing fee has been received, typically by wire transfer. [376]

[2] Exemptions

The HSR Act and HSR Rules exempt a number of transactions that satisfy the jurisdictional tests. Several exemptions apply to acquisitions involving assets outside the United States or involving non-U.S. persons or issuers. [377] (These exemptions do not apply to acquisitions of voting securities of a U.S. issuer or assets located in the United States regardless of the nationality of the acquiring person.) The following categories of transactions involving non-U.S. parties or assets are exempt:

- acquisitions of assets located outside the United States (regardless of the nationality of the acquiring person), unless those assets generated more than $78.2 million of sales into the United States during the seller's most recent fiscal year; [378]
- acquisitions by a non-U.S. acquiring person of voting securities of a non-U.S. issuer, unless the acquisition confers control of the issuer *and* the issuer (including all entities controlled by the issuer) either holds assets located in the United States with a total value of more than $78.2 million or it had sales in or into the United States of more than $78.2 million in its most recent fiscal year; [379]
- acquisitions by a U.S. acquiring person of voting securities of a non-U.S. issuer, unless the issuer (including all entities controlled by the issuer) either holds assets located in the United States with a total value of more than $78.2

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  million or it had sales in or into the United States of more than $78.2 million in its most recent fiscal year; [380] and
- acquisitions involving an entity controlled by a foreign state, foreign government or agency thereof, provided that the acquisition is of (i) assets located within that foreign state or (ii) voting securities of an issuer organized under the laws of that state. [381]

There are a number of other exemptions under the HSR Rules that do not focus on the connection with the United States. [382] For example, a person's acquisition of goods or realty in the ordinary course of business—such as an airline's acquisition of an aircraft—is exempt. [383] Similarly, acquisitions of voting securities by an underwriter (including a broker-dealer) for the purpose of resale in the ordinary course of the underwriter's business are also exempt. [384] In addition, acquisitions in foreclosure or upon default (or in connection with a lease financing) are exempt if they result from a transaction that was made for the purpose of providing credit in the ordinary course of the creditor's business. [385] Another financing exemption applies to acquisitions of control of a new or existing unincorporated entity. This exemption applies if the acquiring person contributes only cash to the unincorporated entity for the purpose of providing financing and the terms of the financing agreement are such that the acquiring person will no longer control the entity after it realizes its preferred return. [386]

There is also a broad exemption for transactions involving entities that are controlled by the same ultimate parent entity known as the "intra-person" exemption. [387] This exemption may also apply to certain acquisitions of voting securities or certain acquisitions of a controlling interest in an unincorporated entity that are made in exchange for a contribution of assets. [388] This exemption further

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applies to the buyout of one 50-50 joint venture partner by the other partner, since both partners are considered ultimate parent entities of the venture. [389]

Institutional investors, such as savings banks, trust companies, insurance companies and finance companies, may be exempt from HSR notification requirements provided that the acquisition of voting securities is: (1) made directly by the institutional investor; (2) made in the ordinary course of business; (3) made solely for the purpose of investment (meaning the investment is passive) and (4) the institutional investor does not hold more than 15% of the issuer's outstanding voting securities. [390]

Transactions involving "investment rental property assets" may also be exempt under HSR Rule § 802.5. However, in 2015 the FTC announced its repudiation of its previous informal interpretations of the exemption, which had "expanded the rule's application well beyond the original intent." [391] The FTC's narrower interpretation moving forward emphasizes the requirement "that the property [must] be held solely for rental or investment purposes." [392] In determining whether a transaction falls into this category, the FTC analyzes whether the buyer is acting as a landlord that solely intends to profit from the investment in the real estate and is therefore exempt, or whether the buyer is participating in the business conducted on the property and intends to profit from the business activity, in which case the exemption under § 802.5 does not apply.

Currently, the Premerger Notification Office ("PNO") at the FTC exempts a broad range of acquisitions by real estate investment trusts ("REITs") of real property or other REITs from the HSR Act under the theory that they are "in the ordinary course of business," even if they would not otherwise be exempt. [393] To be exempt a REIT must act in conformity with a REIT's special tax status under the IRS rules and regulations. Recent public statements by PNO officials, however, suggest that the exemption may soon be revised and likely narrowed. At an American Bar Association event in January 2016, a PNO official stated that a REIT holding an operating company is "perhaps not in the ordinary course" of

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business and that the office was reevaluating the scope of this exemption, but provided no details about the timing of any official action. [394]

Finally, the HSR Act creates an exemption for acquisitions of less than 10 percent of a company's outstanding voting securities if that acquisition is made "solely for the purpose of investment." [395] This is known as the "investment-only exemption." The FTC narrowly construes the investment purpose required to fall within the exemption, emphasizing that the acquiring person's sole purpose in making the acquisition must be passive investment. There must be "no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." [396]

Recent enforcement actions by the DOJ and the FTC under the investment-only exemption have tested what activity counts as "participation" in the issuer's business decisions. On July 12, 2016 ValueAct Capital ("ValueAct"), an activist hedge fund, agreed to settle a civil antitrust lawsuit brought by the DOJ for improperly relying on the investment-only exemption when it acquired approximately $2.5 billion in shares of Baker Hughes Inc. and Halliburton Co. in 2014 and 2015 shortly after the companies announced their plan to merge. The DOJ claimed that ValueAct had intended to influence the issuers' business decisions by pressuring directors and officers of each company to take certain actions during the antitrust review of the Baker Hughes/Halliburton transaction. As part of the settlement, ValueAct agreed to pay a record $11 million fine under the HSR Act.

ValueAct had a history of alleged failures to make required HSR Act notifications. [397]

To prove ValueAct's intentions to influence the companies' business decisions, the DOJ relied on communications between the fund and senior executives at Halliburton and Baker Hughes as well as the fund's marketing and advertising materials. The complaint focused on the numerous steps ValueAct allegedly took to pressure directors and officers of each company to adopt a course of action during the difficult antitrust review process. The DOJ also placed particular significance on ValueAct's website and advertising materials, which promoted its strategy of "active, constructive involvement," and explained, "[t]he goal in each investment is to work constructively with management and/or the company's board to implement a strategy or strategies that maximize returns for all shareholders." [398]

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In an earlier enforcement action, the DOJ (acting on behalf of the FTC) filed suit against another activist fund, Third Point LLC, for wrongfully avoiding HSR premerger reporting requirements through its reliance on the investment-only exemption. [399] In its civil complaint in 2015, the FTC alleged that Third Point was acquiring Yahoo shares while simultaneously trying to influence Yahoo's business decisions, specifically taking concrete steps to change the composition of Yahoo's senior management and board. The FTC described some of ValueAct's actions that were inconsistent with the intent of a passive investor:

- contacted certain individuals to gauge their interest and willingness to become the CEO of Yahoo or a potential board candidate of Yahoo;
- assembled an alternative slate for the Yahoo Board;
- drafted correspondence to Yahoo announcing that Third Point was prepared to join the Yahoo Board;
- internally discussed the possible launch of a proxy battle for directors of Yahoo; and
- stated publicly that it was prepared to propose a slate of directors at Yahoo's next annual meeting. [400]

Because this was Third Point's first violation, the FTC only sought injunctive relief. [401] Shortly after the suit, Third Point came into compliance by filing the required HSR notification and on August 24, 2015, it settled the charges.

The high profile ValueAct and Third Point cases generated a series of questions about the scope of the investment-only exemption, the direction of enforcement actions, and its implications for activist funds and other investors. The recent enforcement actions may hinder activist funds by impeding their ability to buy shares "under the radar" and consequently increasing their upfront investment costs. Another key implication is that behavior once considered commonplace for investors who relied on the investment-only exemption, such as conveying opinions about governance reforms or other strategic courses of

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action, may be treading into territory that requires HSR notification. The ValueAct case also provides a lesson on how a fund's self-promotion may later serve as evidence of non-passive intent. Still, in the aftermath of these two cases, several ambiguities remain as to what qualifies as non-passive intent.

In an effort to clarify the scope of the investment-only exemption, the FTC director of the Bureau of Competition, Debbie Feinstein, and her staff, published a blog post titled "‘ *Investment-only’ means just that*." In it, the FTC firmly asserts that the investment-only exemption is a "narrow" one and lists conduct it considers "inconsistent" with the intent to be a passive investor such as: "nominating a candidate for the board of directors, holding a board seat or being an officer, proposing corporate action that requires shareholding approval, soliciting proxies, or being a competitor of the issuer." [402] This list, which was derived from the rule's Statement of Basis and Purpose, is by no means exhaustive. The FTC's announcement ends with a broad warning: "[A]ny investor who is considering engaging with management or any person considering taking a board seat should proceed with caution when relying on the investment-only exemption." [403] As to CEOs, board members, and other managing members of companies, the FTC believes these actors should "be aware of the requirements of the HSR Act, should take steps to determine the applicability of the Act to their transactions, and should conduct routine compliance audits as necessary." [404]

[3] Notification and Report Form

Whenever a transaction is reportable, the acquiring person and acquired person must each file an HSR Act Notification and Report Form ("HSR Form") with the DOJ and FTC. The HSR Form requires detailed information about the party's revenues from U.S. operations, the party's subsidiaries and minority stock holdings and copies of certain documents. The buyer must provide information on the basis of its ultimate parent entity, all controlled entities and any "associates" (generally any other entity under common management). On the other hand, the seller must provide certain information only with respect to the entities or assets that will be sold. [405]

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In particular, each party must submit all documents prepared by or for any officer or director (of the ultimate parent entity or any entity it controls) for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, potential for sales growth or expansion into product or geographic markets, synergies or efficiencies. [406] Parties must supply these documents even when they were created by unsolicited third parties, such as investment banks, and must submit all confidential information memoranda, regardless of content. These documents are called for by Items 4(c) and 4(d) of the HSR Form. These documents often have information directly related to competition and the parties' view of the relevant markets, so they are often the most important aspect of the HSR Form. [407]

The DOJ and FTC maintain in strict confidentiality all information in an HSR Form and the accompanying documents, none of which is subject to disclosure under the Freedom of Information Act. [408] Such materials may not be revealed except in response to a request from the U.S. Congress or as evidence in an administrative or judicial proceeding relating to the underlying transaction. [409] (As discussed below, also note that if the parties request early termination of the waiting period and the request is granted, the FTC will disclose the names of the ultimate parent entities, the acquired entity, and the fact that early termination has been granted.)

An HSR Act filing can be withdrawn voluntarily by written notification to the DOJ and the FTC. If a filing with the SEC under the Exchange Act [410] publicly announces the expiration, termination or withdrawal of a tender offer or the termination of an agreement or letter of intent, then the acquiring person or acquired person must send a letter to the FTC and the DOJ notifying them of the SEC filing, and that letter serves as a withdrawal of the HSR Act filing. [411] Subject to certain conditions, a notification may be resubmitted with no additional filing fee after a withdrawal, resetting the waiting period. [412] This tactic is commonly known as "pull and re-filing" and is typically done in an effort to avoid an in-depth investigation. [413]

In 2016, the FTC and DOJ announced new instructions for submitting HSR filings to clarify language and allow for the use of DVD filings. Although the FTC classified these changes (which were published in the Federal Register) as

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merely procedural and non-substantive—in order to avoid the need for notice and comment under the Administrative Procedure Act—a comparison with the previous instructions reveals some changes may be substantive after all. [414] For example, under Item 3(b) the FTC now requires the acquiring person produce "agreements not to compete *and other agreements between the parties*." Under the previous instructions acquirors provided documents that "constituted the agreement and non-competes." Under the new rule it remains unclear what "other agreements" may be required, though there is suspicion that the new language was intended to capture the use of privileged "side letters" between parties allocating the risk of an antitrust challenge. The new HSR filing form also creates additional requirements for withholding or redacting privileged materials. If the filing person withholds or redacts portions of any document responsive to Items 4(c) or 4(d), a "privilege log" must explain the reasons for noncompliance and also state the factual basis with enough detail to support the claim and to be evaluated for its validity. The HSR form also creates a new item, 7(c)(iv)(c), which adds several new industries (furniture, electronics, recreational vehicle parks and camps, rooming and boarding houses, and personal and household good repair and maintenance) for which filers must provide the state, or portion thereof, in which the person filing the notification conducts such operations.

[4] Waiting Periods

As discussed above, the HSR Act requires that parties to a reportable acquisition observe a waiting period before closing the transaction. For tender offers (and other acquisitions of voting securities, such as open market purchases, from a holder that is not included within the same ultimate parent entity as the issuer), the waiting period begins once the acquiring person alone completes its filing (including the payment of the applicable fee) with the FTC and the DOJ. [415] The acquired person is then required to make its filing no later than the fifteenth (or, in the case of a cash tender offer, the tenth) day following the notification by the acquiring person. [416] For acquisitions for which there is a

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signed agreement between the acquiring person and the acquired person, the initial waiting period begins to run only after both have filed their respective HSR Forms with the FTC and the DOJ and paid the appropriate fee. [417]

The length of the waiting period varies depending on the form of the transaction and the course of the reviewing agency's investigation. For cash tender offers [418] and acquisitions out of bankruptcy subject to 11 U.S.C. § 363(b), the initial waiting period is 15 days. [419] For other transactions, the initial waiting period is 30 days. The parties may request early termination of the initial waiting period, which is often granted in cases raising no significant competitive issues. In the event that early termination is granted, notice is published in the Federal Register and on the FTC's website identifying the ultimate parent entities, the acquired entity and the fact that early termination was granted. [420] If any waiting period would otherwise end on a Saturday, Sunday or holiday, the waiting period is automatically extended to the next business day. [421]

Before the initial waiting period expires, the FTC or the DOJ can request additional information and documentary material concerning the proposed transaction. [422] Such requests for additional information are commonly referred to as "second requests." A second request is essentially a civil subpoena requiring the recipient to collect and submit a wide range of documents and data. When a second request is issued, the waiting period is extended until each of the parties (or, in the case of a tender offer, the acquiring person) substantially complies with the second request and an additional waiting period has expired. [423] For cash tender offers and acquisitions out of bankruptcy subject to 11 U.S.C. § 363(b), this additional waiting period is ten days; for all other transactions, the additional waiting period is 30 days. [424] Alternatively, at any time before the parties substantially comply with the second request, the reviewing agency may end the waiting period by granting early termination, *i.e.*, if it concludes that the competitive issues it was investigating will not be a problem, or the parties and the reviewing agency may enter into a consent decree requiring a remedy to resolve the reviewing agency's competitive concerns.

The reviewing agency may, at any time prior to the consummation of the transaction, seek a preliminary injunction blocking the transaction in federal court. The standards for obtaining such an injunction differ for the DOJ and the

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FTC. Whereas the DOJ seeks a preliminary injunction under the same standards as other litigants, the FTC must demonstrate that a preliminary injunction is in the public interest (albeit considering the equities and the likelihood of success). [425] Courts have traditionally treated the DOJ and FTC similarly in practice, notwithstanding some decisions that suggest the FTC's standard may be less onerous. [426] In either case, the likelihood of the agency's success on the merits is judged under § 7 of the Clayton Act because it would substantially lessen competition or tend to create a monopoly in a line of commerce. [427] However, the DOJ presents its merits case in the same federal court in which it seeks its preliminary injunction, while the FTC presents its merits case before an internal administrative tribunal.

Because the parties are free to consummate the transaction at any time after the waiting period expires, the reviewing agency often requests additional time from the parties to make its decision on whether to challenge the transaction in court. Parties often find it is in their interest to grant such requests, as this can give the parties more time to demonstrate that the transaction is not anticompetitive or enable the parties and the reviewing agency to negotiate a mutually acceptable settlement of the case such as a divestiture.

[5] Gun Jumping

The parties to a transaction must maintain their separate and independent existence until the HSR Act waiting period expires and the transaction closes. When parties fail to observe these requirements, they are said to engage in "gun jumping." Gun jumping may violate the HSR Act (if the parties effectively transfer beneficial ownership to the buyer before the HSR Act waiting period expires) or § 1 of the Sherman Act (if the parties coordinate their competitive behavior before closing). Enforcement actions by the DOJ and FTC have generally focused on three types of gun jumping behavior: (i) implementing integration plans or asserting management control over the company to be acquired, (ii) sharing competitively sensitive information or coordinating competitive behavior, and (iii) transferring to the buyer an excessive amount of the economic risk associated with the company to be acquired. Although gun-jumping analysis is slightly different under the HSR Act than the Sherman Act, enforcement

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actions based on either statute have generally been brought only in the most flagrant cases, where it was obvious that the parties simply "acted as if the merger had already occurred." [428]

[6] Penalties

Failure to comply with the HSR Act may result in civil penalties. Violation of the HSR Act may subject any person, or any officer, director, or partner of such person, to a civil penalty of up to $40,000 per day from the day of closing to the day the party complies. [429] Such penalties have been imposed for failing to file, submitting incomplete or inaccurate files [430] and engaging in gun jumping while the waiting period is running. [431] The HSR Act also authorizes federal courts to order compliance, grant other discretionary equitable relief and extend the statutory waiting periods until there has been substantial compliance, [432] although these procedures have seldom been used.

Footnotes

362 Hart-Scott-Rodino Antitrust Improvements Act, Pub. L. No. 94-435, tit. II, § 201, 90 Stat. 1383 (1976) (codified as amended at 15 U.S.C. § 18a). The HSR Act was most recently amended in December 2000. District of Columbia Appropriations Act, 2001, Pub. L. No. 106-553, § 630, 114 Stat. 2762 (2000). References in this section to the HSR Act are to the statute as most recently amended.

363 The HSR Rules are codified at 16 C.F.R. § 801–03.

364 Proper application of the HSR Rules requires an understanding of a few key terms. "Person" is defined by reference to an "ultimate parent entity," meaning an individual or a legal entity not controlled by an individual or any other entity. *See* HSR Rules § 801.1(a)(3). An acquiring person includes all the entities controlled by the ultimate parent entity. *See* HSR Rules § 801.1(a)(1). "Control" means: (i) holding 50% or more of the outstanding voting securities of an issuer, (ii) having the contractual power presently to designate 50% or more of the directors of a corporation, or in the case of trusts, the trustee of such trust or (iii) in the case of an unincorporated entity, having the right to 50% or more of the profits of the entity (or, on dissolution, the right to 50% or more of the assets of the entity). HSR Rules § 801.1(b). "Voting security" means any security that presently or upon conversion gives its holder the ability to vote for the election of

directors of the issuer of the security or an entity in the same person as the issuer. HSR Rules § 801.1(f)(1)(i). "Non-corporate interest" means an interest in any unincorporated entity that gives the holder the right to any profits of the entity or the right to any assets of the entity in the event of the dissolution of that entity. HSR Rules § 801.1(f)(ii).

365 H.R. Rep. No. 94-1373, at 8 (1976). The HSR Act is strictly procedural and does not affect the FTC's or DOJ's jurisdiction to challenge any transaction, even those that are not reportable under the HSR Act or those for which the HSR Act waiting period has expired. Nonetheless, companies generally interpret expiration of the HSR Act waiting period as an indication that the FTC and DOJ will not challenge a transaction. In 2003, however, the FTC obtained an order from an FTC Administrative Law Judge requiring Chicago Bridge & Iron Works Co. to divest assets it acquired from Pitt-Des Moines Inc. in a reported transaction that had closed over two years before the ruling. The FTC commissioners then reviewed the case, issuing an opinion in 2004 that largely upheld the administrative law judge's findings and also required a divestiture (although a slightly modified one) as a remedy. This appears to be the first challenge of a consummated transaction after expiration of the waiting period (there was no indication that the parties' HSR Act filings did not give the FTC the intended opportunity to assess potential competitive harm). It is worth noting, however, that the FTC began investigating before the acquisition closed, giving the parties notice of a possible challenge despite the expiration of the HSR Act waiting period. In light of this case, companies should not necessarily interpret expiration of the HSR Act waiting period as a guarantee that the FTC or DOJ will not challenge their transaction, especially where the reviewing agency launches an investigation after the waiting period has expired but before the parties have consummated their transaction. *See In the Matter of Chicago Bridge & Iron Company, N.V.*, 2004 FTC LEXIS 250 (Dec. 21, 2004).

366 The HSR Act reporting thresholds are adjusted annually based on the change in U.S. gross national product. The reporting threshold increased from $76.3 million for 2015 to $78.2 million for 2016. *See* Revised Jurisdictional Thresholds For Section 7A of the Clayton Act, 81 Fed. Reg.16, 4299 (Jan. 26, 2016).

367 This threshold is known as the "size-of-transaction" test. For transactions valued at more than $78.2 million (as adjusted) but not more than $312.6 million (as adjusted), an additional jurisdictional threshold—called the "size-of-person" threshold—must be met for the transaction to be reportable. Specifically, such a transaction is not reportable unless one of the following three conditions is satisfied: (i) voting securities or assets of a person engaged in manufacturing with annual net sales or total assets of $15.6 million (as adjusted) or more will be acquired by a person with total assets or annual net sales of $156.3 million (as adjusted) or more, (ii) voting securities or assets of a person not engaged in manufacturing with total assets of $15.6 million (as adjusted) or more, will be acquired by a person with total assets or annual net sales of $156.3 million (as adjusted) or more; or (iii) voting securities or assets of a person with annual net sales or total assets of $156.3 million (as adjusted) or more will be acquired by a person with total assets or annual net sales of $15.6 million (as adjusted) or more. HSR Act § 18a(a)(2)(B). Annual net sales and total assets must include all net sales and assets, whether foreign or domestic, of the "ultimate parent entity" (and all entities it controls).

368 Clayton Act, ch. 223, § 7, 38 Stat. 730 (1914) (codified as amended at 15 U.S.C. § 18); FTC Act, Act of September 26, 1914, ch. 311, § 5, 38 Stat. 717, 719 (codified as amended at 15 U.S.C. §§ 41–58). On January 10, 2013, the DOJ filed lawsuit in the U.S. District Court for the Northern District of California seeking to unwind Bazaarvoice's June 2012 acquisition of PowerReviews. The transaction was not reportable under the HSR Act, but the DOJ challenged the merger on the grounds that it allegedly eliminated Bazaarvoice's only significant rival, in violation of § 7 of the Clayton Act. The DOJ began its investigation shortly after the transaction closed. The trial was held in September 2013, and in January 2014, the U.S. District Court for the Northern District of California ruled in favor of the DOJ, finding that the transaction violated § 7 of the Clayton Act. *United States v. Bazaarvoice, Inc.*, Trade Cas. (CCH) ¶78,641 (N.D. Cal. Jan. 8, 2014).

369 HSR Rules § 801.10.

370 HSR Rules § 801.13.

371 HSR Rules § 801.1(h). On the other hand, the formation of an unincorporated entity or the acquisition of noncorporate interests is only reportable if the acquiring person would control the entity as a result of the transaction. HSR Rules § 801.50, § 801.2(f).

372 HSR Rules § 801.1(h).

373 HSR Rules § 803.7.

374 HSR Rules § 802.21.

375 However, another notification requirement may only be triggered by another acquisition. *See* HSR Act § 18a(a). An increase in the market price of voting securities such that the value held by the acquiring person would exceed a notification threshold (or a higher notification threshold than previously reported during the five-year period) does not require notification under the HSR Act.

376 HSR Rules § 803.10(b)(2) (although there is no specific rule regarding receipt of the filing fee, the FTC will consider a notification "deficient" until the filing fee is received).

377 A non-U.S. person or issuer is one that (i) is not incorporated in the United States, (ii) is not organized under the laws of the United States, (iii) does not have its principal offices within the United States and (iv) in the case of an individual, is neither a citizen nor resident of the United States. HSR Rules § 801.1(e)(2)(i)–(ii). Conversely, a U.S. person or issuer is one that (i) is incorporated in the United States, (ii) is organized under the laws of the United States, (iii) has its principal offices within the United States, or (iv) in the case of an individual, is a citizen or resident of the United States. HSR Rules § 801.1(e)(1)(i)–(ii).

378 HSR Rules § 802.50.

379 HSR Rules § 802.51(b). If controlling interests in multiple foreign entities are being acquired, the sales and assets of all the non-U.S. entities are aggregated to determine whether either of the $78.2 million thresholds is met. Even if these thresholds are exceeded, the acquisition will still be exempt if it is valued at $312.6 million or less and the parties' combined U.S. assets and combined sales in or into the United States in their most recent fiscal years are both less than $171.9 million.

380 HSR Rules § 802.51(a). If voting securities of multiple foreign issuers are being acquired, the sales and assets of all the non-U.S. issuers (and the sales and assets of any unincorporated foreign entities in which a controlling interest is being acquired) are aggregated to determine whether either of the $78.2 million thresholds is met.

381 HSR Rules § 802.52.

382 *See* 15 U.S.C. § 18a(c); HSR Rules § 802 (listing various exemptions). The full range of HSR Act exemptions is beyond the scope of this treatise. Parties to potentially reportable transactions should review the available exemptions carefully to determine if an exemption applies to the particular transaction.

383 15 U.S.C. § 18a(c)(1); HSR Rules § 802.1.

384 HSR Rules § 802.60.

385 HSR Rules § 802.63.

386 HSR Rules § 802.65.

387 HSR § 18a(c)(3); HSR Rules § 802.30.

388 *See* HSR Rules § 802.30(c), and related examples, discussing the interaction of the exemption in HSR Rules § 802.4 and the intra-person exemption.

389 *See* HSR Rules § 802.30(a), example 1.

390 HSR Rules § 802.64.

391 Premerger Notification Staff, Bureau of Competition, Federal Trade Commission, *HSR Rule 802.5: The Investment Rental Property Exemption*, FTC Blogs (July 20, 2015, 10:56 AM), https://www.ftc.gov/news-events/blogs/competition-matters/2015/07/hsr-rule-8025-investment-rental-property-exemption.

392 Premerger Notification Staff, Bureau of Competition, Federal Trade Commission, *HSR Rule 802.5: The Investment Rental Property Exemption*, FTC Blogs (July 20, 2015, 10:56 AM), https://www.ftc.gov/news-

events/blogs/competition-matters/2015/07/hsr-rule-8025-investment-rental-property-exemption.

393 American Bar Association, Premerger Notification Practice Manual #105 (5th ed. 2015); *see* 15 U.S.C. § 18a(c)(1); HSR Rules §§ 802.1, 802.4, 802.5.

394 Kathryn E. Walsh, Deputy Assistant Director in Hart-Scott-Rodino: Back to Basics," American Bar Association webinar. Presented on January 14, 2016.

395 15 U.S.C. § 18a(c)(9).

396 HSR Rule § 801.1(i)(1).

397 *See United States v. ValueAct Capital Partners, L.P.*, No. 1:07-cv-02267 (D.D.C. Dec. 19, 2007).

398 Complaint, 2-4, *United States v. VA Partners I, LLC*, No. 3:16-cv-01672 (N.D. Cal. Apr. 4, 2016).

399 *See* Complaint, *United States v. Third Point Offshore Fund, Ltd.*, No. 15-cv-01366 (D.D.C. Aug. 2015).

400 Debbie Feinstein, Ken Libby and Jennifer Lee, Federal Trade Commission, *"Investment-only" means just that*, FTC Blogs (Aug. 24, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just.

401 The FTC has the authority to impose civil penalties of $40,000 per day that the offending party is in violation. HSR Act § 18a(g)(1); 16 C.F.R. § 1.98(a); *See* Adjustments of Civil Monetary Penalty Amounts, Interim Final Rule, 81 Fed. Reg. 126, 42476 (June 30, 2016) (increasing the maximum civil penalty amount under the Hart-Scott-Rodino Act from $16,000 to $40,000).

402 Debbie Feinstein, Ken Libby and Jennifer Lee, Federal Trade Commission, *"Investment-only" means just that*, FTC Blogs (Aug. 24, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just.

403 Debbie Feinstein, Ken Libby and Jennifer Lee, Federal Trade Commission, *"Investment-only" means just that*, FTC Blogs (Aug. 24, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just.

404 Debbie Feinstein, Ken Libby and Jennifer Lee, Federal Trade Commission, *"Investment-only" means just that*, FTC Blogs (Aug. 24, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/08/investment-only-means-just.

405 HSR Rules § 803.2(b)(1)(ii)–(iii).

406 *See* HSR Form Instructions for Items 4(c) and 4(d).

407 The FTC and DOJ have imposed substantial penalties for failing to submit all such documents. *See infra* Note 417; HSR Act § 18a(h).

408 HSR Act § 18a(h).

409 HSR Act § 18a(h).

410 15 U.S.C. 78a *et seq*.

411 HSR Rules § 803.12 (effective as of Aug. 9, 2013).

412 HSR Rules § 803.12 (effective as of Aug. 9, 2013).

413 *See* § 9.06[4] the next section for additional detail.

414 Premerger Notification; Reporting and Waiting Period Requirements, Final Rule, 81 Fed. Reg. 170, 60257-170, 60258 (Sept. 1, 2016) ("These changes are not substantive in nature, and involve formatting, clarification, and simplification, as well as the deletion of immaterial language, with the goal of eliminating confusion for filing parties.")

415 HSR Rules § 803.10(a).

416 Failure of the acquired person to file in such situations does not, however, affect the running of the waiting period. HSR Rules § 803.10.

417 HSR Rules § 803.10(b)–(c).

418 A cash tender offer is defined as a tender offer in which cash is the only consideration offered to the holders

of the voting securities to be acquired. HSR Rules § 801.1(g)(2).

419 HSR Act § 18a(b)(1)(B); HSR Rules § 803.10(b).

420 HSR Act § 18a(b)(2).

421 HSR Act § 18a(k).

422 HSR Act § 18a(e).

423 HSR Rules § 803.20(c).

424 HSR Act § 18a(e)(2); HSR Rules § 803.10(b).

425 15 U.S.C. § 53(a).

426 *See*, *e.g.*, *FTC v. Whole Foods Market, Inc.*, 548 F.3d 1028, 1035 (D.C. Cir. 2008) (reaffirming that the FTC need only show "questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation").

427 *See* 15 U.S.C. § 18. If the FTC rather than the DOJ files the lawsuit, the FTC would also allege that the transaction violates § 5 of the FTC Act, 15 U.S.C. § 45(b), for the same reason.

428 William Blumenthal, General Counsel, FTC, Remarks before the Association of Corporate Counsel, Annual Antitrust Seminar of Greater New York Chapter: The Rhetoric of Gun Jumping, at 7 (Nov. 10, 2005).

429 HSR Act § 18a(g)(1); 16 C.F.R. § 1.98.

430 *See*, *e.g.*, *United States v. Hearst Corp.*, Trade Cas. (CCH) ¶73,451, Final Judgment (D.D.C. Oct. 15, 2001) (Hearst paid $4 million to settle charges that it failed to produce certain 4(c) documents in connection with its acquisition of Medi-Span); *United States v. Automatic Data Processing, Inc.*, Trade Cas. (CCH) ¶71,361 (D.D.C. Apr. 10, 1996) (ADP paid a $2.97 million fine, the maximum allowed under the circumstances, to settle charges that it failed to include 4(c) documents with its HSR filing regarding its acquisition of Autoinfo, Inc.).

431 *See*, *e.g.*, *United States v. Gemstar-TV Guide International, Inc.*, Trade Cas. (CCH) ¶74,082, Final Judgment (D.D.C. July 11, 2003) (parties agreed to $5.676 million penalty to settle charges they implemented integration plans and coordinated competitive behavior).

432 HSR Act § 18a(g)(2).

U.S. Regulation of the International Securities and Derivatives Markets, § 9.07, REPORTING REQUIREMENTS AND NATIONAL SECURITY REVIEW UNDER THE EXON-FLORIO AMENDMENT

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 § 9.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Foreign investors in U.S. companies must also consider the potential applicability of the Exon-Florio Amendment to the Defense Production Act of 1950 (the "Exon-Florio Amendment") [433] and the regime it establishes to review foreign investment in U.S. companies from a national security perspective. The

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Exon-Florio Amendment grants the President the authority to suspend or prohibit [434] acquisitions, mergers or takeovers by foreign persons [435] of U.S. businesses [436] that threaten to impair the national security of the United States. [437] To exercise this authority, the President must find that (i) there is credible evidence that the foreign interest exercising control [438] "might take action that threatens to impair the national security" and (ii) other laws do not, in the President's judgment, provide "adequate and appropriate authority" to protect the national security. [439] Both "control" and "national security" are interpreted expansively and give CFIUS considerable discretion to review transactions of interest.

The Exon-Florio Amendment establishes CFIUS to review transactions. [440] CFIUS is a committee comprised of representatives from various government agencies and offices, including the heads of the Departments of Defense, Justice, State, Commerce, Energy and Homeland Security and of the Offices of the U.S. Trade Representative and Science and Technology Policy, and it is chaired by the Secretary of the Treasury. The Exon-Florio Amendment sets forth a procedure under which parties to a transaction wishing to obtain assurances regarding the absence of national security issues can file a voluntary notification, which is confidential, that triggers a national security review. [441] If CFIUS determines at the conclusion of an initial 30-day review period (following a pre-notification review and acceptance of the filing) that the transaction raises no national security concerns or does not fall within the statute, no further investigation will occur. If CFIUS decides that a full investigation is necessary, it has 45 days to conduct the investigation. At the end of the investigation period, CFIUS can clear the transaction or clear it with conditions (including so-called "mitigation agreements" imposing future obligations on the acquiror, described below). If CFIUS finds that the transaction should be blocked or it cannot come to a conclusion about the transaction, CFIUS submits a report to the President, [442] who has 15 days thereafter to announce a decision. [443]

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Parties to an acquisition are presented with a difficult decision: notification to CFIUS is voluntary in the absence of a government-initiated review, the statutory standards for evaluating threats to "national security" are vague and the process is unpredictable and subject to political risk. On the one hand, if the transaction is notified to CFIUS, while the parties are technically free to proceed while CFIUS review is underway, as a practical matter, an ongoing review is likely to impede consummation of the transaction. The timing of reviews, particularly the pre-notification and acceptance periods, is becoming more uncertain. Moreover, notification may draw attention to a transaction of marginal interest that otherwise might pass unaffected, may impose burdensome requirements on parties to provide additional information to CFIUS, and may lead to pressure from U.S. government agencies to make changes in the transaction that might not be made in the absence of a request for clearance. On the other hand, if no notice is given, the parties may be at some disadvantage if the government initiates its own review, and the parties will be exposed to the fairly remote but indefinite risk that CFIUS might in the future review the transaction and the President impose conditions or order divestiture. The parties may also be more vulnerable to political criticism of the transaction and subject to the timing risk that the target, a rival bidder or another interested party may seek to generate controversy and demands for a CFIUS review at a late stage.

[1] Acquisitions by Entities Controlled by Foreign Governments

If a transaction that would result in control of a U.S. person by "a foreign government or an entity controlled by or acting on behalf of a foreign government" is notified, a second-stage 45-day investigation is presumptively required. [444] The 45-day investigation may, however, be waived if the Treasury Department and the agency leading the review make a specific determination at a senior level (Deputy Secretary or Secretary) that the transaction will not impair national security.

[2] Approvals Conditioned on Mitigation Agreements

CFIUS may enter into or impose (and enforce) "any agreement or condition" with any party to a transaction in order to mitigate any national security threat that arises in connection with the transaction, and CFIUS may refuse to

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approve a transaction until a satisfactory agreement is in place. [445] Mitigation agreements have become increasingly prevalent in CFIUS reviews, particularly for transactions involving classified contracts or "critical infrastructure" sectors such as energy, telecommunications and transportation. Typical agreements might require a security plan, restrictions on foreign personnel, restrictions on locating assets outside the United States, reserving certain matters to U.S. management and reporting or cooperation obligations. In more difficult cases, a sensitive business may have to be segregated in a subsidiary with an independent board.

Senior officials of the CFIUS agencies may unilaterally reopen a transaction that had previously been approved if any party to the transaction or entity resulting from the deal "intentionally materially breaches a mitigation agreement or condition." [446] Such a breach must be certified by the lead agency monitoring the mitigation arrangement, and CFIUS must determine that there are "no other remedies or enforcement tools" available to address it. The agreements may also provide monetary penalties for breach.

[3] Exempted Transactions

Certain types of transactions are exempted from CFIUS review. The regulations specifically exempt from CFIUS review acquisitions of 10% or less of the outstanding voting interest in a U.S. business (regardless of the dollar value of the interest so acquired) if the transaction is "solely for the purpose of passive investment." [447] A transaction meets the passive criterion if the investor "does not plan or intend to exercise control, does not possess or develop any purpose other than passive investment, and does not take any action inconsistent with holding or acquiring [the interest] solely for purposes of passive investment." [448] It is important to note that this exemption does *not* create a "safe harbor" for investments of 10% or less–the key element for applying the exemption is passivity. Equally, exceeding the 10% benchmark does not create a presumption that an acquisition of control has taken place, although in controversial cases the likelihood of review increases significantly.

Also exempt from CFIUS review is the acquisition of assets in the United States that do not constitute a business in the United States at the time of the acquisition. [449] Thus, a foreign person will not be deemed to have acquired a U.S.

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business if it acquires from separate and distinct U.S. persons the individual elements of a business such as inventory, real estate, production equipment or a license to manufacture a particular product. [450]

A lending transaction generally is exempt from CFIUS review because it is not considered a "transaction" except where "the foreign person acquires economic or governance rights in the U.S. business characteristic of an equity investment, but not of a loan." [451] Absent such a finding, typical loan covenants giving the lender negative rights over certain decisions of the borrower do not implicate CFIUS jurisdiction. However, a loan or other financing arrangement whereby the lender acquires an interest in profits, a right to appoint directors or other financial or governance rights characteristic of equity investments may constitute a covered transaction potentially subject to review. [452] Furthermore, a secured lending transaction may create a notifiable acquisition if the lender forecloses on collateral. The acquisition of collateral may only be notified for review when default is imminent, not at the time of the initial secured loan. [453]

Finally, an acquisition by the same foreign person of an additional interest in a U.S. business, where the foreign person's prior acquisition of an interest in the same entity was a covered transaction that underwent a complete CFIUS review following notification, is not a new covered transaction subject to review. [454] In other words, if an earlier transaction was found to be an acquisition of "control" and cleared, subsequent transactions need not be notified; however, if (as sometimes happens) a minority investment were found *not* to be an acquisition of control, future transactions would still be potentially subject to CFIUS review.

Footnotes

433 50 U.S.C. app. § 2170. The Exon-Florio Amendment was most recently amended by the Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (hereinafter "FINSA"). In 2008, the Department of the Treasury extensively revised its regulations under the Exon-Florio Amendment to implement FINSA, 31 C.F.R. pt. 800, and issued guidance describing certain factors that the Committee on Foreign Investment in the United States ("CFIUS"), established under the Exon-Florio Amendment (and more fully described below), considers in assessing potential national security concerns. U.S. Department of the Treasury, Office of Investment Security; Guidance Concerning the National Security Review Conducted by the Committee on Foreign Investment in the United States, 73 Fed. Reg. 74,567 (Dec. 8, 2008).

Additional industry-specific reporting requirements apply to certain significant acquisitions of securities or assets (including acquisitions taking the form of business combinations). These most typically arise in regulated industries, such as telecommunications, television, radio, railroad, airline, banking and insurance. The particular requirements are beyond the scope of this book.

434 In addition, completed transactions not submitted to the voluntary review process described below are subject to divestiture following a post-closing review. 50 U.S.C. app. § 2170(d)(3).

435 A "foreign person" is defined to mean "any foreign national, foreign government or foreign entity" or "any entity over which control is exercised or exercisable by a foreign national, foreign government, or foreign entity." 31 C.F.R. § 800.216. As discussed below, "control" is a very broad concept.

436 A "U.S. business" is defined to include "any entity engaged in interstate commerce in the United States [regardless of the nationality of the persons that control it], but only to the extent of its activities in interstate commerce." 31 C.F.R. § 800.226. The definition thus includes not only U.S.-owned or -controlled corporations but also branches, subsidiaries, offices or operations owned by foreign interests doing business in the United States. A foreign entity that is owned by a U.S. entity and does not have a branch office, subsidiary or fixed place of business in the United States is not a U.S. business, even if it exports to the United States. However, a foreign corporation that is owned by foreign nationals and has a branch or subsidiary in the United States that engages in business in the United States would be, to the extent of its U.S. operations, a "U.S. business" for purposes of the Exon-Florio Amendment. Thus, mergers and acquisitions by non-U.S. entities taking place outside the United States are potentially subject to the Exon-Florio Amendment if either party has operations in the United States. In theory, as described below, a sale of assets (*e.g.*, licensing or sale of technology with no production facility) may not constitute a "business";

in practice, CFIUS has considerable discretion to make that determination.

437 The regulations implementing the Exon-Florio Amendment deliberately do not define "national security," allowing for considerable discretion in its interpretation. However, FINSA specifically clarified that homeland security, including its application to "critical infrastructure," is part of "national security," 50 U.S.C. app. § 2170(a)(5), with the regulations further defining critical infrastructure as "a system or asset, whether physical or virtual, so vital to the United States" that its incapacity or destruction "would have a debilitating impact on national security." 31 C.F.R. § 800.208. CFIUS engages in a two-stage assessment: "whether a foreign person has the capability or intention to exploit or cause harm (*i.e.*, whether there is a threat) and whether the nature of the U.S. business, or its relationship to a weakness or shortcoming in a system, entity, or structure, creates susceptibility to impairment of U.S. national security (*i.e.*, whether there is a vulnerability)." U.S. Department of the Treasury, Office of Investment Security; Guidance Concerning the National Security Review Conducted by the Committee on Foreign Investment in the United States, 73 Fed. Reg. 74,567, 74,569 (Dec 8, 2008). Many recent reviews have focused on transactions in industries deemed "critical infrastructure," including energy, telecommunications and transportation.

438 There is no bright line test for "control"; rather, it is evaluated on a case-by-case basis, considering the level of ownership interest, extent of rights and restrictions on them, and other circumstances, and it is defined in general terms as the power, direct or indirect, whether or not exercised, through a majority or dominant minority voting interest or other means, "to determine, direct, or decide important matters affecting an entity." 31 C.F.R. § 800.204(a). However, in practice CFIUS's analysis of "control" does not require anything close to *de jure* control and may be understood informally as "substantial influence." As a formal matter, the regulations identify a number of decision-making rights beyond equity ownership that factor into the analysis of control. 31 C.F.R. § 800.204(a). On the other hand, the regulations list certain minority shareholder protections that are not in themselves deemed to confer control and state that other minority shareholder protections will be considered on a case-by-case basis. 31 C.F.R. § 800.204(c)–(d). Where a number of different foreign persons hold an interest in a U.S. person (even if, taken together, they hold the majority of the stock), the question of whether any one foreign person or group controls the entity will be examined using factors such as whether the foreign persons are related or whether they act in concert. 31 C.F.R. § 800.204(b).

439 50 U.S.C. app. § 2170(d)(4).

440 50 U.S.C. app. § 2170(k)(1).

441 50 U.S.C. app. § 2170(b)(1). Voluntary notices can be withdrawn with the consent of CFIUS, but the relevant transactions are monitored and may be subject to "interim measures" imposed by CFIUS pending resubmission. 50 U.S.C. app. § 2170(b)(1)(C)(ii), (l)(2). CFIUS also retains the right to review in the future any acquisition not notified to it, and has in fact reviewed a number of non-notified transactions post-closing. 50 U.S.C. app. § 2170(b)(1)(D).

442 31 C.F.R. § 800.506(b).

443 50 U.S.C. app. § 2170(d)(2).

444 50 U.S.C. app. § 2170(b)(2)(B)(i)(II) (mandating an investigation); 50 U.S.C. app. § 2170(a)(4) (defining "foreign government-controlled transaction").

445 50 U.S.C. app. § 2170(l)(1)(A). The lead agency is charged with negotiating, modifying, monitoring and enforcing the mitigation agreement, and it must also report on any material modifications.

446 50 U.S.C. app. § 2170(b)(1)(D)(iii).

447 31 C.F.R. § 800.302(b).

448 31 C.F.R. § 800.223.

449 31 C.F.R. § 800.302(c).

450 Such investments in assets are distinguished from the acquisition of assets that are or could readily be operated as businesses (*e.g.*, branches or operational warehouse facilities that are not separate legal entities at the time of the acquisition)—such acquisitions can be subject to CFIUS review. 31 C.F.R. §

800.301(c).

451 73 Fed. Reg. 70,702, 70,710 (Nov. 21, 2008) (discussing 31 C.F.R. § 800.303(a)).

452 31 C.F.R. § 800.303(b).

453 31 C.F.R. § 800.303(a).

454 31 C.F.R. § 800.204(e).

U.S. Regulation of the International Securities and Derivatives Markets, § 9.08, COUNTRY- AND PERSON-SPECIFIC INVESTMENT SANCTIONS

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 § 9.08 (11th and 12th Editions 2014-2017)
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[1] Office of Foreign Assets Control Sanctions

While foreign investors in U.S. companies must consider the application of the Exon-Florio Amendment to such investments, all parties with a relationship to the United States must determine the relevance to their transactions and operations (including those located outside the United States) of U.S. economic

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sanctions administered by the Office of Foreign Assets Control ("OFAC") of the U.S. Department of the Treasury. [455] Through regulations (the "OFAC Regulations") issued under authority of the International Emergency Economic Powers Act [456] and other statutes, OFAC administers a range of complex sanctions programs that generally restrict persons acting within U.S. jurisdiction—including U.S. citizens and residents, entities formed under U.S. law (including their non-U.S. branches and, in some cases, non-U.S. entities controlled by such persons), any individual or entity located in the United States, and, importantly, foreign persons taking or causing actions within U.S. jurisdiction (including the supply of U.S. origin services, including U.S. dollar payment clearing)—from some or all dealings with: (i) governments (including government-controlled entities) of, or persons in, sanctioned countries or areas, [457] and (ii) certain individuals and entities ("*sanctioned persons*") specifically designated by OFAC as sanctions targets (as well as entities 50% or more owned by sanctioned persons in the aggregate). [458] While neither SEC registration nor operations in the United States (through a subsidiary or otherwise) require a non-U.S. company to comply globally with OFAC Regulations, as a practical matter they may both make it more likely that U.S. jurisdictional contact may exist (for example, services provided by a U.S. subsidiary that directly support potentially sanctioned activities) and make it more likely as a practical matter that any sanctions violations will come to the attention of the U.S. authorities and result in enforcement action.

In general, the broader OFAC Regulations restrict not only exports to and imports from sanctioned countries, but also equity investments in, business combinations with, sales of securities to and other financial transactions with any

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government of, or person or entity based in, or controlled from, such a country. [459] Violation of OFAC regulations may result in substantial civil and criminal penalties, including imprisonment.

Of particular interest to non-U.S. SEC-reporting companies is the potential obligation to disclose business activities involving countries and persons subject to OFAC sanctions. In 2001, then-Acting SEC Chairman Laura Unger, confirming the SEC's policy requiring SEC reporting companies to disclose their material business activities involving sanctioned countries and persons, stated in a letter to a U.S. Congressman that "[t]he fact that a foreign company is doing material business with a country, government, or entity on OFAC's … sanctions list is, in the SEC staff's view, substantially likely to be significant to a reasonable investor's decision about whether to invest in that company." [460]

More recently, § 13(r) of the Exchange Act added a requirement for all companies issuing annual or quarterly reports under the Exchange Act to specifically disclose certain Iran-related dealings either by the issuer or by any of the issuer's affiliates. [461] Most important, the issuer must disclose any dealings by it or any of its affiliates with any entity controlled by the Iranian government or any entity subject to U.S. sanctions in connection with terrorism or weapons of mass destruction (which includes many major Iranian institutions), as well as certain activities subject to secondary sanctions (see below). Any disclosable activity must be described in detail, including the nature and extent of the activity, gross revenues and net profits associated with the activity, and whether the issuer intends to continue the activity.

[2] Sectoral Sanctions

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OFAC also administers targeted financial and economic sanctions on designated entities in the Russian financial, energy and defense sectors, known as sectoral sanctions. The U.S. Treasury Department issued four directives on July 16, 2014 and September 12, 2014 that identified the Russian financial, energy and defense sectors for sanctions pursuant to Executive Order 13662. [462] Pursuant to sectoral sanctions, specifically designated entities within the identified sectors (not all entities) are subject to limited sanctions that do not prohibit all dealings with the listed entities ("SSIL Targets") but instead target certain new equity, long-term debt, and oil development transactions.

As with other U.S.-sanctioned persons, all entities 50% or more owned by SSIL Targets are SSIL Targets themselves and are subject to the same restrictions applicable to their parent entities. Principles of aggregation and attribution of ownership interests likewise apply. The SEC has not taken a public position regarding whether material dealings that would be prohibited by sectoral sanctions were they conducted within U.S. jurisdiction should be disclosed, but issuers may wish to consider the possibility.

[3] Secondary Sanctions

In recent years, the United States has increasingly used sanctions regimes that may be triggered by acts entirely outside U.S. jurisdiction. These "secondary sanctions" do not technically involve violations of U.S. law; rather, the United States has authority to impose U.S. economic sanctions on persons (domestic or foreign) that engage in the targeted activities.

Under most of these secondary sanctions, which are administered primarily by the State Department and, to a lesser extent, by the Treasury Department, the United States has the authority to impose a variety of sanctions on persons engaging in the targeted conduct, ranging from fairly minor (such as disqualification from U.S. export assistance) to severe (designation as a blocked person, or "SDN," subject to full U.S. sanctions freezing all property and barring all transactions within U.S. jurisdiction). Secondary sanctions do not apply automatically once sanctionable conduct becomes known; further administrative action to designate the relevant parties is required, and as a practical matter the decision to impose sanctions is more political than enforcement of OFAC sanctions.

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The full range of targeted conduct and the corresponding sanctions available is extensive and complex, and a full inventory is beyond the scope of this chapter. To summarize briefly, prior to "Implementation Day" of the Joint Comprehensive Plan of Action ("JCPOA") between Iran and the P5+1 powers, secondary sanctions targeted a wide range of dealings with Iran, focusing particularly on the energy and financial sectors. [463] However, as a result of the JCPOA, the majority of U.S. secondary sanctions against Iran were lifted, other than those targeting dealings with the remaining U.S.-designated SDNs, nuclear proliferation, and terrorism. [464] Secondary sanctions also continue to apply to "deceptive transactions" with Iran or Syria designed to conceal the interest of U.S. sanctioned persons as well as to transactions linked to ongoing human rights violations in Iran and Syria, "trafficking" in expropriated Cuban property to which a U.S. person has a claim, financial transactions with Hizballah, persons violating U.S. sanctions but evading prosecution, and a variety of arms proliferation activities. [465] There are secondary sanctions that target persons involved in the destabilization of Ukraine, but the United States has indicated that it does not currently intend to enforce them. [466]

Footnotes

455 31 C.F.R. pts. 500–599. At present, the OFAC regime prohibits U.S. persons from certain dealings (to a greater or lesser extent) related to: (i) Cuba, (ii) Iran, (iii) Sudan, (iv) Syria, (v) Burma (Myanmar) and (vi) North Korea, as well as specified individuals and organizations (and entities 50% or more owned or, in some cases, controlled by sanctioned persons in other jurisdictions (including, but not limited to, Belarus, Russia and Ukraine, and Zimbabwe) or with no fixed jurisdiction).

456 International Emergency Economic Powers Act, Pub. L. No. 95–223, 91 Stat. 1625 (1977) (codified as amended at 50 U.S.C. §§ 1701-07).

457 *See*, *e.g.*, 31 C.F.R. § 515.201(d) (prohibiting persons subject to the jurisdiction of the United States from dealing with Cuba). As of the date of publication, the countries subject to territorial restrictions include Crimea, Cuba, Iran, North Korea, Sudan and Syria.

458 The lists of sanctioned persons change frequently and may be found on the OFAC website at https://sanctionssearch.ofac.treas.gov. The lists are often referred to as the "SDN List" (for the list of specially designated nationals and blocked persons, or "SDNs"), though technically there are now several lists subject to varying restrictions. The persons designated are not necessarily located in or even related to countries that are the subject of OFAC sanctions programs. For example, the lists include individuals and entities designated under various activity-based OFAC programs as, *inter alia*, "specially designated global terrorists," "foreign terrorist organizations," "specially designated narcotics traffickers" and proliferators of weapons of mass destruction.

459 *See*, *e.g.*, 31 C.F.R. § 515.570. The full range of the sanctions regimes described in this § 9.08 is beyond the scope of this book. Given the substantial penalties that may be imposed under them, however, U.S. persons contemplating investments, business combinations or other transactions in or involving nationals of any sanctioned country or area, or any sanctioned person (whether designated under a country- or activity-based program), should carefully evaluate their potential applicability in advance.

460 Letter from Laura Unger, Acting SEC Chairman, to Rep. Frank Wolf (May 8, 2001). In 2007, the SEC briefly implemented a "web tool" that would allow investors to directly pull information about a public company's dealings with certain sanctioned countries from its SEC disclosures. Press Release, SEC, SEC Adds Software Tool for Investors Seeking Information on Companies' Activities in Countries Known to Sponsor Terrorism (June 25, 2007). After criticism regarding, among other issues, the tool's lack of access to updated information, the SEC temporarily suspended the tool and issued a concept release requesting comment on how best to provide investors access to information about companies' dealings with sanctioned countries. Press Release, SEC, Statement by SEC Chairman Christopher Cox Concerning Companies' Activities in Countries Known to Sponsor Terrorism (July 20, 2007); SEC Release No. 33–8860 (Nov. 16, 2007).

461 15 U.S.C. § 78m(r).

462 The Sectoral Sanctions Identifications List can be accessed on OFAC's website at: https://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/ssi_list.aspx., and the directives are *available at* https://www.treasury.gov/resource-center/sanctions/Programs/Pages/ukraine.aspx.

463 *See* U.S. Dept. of the Treasury, *JCPOA Implementation*, *available at* https://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/jcpoa_implementation.aspx. The P5+1 consists of the United States, China, Russia, France, Germany, and the United Kingdom, together with the EU.

464 *See* U.S. Dept. of the Treasury, *JCPOA Implementation*, *available at* https://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/jcpoa_implementation.aspx. The P5+1 consists of the United States, China, Russia, France, Germany, and the United Kingdom, together with the EU.

465 Executive Order 13608; Executive Order 13606; Cuban Liberty and Democratic Solidarity Act of 1996, Pub.

L. No. 104-114, 110 Stat. 785 (1996) (codified at 22 U.S.C. §§ 6021–6091); 31 C.F.R. 566.201(a); Iran, North Korea, and Syria Non-Proliferation Act, codified at 50 U.S.C. § 1701 note/Arms Export Control Act, 22 U.S.C. § 2798; Export Administration Act 50 U.S.C. App § 2410c; Chemical and Biological Weapons Control and Warfare Elimination Act, 22 U.S.C. §§ 5604–5605; Executive Order 13382, 70 Fed. Reg. 38,567 (July 1, 2005).

466 Ukraine Freedom Support Act of 2014, Pub. L. No. 113-272; "Statement by the President on the Ukraine Freedom Support Act," Press Release (issued on Dec. 18, 2014), *available at* http://www.whitehouse.gov/the-press-office/2014/12/18/statement-president-ukraine-freedom-support-act. The sanctions target persons responsible for or complicit in certain activities with respect to Ukraine; against officials of the Government of the Russian Federation; against persons operating in the arms or related materiel sector of the Russian Federation; and against individuals and entities operating in the Crimea region of Ukraine.

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)
11th and 12th Editions

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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). [1]

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

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 § 10.02 (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," [2] 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. [3] Other regulatory concerns will generally limit participation in equity distribution programs to issuers with a public market float of $150 million or more. [4]

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. [5] 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. [6] As a result of subsequent amendments to rules under the Securities Act over time, however, such offerings are now relatively commonplace. [7]

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Historically, certain categories of issuers, particularly those with predictable but significant capital requirements, have used at-the-market offerings more frequently than other issuers. [8] 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. [9] 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, [10] as well as various supporting documents from accountants, lawyers and other parties. The offering process, however, varies from the

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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. [11] 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, [12] 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.

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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. [13] 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. [14]

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. [15] 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. [16] 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

post-effective amendment to the registration statement). [17] 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 [18] (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. [19] 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. [20] The issuer will pay the agent a commission with respect to the shares it

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. [21] 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, [22] and the agreement will not impose any restrictions on directors or officers. [23] 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. [24] 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. [25]

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. [26] 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. [27] 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. [28] 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. [29] 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). [30] 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. [31] 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, [32] 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. [33] 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. [34]

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." [35] 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. [36] 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) a

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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. [37]

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. [38] 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. [39]

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. [40] Rule 139(a) research reports need not be limited as to content. [41]

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. [42]

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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. [43]

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. [44] 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. [45]

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. [46]

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 depositary and then cause the depositary to credit the agent so that the agent can credit the purchasers. Therefore, a foreign private issuer's ADR depositary 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 [47] 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%. [48]

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.

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)(I)(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)(I)(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)
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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. [49] 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. [50]

[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. [51] 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. [52]

[2] Rule 144 Blocks

Selling stockholders that are affiliates [53] 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. [54] With regard to the manner of sale restrictions, Rule 144 block trades are made directly to a market maker. [55] 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. [56]

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)
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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 [57] 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. [58] 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. [59]

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, [60] 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.

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 7.

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. [61] 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. [62] In the case of HBOS, the rights offering proved unsuccessful, and the company was later acquired by Lloyds TSB. [63]

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. [64] 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 disapplied their statutory preemption rights. [65] In circumstances where statutory preemptive rights have not been disapplied 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. [66] 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. [67] 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. [68]

[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

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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. [69] 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. [70] 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. [71] 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. [72] 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. [73] If the issuer's home country laws can accommodate exclusion of U.S.

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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 [74] and the subscription period must extend at least 16 days after mailing of the rights offering prospectus to holders of record. [75] 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. [76] 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

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United States. [77] 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. [78] 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, [79] 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. [80]

[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. [81] Rule 801 under the Securities Act provides foreign private issuers [82] 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% [83] or less of the class of securities being issued is held of record by U.S. holders. [84]

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. [85] 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, [86] 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. [87] 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. [88] 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. [89] 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. [90] 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. [91] 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. [92] 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. [93]

[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. [94] 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. [95] 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. [96]

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. [97] 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. [98] 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. [99]

[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

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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. [100] 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. [101] 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. [102]

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. [103]

[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.

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"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, [104] 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

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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).

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 M ANUAL.

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. [105] 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. [106] During the term of the security, the holder also receives a current (generally) fixed coupon. [107] 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. [108]

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. [109] 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. [110]

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. [111] In addition, underwriters will generally seek indemnification with respect to disclosure relating to both the convertible or exchangeable security and the underlying shares. [112]

[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." [113] 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, [114] 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. [115] 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. [116] 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. [117]

[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. [118] U.S. investors in these transactions take "restricted securities" subject to limitations on resale in the United States pursuant to Rule 144. [119]

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") [120] or are exempt from registration because they are not "restricted securities" and can be

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resold in reliance on Rule 144 [121]) 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. [122] 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). [122.1]

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. [123] 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. [124] 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. [125]

[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. [126] 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. [127] 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. [128] 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. [129]

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, [130] 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, [131] 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. [132]

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. [133] 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. [134]

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. [135] 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. [136]

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. [137] 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. [138] 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. [139] 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. [140]

[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. [141] 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. [142] 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. [143] 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. [144]

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. [145] In addition, the underlying shares to which the exchangeable security relates may not exceed 5% of the total number of shares outstanding. [146]

The NYSE requires (other than for foreign private issuers) [147] 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 [148] of the underlying shares. [149]

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 [150]); 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

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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.

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)
11th and 12th Editions

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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. [151] 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. [152] 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. [153] 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. [154] 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.

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 [155] 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. [156]

[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. [157] However, Form S-8 is not available to companies that are not subject to the periodic reporting requirements of the Exchange Act. [158]

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." [159] The requirements of the rule are minimal: offerings must be pursuant to a written plan, [160] the securities must form part of the employees' compensation [161] and plan participants must receive a copy of the plan. [162] Rule 701 is not available to companies required to file periodic reports under the Exchange Act. [163] 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. [164] 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. [165]

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. [166] Such an offering

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must be made only to proper private placement investors, [167] 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 [168] and allows offers of up to $5 million in any 12-month period. [169] 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. [170]

[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. [171] 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. [172]

[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. [173]

[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. [174] However, notably, the State of California does not recognize the "no sale" theory referred to above.

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.

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

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. [175] 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, [176] and the extent to which there are third-party agreements that otherwise restrict corporate restructuring and/or dividends. [177] Shareholder approval may also be required. [178]

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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. [178.1]

Pursuant to SEC staff guidance, spin-offs are generally exempt from registration under the Securities Act. [179] Subject to the above discussion for foreign private issuers, spun-off companies will be required to register under the Exchange Act. [180] 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 [181] 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. [182] 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 [183] 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 [184] 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. [185]

[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"). [186] 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. [187] 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 [188] 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. [189]

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. [190] 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. [191]

[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. [192] 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. [193] 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. [194]

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. [195]

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. [196] 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. [197] 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. [198] In addition, an issuer may elect to provide additional information to the market regarding its tracked business. [199]

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 ANN. 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 depositary 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 [200], in recent years they have been relatively rare [201]. 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"). [202]

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. [203] 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 [204] and events of default [205] designed to protect the holders.

[3] Event-Driven CVRs

Event-driven CVRs are more commonly used in acquisitions than price-protection CVRs. [206] 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 [207] 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) [208].

[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) [209], 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. [210] 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.

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).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.01, 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 § 11.01 (11th and 12th Editions 2014-2017)
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As the earlier chapters of this book indicate, the United States has a complex system of securities regulation. This chapter discusses a further important aspect of this system: how the rules and regulations are enforced. The financial crisis and collapse of several financial institutions, coming on the heels of several high-profile corporate scandals and the enactment of the Sarbanes-Oxley Act, along with public outrage and resulting Congressional pressure, including the enactment of the Dodd-Frank Act, created an environment for heightened enforcement in the United States. Particularly in the wake of the financial crisis, criminal prosecutors, the SEC and civil litigants brought and are continuing to bring actions with unprecedented speed against financial institutions, corporations, executives and, in some cases, their outside accountants and advisors. At the same time, state regulators have instigated a series of investigations and enforcement actions against financial institutions and other market participants.

Similar to the basic regulatory framework, the enforcement structure is multifaceted. In many instances, the same allegedly improper conduct can give rise to liability based on more than one statutory provision, and this liability can be enforced in legal actions brought by both governmental entities and private parties. Remedies and sanctions for improper securities activities can be sought in three basic ways: through civil litigation, administrative proceedings and criminal prosecutions. None of these mechanisms is exclusive. Thus, a party accused of violative conduct may be forced to defend itself in more than one type of proceeding.

In *civil litigation*, private parties seek to recover losses allegedly suffered as a result of the defendant's conduct, or request injunctive relief to compel or enjoin action by the defendant. These private rights of action either arise from express statutory provisions or are implied, *i.e.*, created by judges to provide remedies for violations of statutes or rules that are silent as to possible remedies for noncompliance. Government agencies, such as the SEC, may also bring civil actions to seek forfeiture of illegally obtained profits, civil monetary penalties (which may be greater or less than damages awarded in a private civil suit) and/or injunctive relief.

The SEC has an active enforcement program with substantial available resources.

Administrative proceedings are brought by government agencies such as the SEC and are conducted pursuant to rules promulgated by the relevant agency before administrative law judges it employs. An agency's determination in an administrative proceeding is subject to review by an appellate court, but the scope of review is limited. For certain violations of the federal securities laws, the SEC may bring administrative proceedings to impose civil penalties or to

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obtain cease and desist orders mandating an immediate halt to the allegedly improper conduct.

Unlike civil litigation, *criminal proceedings* based on the federal securities laws may be brought only by the Department of Justice (the "DOJ"), either on its own initiative or as a result of a referral by the SEC. Defendants convicted in criminal proceedings face substantial fines and, in the case of individuals, terms of imprisonment. Increasingly, state authorities are seeking to use state criminal laws to prosecute perceived misconduct in the securities markets.

These enforcement mechanisms and remedies are, as a basic matter, applicable to conduct in the United States and to entities registered and regulated under the U.S. securities laws, such as broker-dealers and investment advisers. In addition, these enforcement mechanisms and remedies may reach certain conduct occurring or entities located outside the United States in connection with securities transactions on U.S. exchanges or in the United States.

This chapter deals with the most significant consequences of violating the U.S. securities laws. [1] Its focus is on enforcement of the securities laws as they

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relate specifically to *securities transactions*; the principal enforcement mechanisms available for other regulatory schemes, such as the broker-dealer sections of the Exchange Act and the Advisers Act, are summarized in the chapters dealing with the subject matter to which they relate. [2]

Section 11.02 examines liability for failing to register securities. Section 11.03 discusses liability for disclosure improprieties connected with registered public offerings. Section 11.04 discusses disclosure liabilities connected with private offerings, including a separate discussion of offerings under Rule 144A. Section 11.05 reviews liabilities connected with secondary market transactions, including disclosure violations, insider trading, market manipulation and other fraudulent conduct. Section 11.06 considers liabilities connected with tender and exchange offers, including fraudulent or manipulative conduct and insider trading. Section 11.07 discusses the enforcement provisions of the Sarbanes-Oxley Act. Section 11.08 examines the Foreign Corrupt Practices Act, an important piece of legislation mandating certain accounting controls and prohibiting certain payments to foreign officials. Section 11.09 discusses various enforcement scenarios for violation of these laws, including the possibility of class action lawsuits, SEC enforcement actions, civil or criminal actions under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), [3] or other criminal proceedings. Section 11.10 reviews the circumstances in which U.S. law will be applied, and the reach of the U.S. judicial system, to activities and entities outside the United States. Finally, § 11.11 discusses special litigation issues relating to derivatives.

Although the U.S. securities law enforcement process must be respected by those engaged in securities activities with U.S. aspects, it should be kept in perspective. Most important, the vast majority of carefully conducted transactions do not give rise to litigation of any sort, and it is sometimes possible, where securities litigation without merit has been started, for a defendant to secure a favorable judicial ruling dismissing the case at an early stage of its otherwise generally lengthy life. In addition, even in most cases where a case proceeds beyond its preliminary stages, there is a rational sense of proportionality regarding the eventual outcome. Governmental proceedings and civil litigation by private parties relating to relatively less serious alleged violations are often settled by negotiations and do not result in major adverse consequences.

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More serious accusations of improper conduct (in terms of size, intent, the systematic nature of the violation or other factors) can result, whether settled or not, in more significant consequences. Further, SEC enforcement activity has increased in the wake of criticism the Enforcement Division of the SEC faced after its failure to prevent or detect various high-profile corporate scandals. In addition, the SEC has focused on gatekeepers, such as lawyers (both general counsel and outside counsel) and auditors.

The financial crisis of 2008—along with significant frauds and corporate misconduct—spurred a large volume of litigation that has and continues to generate notable decisions that reach into many of the subject matters of this chapter. In one example, plaintiffs attempted to sue all of the parties arguably involved in the sale of mortgage-backed securities—from the issuers, to underwriters, to rating agencies—under a number of theories that, in many ways, test the limits of the securities laws. These cases provide particularly important guidance to market participants, and they are a recurring theme of this chapter.

Footnotes

1 Although this chapter focuses on the consequences of violating the federal securities laws (most particularly, the Securities Act and the Exchange Act), actions that violate the securities laws may also violate other federal or state laws. *See* § 16 of the Securities Act ("[T]he rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist in law or in equity.") and § 28 of the Exchange Act ("[T]he rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.…"). Determining whether claims under the securities laws may coexist with claims under other statutory regimes sometimes presents a complicated statutory question. For example, the U.S. Supreme Court decided in *Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S.264 (2007), that the securities laws preclude the application of the antitrust laws in the context of certain IPO underwriting practices. The Court reached this conclusion by applying a four-pronged test (derived from *Gordon v. New York Stock Exchange*, 422 U.S. 659 (1975)) to determine whether, "given context and likely consequences, there is a 'clear repugnancy' between the securities laws and the antitrust complaint [at issue in *Credit Suisse*]." After applying this analysis, the Court concluded that the securities laws are "clearly incompatible" with antitrust laws, at least in the context of the underwriting practices raised in the *Credit Suisse* action (the plaintiffs alleged that the nation's leading underwriting firms had participated in schemes to inflate the aftermarket prices of the stocks offered in certain IPOs through practices such as "tie-in" agreements, "laddering" arrangements and pre-committing analysts to issue positive reports about the relevant companies). Whereas the *Credit Suisse* plaintiffs framed these facts as violations of the antitrust laws (in particular § 1 of the Sherman Antitrust Act, § 2(c) of the Robinson-Patman Act, and state antitrust laws), the plaintiffs in *In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281, 293–94 (S.D.N.Y. 2003) (consolidated actions), had framed the facts as violations of the securities laws through the use of misleading statements and market manipulation.

In addition, as noted above, state laws may provide bases for state criminal authorities or civil plaintiffs to challenge alleged misconduct in securities transactions. *See, e.g.*, CAL. CORP. CODE §§ 25400 (outlining prohibited activities) (West 2010), 25500 (creating a private right of action), 25540 (establishing criminal liability) (West 2006 & Supp. 2011); DEL. CODE ANN tit. 6, §§ 7303 (Supp. 2010) (securities fraud), 7322 (criminal penalties), 7323 (civil liability) (2005); N.Y. GEN. BUS. LAW §§ 352–359-g (McKinney's 1996 & Supp. 2011) (granting broad investigative powers over suspected securities frauds to New York Attorney General and creating misdemeanor and felony offenses for securities fraud). Although this chapter considers certain jurisdictional aspects of the intersection of state and federal laws, *see* § 11.09[1][a] (discussing the jurisdictional issues raised by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), Pub. L. No. 105-353, 112 Stat. 3227 (1998)), it does not address the substantive provisions of state law that these transactions may implicate.

2 Chapters 14 and 16 respectively.

3 RICO, Pub. L. No. 91-452, 84 Stat. 922 (1970) (codified at 18 U.S.C. §§ 1961–1968).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.02, LIABILITIES CONNECTED WITH SECURITIES ACT REGISTRATION REQUIREMENTS

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 § 11.02 (11th and 12th Editions 2014-2017)
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[1] When Is Registration Required?

Section 5 of the Securities Act requires that every offer and sale of a security be registered with the SEC unless a specific exemption from registration applies. [4] The terms "offer" and "sale" have been broadly construed to include various preliminary activities that, while not normally thought of as offers, might be viewed as impermissibly affecting the market for the securities to be offered. Thus, unusual publicity about an intended offer, including circulation of press releases or publication of research reports, may be held to be a prohibited offer under § 5 of the Securities Act. [5]

If a security is being offered or sold without registration, the seller bears the burden of establishing an exemption from the registration requirement. As discussed in earlier chapters, several broad exemptions may apply to a proposed offer or sale. First, private offerings are generally exempt under § 4(a)(2) of the Securities Act and exempt in certain cases under Rule 144A under the Securities Act. [6] Secondary market transactions are generally exempt under a combination

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of four sections: § 4(a)(1) (exempting transactions by any person other than an issuer, underwriter or dealer), § 4(a)(3) (exempting dealers in most instances), [7] § 4(a)(4) (exempting unsolicited brokerage transactions) and § 4(a)(7) (a new, non-exclusive safe harbor exemption for resales of restricted or control securities other than by an issuer or one of its subsidiaries). Offers and sales of securities outside the United States may be exempt from the registration requirement under Regulation S.

The most important consequence of this structure is that offers and sales to the public in the United States by issuers and underwriters are always subject to registration absent an exemption. In addition, the term "underwriter" is defined more broadly in the Securities Act than its business sense. [8] For example, any kind of public offer or sale (including sales on an exchange, a block trade or a market-maker transaction) for an issuer, or by a person or entity that has acquired from or is selling for an issuer, is subject to registration. The registration requirement is not limited to what the business world refers to as "public offerings" or "underwritten offerings." Finally, because for certain purposes the Securities Act includes within the term "issuer" any person that controls, is controlled by, or is under common control with an issuer, offers and sales to the public by or for such persons (commonly referred to as "affiliates") also require registration. [9] There is no bright-line test to determine whether a person is an affiliate, and the determination depends on the facts of a particular case; common examples of affiliates of an issuer include large shareholders, subsidiaries and certain officers and directors. [10]

[2] Liabilities for Failure to Register

[a] Securities Act § 5

Issuers, underwriters or dealers that violate the registration requirements of § 5 of the Securities Act are subject to a variety of remedies in enforcement actions brought by the SEC. In the case of parties guilty of premature offering

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activity (known as "gun-jumping"), the SEC can, as a practical matter, delay the offering for a substantial period of time by refusing to declare the registration statement effective. [11] In addition, the SEC may bring suit in federal district court to enjoin the acts or practices found to violate § 5, for disgorgement of any profits gained as a result of those acts, and for penalties ranging from $89,078 to $890,780 for corporate entities, depending on the egregiousness of the offending conduct and the harm that may have been caused to other parties. [12] In rare instances involving willful conduct, the SEC may also ask the DOJ to consider instituting criminal proceedings. [13]

[b] Securities Act § 12(a)(1)

Parties who improperly offer or sell securities to the public without complying with the registration requirements of § 5 of the Securities Act are also subject to civil suits by any purchaser of the securities. Under § 12(a)(1) of the Securities Act, the seller is strictly liable to the purchaser irrespective of whether the purchaser's loss was in any way related to the failure to register the securities or whether any material misstatement or omission was made in connection with the sale. The purchaser need only show that the securities were subject to registration but unregistered, that he or she bought the securities and that the defendant was the "seller" within the meaning of § 12(a)(1). [14]

Recovery under § 12(a)(1) is limited to rescission or, if the plaintiff no longer owns the security, damages based upon the difference between the purchase price and the plaintiff's resale price. [15] If the plaintiff obtains rescission, he or she recovers the purchase price plus interest. A § 12(a)(1) claim must be

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brought within one year of the alleged violation. The period is not suspended ("tolled") pending the purchaser's discovery of the alleged violation. [16]

Besides rebutting the elements of the plaintiff's *prima facie* case, a defendant has only two defenses to § 12(a)(1) liability. [17] First, he or she may show that the transaction or the security was exempt from the registration requirements of § 5. [18] If no exemption applies, the defendant must show *both* (i) that the plaintiff was at least equally at fault for the violation, in the sense that he or she actively promoted the unregistered sale, [19] and (ii) that barring the plaintiff's suit does not frustrate the effective enforcement of the securities laws. [20] The Supreme Court has stated that, because the Securities Act is "specifically designed to protect investors, even where a plaintiff actively participates in the distribution of unregistered securities, his or her suit should not be barred where the promotional efforts are incidental to his or her role as an investor." [21]

[3] Preemption of State Securities Law Registration Requirements

Until 1996, issuers involved in most large interstate offerings subject to the registration requirements of U.S. federal law were also required to observe the

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separate registration requirements of state securities (or "blue sky") laws. Most states have adopted the Uniform Securities Act, which among other things declares it unlawful for any person to offer or sell any security without registration unless specified exemptions, such as those for offers or sales of securities listed on one of the major U.S. securities exchanges, apply. [22] As in the federal Securities Act, the Uniform Securities Act provides for multiple remedies for violation of its registration provisions, including private civil suits, stop orders and injunctive proceedings by state regulatory authorities, and even criminal proceedings. [23]

This system of dual federal and state registration requirements was dismantled by the National Securities

Markets Improvement Act of 1996 (the "NSMIA"), [24] which among other things amended § 18 of the Securities Act to provide for federal preemption of state registration requirements. Section 18 now provides that, with respect to all "covered securities" (including securities listed on a national securities exchange and securities issued by registered investment companies), state rules requiring or regulating registration shall not apply, and such rules may not "directly or indirectly prohibit, limit or impose conditions" upon the use of offering documents, proxy statements or similar disclosure documents. [25]

Notably, the amendment to § 18 made clear that the federal preemption with respect to registration requirements did not extend to other areas of state securities regulation, including specifically state power "to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer." [26] Like the federal framework examined in §§ 11.03[2] and

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11.04[2] below, the Uniform Securities Act prohibits sales of securities through fraud or misrepresentation and creates criminal and civil liability for violations of its provisions. These provisions of state law remain intact, except in the context of class actions, [27] and provide additional deterrence against malfeasance in connection with securities transactions.

Footnotes

4 *See* § 5 of the Securities Act. *See also* §§ 1.02 and 3.02 for a discussion of the statutory requirements for registered public offerings in the United States. Issuers should be aware that the registration requirement applies to both their sales of newly issued securities and their resales of securities that they have previously issued and later repurchased ("treasury securities").

5 *See* § 3.02[2] and § 7.02[4] for a discussion of the publicity permitted in connection with an intended offering.

6 *See* § 7.02 and § 7.04[1].

7 Registration is required for underwriter or dealer transactions in securities constituting the whole or part of an unsold allotment, and also is required for dealer transactions in securities within the first 40 days after those securities were first publicly offered. § 4(a)(3)(A) and (C) of the Securities Act. Transactions by a dealer include transactions as agent (or broker), as well as transactions as principal. *See* the definition of "dealer" in § 2(a)(12) of the Securities Act.

8 *See* § 2(a)(11) of the Securities Act.

9 *See* § 2(a)(11) of the Securities Act.

10 *See SEC v. Cavanagh*, 155 F.3d 129, 143 (2d Cir. 1998) ("A control person, such as an officer, director, or controlling shareholder, is an affiliate of an issuer and is treated as an issuer when there is a distribution of securities. Thus, an affiliate ordinarily may not rely upon the § 4(1) exemption—he must either re-register his shares or qualify for a different exemption before undertaking to sell them.").

11 *See* § 2(a)(11) of the Securities Act; *Investment Company Filing Guidance—1993* (avail. Feb. 2, 1993) (Premature offering activity "is commonly referred to as ‘gun jumping.’ In such a case, acceleration of the effectiveness of the registration statement may be delayed and a ‘cooling off’ period with a re-circulation of any preliminary prospectus may be required.").

12 *See* §§ 20(b) and 20(d) of the Securities Act; SEC Release No. 33-10104 (June 27, 2016). These provisions apply to all other violations of the Securities Act and its associated rules and regulations; they are not particular to § 5 of the Securities Act.

13 *See* §§ 20(b) and 24 of the Securities Act. Again, this remedy is available for all violations of the Securities Act and its associated rules and regulations.

14 A person is a seller under the statute if he or she (i) passes title to the security or (ii) solicits the purchase and has a financial interest in the sale. A person who solicits a sale must be "motivated at least in part by a desire to benefit his own financial interests or those of the securities owner" to be a statutory seller under § 12(a)(1) of the Securities Act. *Pinter v. Dahl*, 486 U.S.622, 647 (1988).

15 *See Myers v. Da Silva*, Fed. Sec. L. Rep. (CCH) ¶99,166 (E.D. Cal. Mar. 14, 1983) at 95,628 (noting that the proper remedy is determined by plaintiff's circumstances, not plaintiff's election: "if plaintiff still owns the tainted securities he may only sue for rescission").

16 In the circumstances where it is applicable, the principle of "tolling" delays or suspends the counting of time (a "limitations period") within which a securities action must be commenced. For example, if a one-year statute of limitations for a fraud claim is tolled until discovery of the fraud, the plaintiff has one year to bring a claim after such discovery even if the fraud occurred more than one year before. The principle of tolling does not apply under § 12(a)(1) of the Securities Act. *See Lampf, Pleva, Lipkin, Prupis & Petigrow v. Gilbertson*, 501 U.S.350, 363 (1991); *Gardner v. Investors Diversified Capital, Inc.*, 805 F. Supp. 874 (D. Colo. 1992); *Barton v. Peterson*, 733 F. Supp. 1482, 1490 (N.D. Ga. 1990).

17 These defenses are products of case law; they are not set forth in the statute.

18 The burden is on the defendant to establish that the sale of the security was exempt from registration. *See SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006); *SEC v. North American Research & Development Corp.*, 424 F.2d 63, 71 (2d Cir. 1970).

19 It is not sufficient to show that the plaintiff knew the securities were not registered and that no registration exemption was available. The defendant must prove that the plaintiff's role in the offering was more as a promoter than an investor—for example, that he or she induced the issuer not to register the securities, or was equally involved with the defendant in developing and carrying out a plan to distribute unregistered securities.

20 This is the *in pari delicto* defense, and it is available as a defense against private actions under any of the securities laws. *Pinter v. Dahl*, 486 U.S.622, 635 (1988). The Court first held that the *in pari delicto* defense, as formulated above, was applicable to § 10(b) actions in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S.299, 310–11 (1985). In *Pinter v. Dahl*, 486 U.S. 662 (1988), the Court held that this defense applies to all private actions under the federal securities laws, including actions for rescission under § 12(a)(1).

21 *Pinter v. Dahl*, 486 U.S.622, 638–39 (1988).

22 *See* §§ 301 and 403(a)(8) of the Uniform Securities Act. At least 40 states have adopted the Act in whole or in part. Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 905 (2006). One notable exception is New York, which has never adopted the Uniform Securities Act, and whose current statute, the Martin Act, dates from 1921. N.Y. GEN. BUS. LAW § 352–359-g (McKinney's 1996 & Supp. 2011). *See infra* Note 584.

23 *See* §§ 306 and 408–410 of the Uniform Securities Act. As a practical matter, most state regulatory authorities have lacked the resources to enforce their "blue sky" laws effectively by injunctive or criminal proceedings, so such statutes have been principally enforced through private civil suits. The civil liability provisions of the Uniform Securities Act are patterned after § 12 of the Securities Act, with damage remedies available to the purchaser for offers and sales of securities made in violation of the registration provisions, as well as for other violations of the Act. *See* § 410 of the Uniform Securities Act.

24 *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

25 *See* §§ 18(a) and 18(b) of the Securities Act. *See* § 2.04[8] for a further discussion of state securities laws.

26 § 18(c)(1) of the Securities Act.

27 In 1998, Congress passed the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998) which requires most private securities class action lawsuits alleging fraud to be pursued exclusively in federal court under federal law. *See* § 11.09[1][a].

U.S. Regulation of the International Securities and Derivatives Markets, § 11.03, LIABILITIES CONNECTED WITH DISCLOSURE IN REGISTERED PUBLIC 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 § 11.03 (11th and 12th Editions 2014-2017)
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For both U.S. and non-U.S. companies, one of the most important aspects of the U.S. securities enforcement process is related to remedies for allegedly improper disclosures (such as false statements) in connection with securities activities. Although improper disclosures can arise in a variety of other significant contexts, the most comprehensive framework of remedies for deficient disclosure applies in the case of registered public offerings of securities, including offerings of ADRs representing shares of non-U.S. issuers. [28] We first discuss, therefore, the various remedies and sanctions that exist to deal with asserted disclosure deficiencies in connection with U.S. public offerings, as well as steps that can be taken by issuers and others involved in the offering process to reduce the related risks. [29]

As in many other areas of the U.S. securities laws, remedies for disclosure deficiencies in public offerings are predicated on a variety of statutory provisions. The most important of these are §§ 11 and 12(a)(2) of the Securities Act, which are discussed below in § 11.03[1] and [2], respectively. The SEC's power under § 8 of the Securities Act to issue "stop orders" in response to disclosure violations is examined in § 11.03[3]. Two other liability provisions applicable to disclosure violations in registered public offerings, § 17 of the Securities Act and Rule 10b-5 under the Exchange Act, are addressed briefly in § 11.03[4] below, with further treatment in § 11.04 (disclosure liabilities in private offerings). Section 11.03[5] discusses safe harbors from liability under U.S. securities laws for certain projections and other forward-looking statements. Finally, § 11.03[6] notes the existence of similar enforcement provisions in the state securities laws.

[1] Securities Act § 11

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[a] Elements of Claim

Section 11 of the Securities Act imposes liability for certain types of deficient disclosure in a registration statement, including the prospectus. [30] Specifically, a § 11 claim arises when any part of the registration statement at the time it becomes effective either (i) contains an untrue statement of a material fact or (ii) omits mention of a material fact required to be included in the registration statement or otherwise necessary to make the included statements not misleading. A fact is material if there is a substantial likelihood that a reasonable purchaser would consider it important in making his purchase, or otherwise stated, if the reasonable investor would view it as "significantly alter[ing] the 'total mix' of information made available." [31]

If either of these deficiencies exists, any purchaser of the securities covered by the registration statement may bring a civil suit, whether he or she purchased the securities in the initial distribution or, as some courts have held, in the aftermarket where the securities are traceable to the initial offering. [32] The traceability requirement, however, effectively limits claims in follow-on offerings (*i.e.*, offerings that follow the issuer's initial public offering) to those who purchased in the offering. [33]

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The plaintiff generally need not prove that he or she relied on the misstatement or omission in the registration statement in purchasing the securities. [34] The plaintiff also is not required to prove a causal relationship between the material misstatement or omission and the decline in the value of the security. [35] Finally, the plaintiff is not required to prove fraudulent intent ("*scienter*") on the part of the defendant.

[b] Who May Be Liable

Five basic categories of offering participants are subject to primary liability under § 11 of the Securities Act. [36] They are:

- the issuer;
- every person who signed the registration statement; [37]
- every director or partner of the issuer at the time of the filing, and every person who, with his consent, was named in the registration statement as about to become a director or partner; [38]
- every underwriter for the securities being registered; [39] and

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- every "expert" named with its consent as having prepared a portion of the registration statement. [40]

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In addition, under § 15 of the Securities Act, liability may be extended to any person who "controls" one of these primarily liable parties, in the sense that he or she has the power to direct or cause the direction of its management and policies, whether through the ownership of voting securities, by contract or otherwise. [41] Therefore, a large shareholder (or an officer not otherwise liable) may be liable for claims against the corporation he or she controls. [42] A controlling person may escape liability if that person can show that he or she had neither knowledge nor "reasonable ground to believe" in the existence of the facts giving rise to liability on the part of the person he or she controls. [43]

Because § 11 specifies the persons who are potentially liable thereunder for a disclosure violation, the courts have found that there is no additional liability for "aiding and abetting" a § 11 violation. [44]

[c] Defenses

All defendants, including the issuer, can escape liability by proving that the plaintiff knew of the material misstatements or omissions at the time he or she purchased the security. [45] If this difficult defense [46] cannot be sustained, the issuer is strictly liable for the disclosure violation.

Defendants other than the issuer bear the burden of proving that they have met a prescribed standard of care. [47] For purposes of this defense (commonly known as the "due diligence" defense), the registration statement is deemed to have two sets of sections: those prepared by experts ("expertized") and the others.

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With respect to the nonexpertized portions of the registration statement, a potentially liable defendant [48] must prove that he or she had, after "reasonable" investigation, "reasonable" ground to believe that the included information was true and that no material facts were omitted. [49] The standard of reasonableness is "that required of a prudent man in the management of his own property." [50] Because of the investigation requirement, issuers and underwriters participating in an offering engage, together with their respective advisers, in a detailed examination of the issuer's business and finances. [51] Such an examination can last for weeks in the case of a first-time issuer with a complex business, or can involve a single meeting or conference call for an offering by a seasoned issuer off a "shelf" registration statement involving underwriters and counsel that regularly follow and are familiar with the issuer's affairs. Underwriters generally request that the issuer's accountants deliver "comfort letters" regarding financial information included in the registration statement and that their counsel and issuer's counsel deliver to them "negative assurance" letters indicating that counsel has made certain investigations in connection with preparation of the registration statement and confirming that counsel is not aware of any material misstatement or omission in the registration statement.

With respect to expertized portions of the registration statement, defendants other than the relevant expert must prove that, at the time that the registration statement was effective, they had no reasonable ground to believe, and did not believe, that there was a material misstatement or omission. [52] No reasonable investigation is required to establish the defense. This reduced standard of diligence applies most frequently to the audited financial statements in a registration statement, because such financial statements are included in reliance on the auditors' report thereon and upon the authority of the auditors as experts, as well as the auditors' consent to being named as experts. Although no reasonable

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investigation is required to establish a reliance defense, courts have held that the existence of "red flags" can create a duty to investigate expertized information, including audited financial statements. [53] As a result, the examination of an issuer by underwriters and their advisers includes a thorough review of financial statements and other financial information with an issuer and its accountants.

The due diligence investigation necessary to establish a defense may depend upon the defendant's role in the transaction and his or her relationship to the issuer. In the first of the relatively few reported cases to analyze § 11 liability, [54] the court discussed factors relevant to whether a defendant had established a due diligence defense. The court stated that an underwriter must "make some reasonable attempt to verify the data submitted" to it and may not rely solely on statements or assurances of the issuer's officers and counsel. [55] The court distinguished the greater level of investigation required of a director who is a lawyer preparing the registration statement than of an outside director, *e.g.*, with respect

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to legal and corporate documents. [56] The court also found that a corporate officer could not reasonably rely on expertized information when, based on the officer's own knowledge of the company's financial data, he or she had reason to know it was not correct. [57]

Rule 176 under the Securities Act provides some additional guidance on the factors that should be taken into account in determining the reasonableness of the due diligence investigation. [58] Under this rule, relevant factors include:

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- the type of issuer;
- the type of security;
- the type of person (*e.g.*, whether a director, officer or underwriter);
- for officers, the type of office held;
- for directors, whether they have any other relationship with the issuer;
- for underwriters, the type of underwriting arrangement;
- reasonable reliance on officers, employees and others whose duties should give them knowledge of the facts in question; and
- whether, with respect to information incorporated by reference to another document, the person had any responsibility for preparation and filing of the incorporated document. [59]

An issuer faced with suit under § 11 may also be able to rebut allegations of material misstatements or omissions with respect to statements of opinion, including statements of belief, statements expressing uncertainty about a current matter, and predictions about the future, under certain circumstances. [60] In *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, the Supreme Court identified three bases of liability for statements of opinion under § 11. [61]

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First, because "every such statement explicitly affirms one fact: that the speaker actually holds the stated belief," a statement of opinion can be actionable as a misstatement of material fact if it was subjectively disbelieved by the defendant at the time it was expressed. [62] Second, a statement of opinion can be actionable as a misstatement if it is accompanied by "embedded statements of fact" that are untrue. [63] For example, if a speaker supports its opinion with a specific fact that is untrue, there can be liability for that misstatement. To avoid liability on this ground, an issuer can show that its challenged opinion did not contain embedded statements of facts or that any such facts were true. Third, "because a reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion," a statement of opinion can be actionable under § 11's omissions provision if it "omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion" and "those facts conflict with what a reasonable investor would take from the statement itself." [64] Thus, a statement of opinion about legal compliance (*i.e.*, "we believe our conduct is lawful") may be an actionable omission if the issuer made the statement without having consulted a lawyer because "an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry—rather than, say, on mere intuition." [65] The Supreme Court has cautioned, however, that an opinion statement "is not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way." [66] Further, "whether an omission makes an expression of opinion misleading always depends on context," and requires consideration of the text surrounding the opinion, "including hedges, disclaimers, and apparently conflicting information," as well as "the customs and practices of the relevant industry." [67] An issuer may therefore be able to avoid omission liability for statements of opinion by disclosing the basis for its opinion or by establishing that an investor would not have been misled about that basis when the statements are viewed in context.

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In *Tongue v. Sanofi*, the Second Circuit applied this standard in affirming the dismissal of claims regarding an issuer's optimistic statements of opinion concerning the expected timing of a drug's approval and launch, despite the issuer's alleged failure to disclose the FDA's negative feedback about the methodology used in the drug's trials. [68] In reaching that result, the Second Circuit concluded that the omitted facts did not "conflict with what a reasonable investor would take from the statement itself" because investors in a pharmaceutical company are aware of ongoing dialogue between the company and the FDA, as well as the FDA's previously disclosed concerns with the applicable methodology. [69] The Second Circuit also concluded that the issuer was not under an obligation to disclose the specific negative feedback it received from the FDA "merely because it tended to cut against their projections." [70]

Issuers can also defeat liability with respect to forward-looking opinions and other forms of "soft information," such as predictions and discussions of risk, by including appropriate cautionary language about the reliability of this information within the prospectus. Under the so-called "bespeaks caution" doctrine, which has been developed by the courts and incorporated into federal statutory law outside the initial public offering context, [71] cautionary language such as disclaimers may render certain alleged misrepresentations or omissions immaterial as a matter of law. [72] The idea is that a suitably warned purchaser cannot reasonably have relied on this information in making his or her investment decision.

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Disclaimers, however, are not a failsafe; if the seller did not have at least a reasonable basis for making the predictive statements, the disclaimers will not be sufficient to defeat liability. [73]

The "bespeaks caution" doctrine only protects statements that are considered forward-looking. [74] Courts have at times struggled to define what makes a statement "forward-looking." The Second Circuit tackled the question in *Iowa Public Employees' Retirement System v. MF Global, Ltd.* [75] In *MF Global*, the plaintiffs complained that the defendant had failed to disclose that its risk management protocols, which limited trading in brokerage accounts in certain ways, were not always enforced upon the company's employees trading for their own accounts. The district court dismissed the allegations under the "bespeaks caution" doctrine, interpreting plaintiffs' complaint as an allegation that MF Global had failed to disclose that "the risk management system might be unable to prevent future negative outcomes" and was thus alleging that MF Global "had failed to disclose the risk of a future negative event." [76] The Second Circuit held that the district court had applied the "bespeaks caution" doctrine too broadly for failing to recognize that the "allegation specifies an omission of present fact" that was "ascertainable when the challenged statements were made." [77] Recognizing that the line between forward-looking statements and statements of present fact may be hard to draw, and that some statements may contain elements of both, the court explained that "[a] forward-looking statement expresses the issuer's inherently contingent prediction of risk or future cash flow" whereas "a non-forward looking statement provides an ascertainable or verifiable basis for the investor to make his own prediction." [78]

More recently, in litigation arising out of Facebook's initial public offering, a judge in the Southern District of New York concluded that the defendants were not sheltered from liability under the bespeaks caution doctrine, even

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though the company made "significant disclosures" warning that it could lose revenue in the future as the use of its mobile products increased, because the plaintiffs adequately alleged that the defendants were aware that those trends were already occurring. [79] The court therefore concluded that Facebook had a duty to disclose that known trend under Item 303 of Regulation S-K under the Securities Act, and that the bespeaks caution doctrine did not apply to the alleged omission of that existing information. [80]

Cautionary language can also help an issuer rebut allegations of material misstatements or omissions in contexts other than those involving soft information. In *WorldCom Securities Litigation*, [81] the court held that an issuer unaffiliated with WorldCom did not violate § 11 when it made a registered offering of notes linked to WorldCom's equity. The historical prices for WorldCom's common stock listed in the prospectus supplement relating to the notes were artificially inflated as a result of WorldCom's wrongdoing and were therefore materially false and misleading. The court pointed to language in the issuer's prospectus supplement that clearly cautioned that the issuer did not know whether WorldCom had disclosed all events occurring before the date of the prospectus supplement, that the issuer had not participated in the preparation of any of WorldCom's public filings and that the issuer had not made any due diligence investigation or inquiry of WorldCom in connection with the equity-linked note offering. [82]

Finally, courts generally hold that expressions of "puffery" and corporate optimism do not give rise to securities violations, either because they are too general to cause a reasonable investor to rely upon them or because no investor would consider such statements to be material. [83] For example, the Second

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Circuit recently dismissed claims alleging that an issuer made misstatements about its "culture of high ethical standards, integrity, operational excellence, and customer satisfaction" and "its reputation for upholding the highest standards of personal integrity and business conduct," notwithstanding the plaintiffs' allegation that the statements were "knowingly and verifiably false when made," because the statements' "generality … prevents them from rising to the level of materiality required to form the basis for assessing a potential investment" and "an investor would not depend on the statements as a guarantee that the company would never take a step that might adversely affect its reputation." [84]

[d] Remedies

A plaintiff who prevails on a § 11 claim may recover monetary damages, which are measured in one of three ways. [85] If the plaintiff still holds the security at the time of judgment, the plaintiff may recover the difference between the purchase price and its value at the time the suit was filed. [86] If the plaintiff sold the security before filing suit, he or she may recover the difference between the purchase and resale prices. Finally, if the plaintiff sold the security during the course of the litigation, the plaintiff may recover the difference between the purchase price and either the resale price or the price at the time the suit was filed, whichever is greater. In any of these contexts, the defendant may reduce the plaintiff's damages by proving that the decline in the value of the security is attributable to factors other than the material misstatement or omission. [87]

Defendants are jointly and severally liable to the plaintiff, meaning that any of them may be held responsible for the plaintiff's damages in full. [88] There is an exception for underwriters, whose liability generally is limited to the value

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of their own underwriting commitment. [89] Outside directors are also exempt from joint and several liability, except in cases of "knowing" securities fraud. [90] Under certain circumstances, discussed below, defendants have a right to recover contribution from one another. [91]

[e] Indemnification, Contribution and Insurance

Indemnification, contribution and insurance are methods by which defendants seek to shift liability in whole or in part to fellow wrongdoers, or to insurance carriers who agree to cover their litigation costs and damages in exchange for regular premiums. While contribution and insurance payments are generally permissible under the securities laws, the SEC and the courts have strictly limited the availability of indemnification. These issues, which apply equally to the Securities Act and the Exchange Act, are addressed below.

[i] *Indemnification*

There are no express rights of indemnification under the Securities Act or the Exchange Act, and a majority of courts have held that such rights may not be implied. [92] The SEC takes the position that an issuer's agreement to indemnify its directors, officers and controlling persons for securities law violations is against public policy and unenforceable. [93] Courts have generally agreed, on the grounds

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that indemnification agreements defeat the deterrent policies of the securities laws. [94]

The SEC policy by its terms does not apply to (i) the issuer's indemnification of underwriters for liabilities arising out of information in the registration statement not provided by the underwriters, [95] or (ii) a selling securityholder's indemnification of the issuer (or *vice versa*) in a secondary offering by such securityholder. [96] However, the courts may not enforce such agreements, particularly where the securities law violation involved intentional or reckless conduct. [97] The courts are divided as to whether indemnification is available when the underwriter has been merely negligent. [98] Because of this uncertainty, U.S. underwriting agreements generally provide for a contractual right of contribution if the indemnification provisions are not enforceable.

[ii] *Contribution*

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Contribution is an equitable doctrine developed in response to the traditional regime of "joint and several liability," in which any single defendant could be held liable for the full extent of plaintiff's damages, even if multiple persons were in fact responsible for those damages. The right of the person who discharges the common liability to recover contribution from others who share fault is thought to promote both fairness and the deterrent policies of the securities laws, because all persons potentially liable to the plaintiff will have to bear a share of the loss rather than only those named as defendants. Section 11(f) of the Securities Act expressly provides for contribution among defendants who are jointly liable, although a person found liable for fraudulent misrepresentation cannot recover in contribution from a defendant who is not. [99] Under a 1995 amendment to the Securities Act, outside directors now are exempted from joint and several liability, except in cases of "knowing" securities fraud, and instead are liable only for a portion of the total damages based on the percentage of responsibility that the jury attributes to them. [100]

[iii] *Insurance*

Companies routinely purchase, and the SEC does not object to, liability insurance for directors and officers, although the SEC does require disclosure of the premium paid by the registrant or selling shareholder for any policy, obtained in connection with a registered public offering, that insures or indemnifies directors or officers against liabilities connected with the registration. [101]

[f] Statutes of Limitations and Repose

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The statutes of limitations and repose (the periods in which a plaintiff must commence litigation) for claims brought pursuant to § 11 are "one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence," but in no event more than three years after the security was first *bona fide* offered to the public. [102]

Many courts have held that the plaintiff bears the burden to plead and prove facts demonstrating compliance with the limitations periods. [103] Specifically, a complaint should set forth the (i) time and circumstances of plaintiff's discovery of the fraudulent statement, (ii) reasons why it was not discovered earlier if more than one year has elapsed since the statement was made, and (iii) diligent efforts that plaintiff undertook in seeking such discovery. [104] While ordinarily the plaintiff also bears the burden of pleading and establishing that it is entitled to tolling, [105] the Supreme Court has held that equitable tolling— *i.e.*, tolling in circumstances not contemplated by the statute—is not available. [106]

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As noted above, § 13 provides a three-year repose period for claims under § 11. This period begins when the security is "*bona fide* offered to the public," but the statute is ambiguous as to the meaning of that phrase. In *P. Stolz Family Partnership L.P. v. Daum*, the Second Circuit held that in determining whether a *bona fide* offer was made, "the relevant question … is when was the stock really and truly (genuinely) offered to the public, as opposed to, say, a simulated offering." [107]

The court in *P. Stolz* further interpreted § 13 to mean that the statute of repose begins to run from the *first bona fide* offering of the security to the public, rather than from the *last* such offering. The court reasoned that this interpretation was appropriate because the entire purpose of a statute of repose is to

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provide an easily ascertainable and certain date for the quieting of litigation, and using the last offered date would add uncertainty and fluidity to that calculation and prevent finality. It held as much notwithstanding its acknowledgement that the rule leaves open the remote possibility that a plaintiff's claim may in some instances become barred before it even accrues. [108]

[2] Securities Act § 12(a)(2)

[a] Elements of Claim

Section 12(a)(2) of the Securities Act provides a second basis for liability for deficient disclosure in connection with public offerings. [109] Unlike § 11, which is limited to disclosure in a registration statement, § 12(a)(2)'s remedy applies to both written and oral communications in connection with the offer or sale of a security. [110] The statute provides that any person who offers or sells a

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security by means of a "prospectus or oral communication" [111] that contains a material misstatement, or fails to state a material fact that is "necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading," is liable to the purchaser for damages. [112] An oral communication must relate to the prospectus for it to be actionable under § 12(a)(2). [113]

As in § 11, the plaintiff is not required to establish that the defendant acted with fraudulent intent (*scienter*), or that the plaintiff relied upon the misstatements or omissions in making his or her purchase—although the plaintiff must prove that he or she was not actually aware of these disclosure violations at the time. [114] The plaintiff also must demonstrate that the misstatement or omission somehow affected (though not necessarily prompted) the purchase, but this

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showing has been presumed where the misleading information was in a written prospectus, since the dissemination of such information is deemed to affect the market price of the security. [115]

Unlike § 11, which establishes liability for a range of offering participants, § 12(a)(2) liability is expressly limited to those who offer or sell the securities. However, this provision has been construed to include not only the immediate seller, but also others who had a financial interest in the sale and actively participated in its solicitation. [116] Thus, directors, officers and principal shareholders of an issuer may be liable as "sellers" under § 12(a)(2) where they authorize the promotional efforts of the underwriters, help prepare the offering documents and work closely with the underwriters in conducting sophisticated "information" or "due diligence" meetings with retail and institutional sales personnel. [117]

Moreover, as in § 11, liability may be extended to "controlling persons," unless these persons can prove that they neither knew nor had a reasonable basis to know the facts giving rise to the liability of those they control. [118] The courts have held that there is no aiding and abetting liability under § 12(a)(2) of the Securities Act. [119]

[b] Defenses

A seller has an affirmative defense to § 12(a)(2) liability if he or she can prove that he or she "did not know, and in the exercise of reasonable care could not have known," of the untrue statement or omission. One court has interpreted

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this standard as requiring the exercise of "ordinary care," with the determination of what this involves dependent on the circumstances of the transaction. [120]

Unlike the due diligence defense under § 11, § 12(a)(2) does not expressly impose a duty to investigate. However, some courts have implied such a duty under certain circumstances. [121] Accordingly, it has become customary for underwriting banks in public offerings exempt from SEC registration, such as offerings of commercial paper exempt under § 3(a)(3) of the Securities Act, to proceed as if the duties necessary to establish a defense under § 12(a)(2) are the same as those under § 11, and as if the same measures they use to protect themselves under § 11 also will protect them under § 12(a)(2).

The indemnification and contribution provisions in underwriting agreements for registered public offerings apply to liability arising from misleading misstatements or omissions in the preliminary and final prospectuses as well as the registration statement. As previously discussed, the courts may not always enforce these indemnification provisions, but generally will honor contractual provisions providing for contribution rights among offering participants. [122]

[c] Remedies

Section 12(a)(2) of the Securities Act provides an express measure of damages for disclosure violations. If the plaintiff still owns the security, he or she is entitled to rescind the sale and recover the purchase price, plus interest, less income earned. If the plaintiff no longer owns the security, he or she can recover

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damages. Pursuant to the Litigation Reform Act, [123] damages for violations of § 12(a)(2) are limited to the depreciation in the value of the plaintiff's securities actually caused by the false statements or omission. [124]

[d] Statute of Limitations

Like § 11 suits, claims under § 12(a)(2) of the Securities Act are governed by the limitations and repose periods imposed by § 13 of the Securities Act. Such periods are one year after the plaintiff discovered or reasonably should have discovered the misstatement or omission, but in no event more than three years after the sale. [125] Because § 12(a)(2) is governed by the same statute of limitations as § 11 claims, the issues discussed in § 11.03[1][f] are also germane to limitations issues under § 12(a)(2). [126]

[3] Stop Orders

In addition to the civil damage remedies provided by §§ 11 and 12(a)(2), the Securities Act provides for various remedies by the SEC in response to improper disclosure in a registration statement. Chief among these remedies is the so-called "stop order" under § 8 of the Securities Act, by which the SEC may (i) deny effectiveness to a registration statement that will otherwise automatically become effective if it appears inaccurate or incomplete in any material respect, [127] or (ii) suspend the effectiveness of a previously filed registration statement if it contains a material misstatement or omission. [128] In both cases, the issuer is entitled to notice and a hearing before the SEC issues the stop order, and the stop order remains in effect until the registration statement has been amended in accordance with the SEC's instructions.

[4] Other Liability Provisions

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Disclosure violations in registration statements may also implicate § 17 of the Securities Act and Rule 10b-5 under the Exchange Act, broad antifraud provisions that provide a variety of remedies, including civil or administrative proceedings by the SEC, criminal liability and, in the case of Rule 10b-5, civil damage suits by private parties. [129] These provisions, which also apply to fraudulent acts in connection with private placements and secondary market transactions, are discussed further in § 11.04[2] and [3].

[5] Special Liability Rules for Forward-Looking Statements

Projections and forecasts about an issuer and other forward-looking statements are by their nature uncertain and may prove to be incorrect, thus raising special liability concerns for an issuer, including a potential duty to correct or update them when they are no longer true. [130] With the adoption of Regulation FD, [131] these statements are required to be disclosed to a much wider audience when material, which will often (and for earnings, revenue or similar line item forecasts, always) be the case, with an attendant increase in the issuer's exposure to liability for such statements.

Special liability rules apply with respect to both written and oral forward-looking statements. Forward-looking statements may be protected as statements of opinion under certain circumstances. [132] Outside the initial public offering context, corporate issuers also generally now enjoy a qualified safe harbor for forward-looking statements, so long as these statements are accompanied by "meaningful cautionary statements" or were not made with actual knowledge of their falsity.

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The Litigation Reform Act, enacted in 1995, provides issuers that are subject to the reporting requirements of the Exchange Act, their officers, directors and employees and their underwriters (with respect to information provided by such issuers or derived therefrom) the principal source of protection for projections and other forward-looking statements, whether written or oral, that turn out to be inaccurate or materially misleading. The Litigation Reform Act creates a two-pronged safe harbor from liability under the Securities Act and the Exchange Act where (i) a forward-looking statement [133] is identified as

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such [134] and is accompanied by [135] meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement or is "immaterial" [136] *or* (ii) a plaintiff is unable to prove that the forward-looking statement was made with actual knowledge that it was materially false or misleading. [137] At least two issues have caused courts to differ in their applications of the first prong. Most courts have noted that the first prong, unlike the second prong, contains no reference to the defendant's state of mind. Thus, these courts have found that the first prong is satisfied irrespective of defendants' knowledge of the truth or falsity of their forward-looking statements. [138] This position, however, has not been uniformly adopted. [139]

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Second, courts have struggled to define what makes a cautionary statement "meaningful" in order to benefit from the safe harbor. Courts have generally agreed that mere "boilerplate" cautionary language will not suffice, and the risk disclosures must be tailored to the defendant's actual business. [140] These principles, like much of the analysis of the safe harbor provision, have been borrowed from the "bespeaks caution" doctrine; [141] the House Conference Committee that adopted the Litigation Reform Act stated that the statutory safe harbor was based on—but not intended to replace—the common law doctrine. [142]

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Disagreement among the courts has focused on how to apply the safe harbor at the pleadings stage in cases where the plaintiff alleges that an undisclosed contingency caused worse-than-predicted results. The Seventh Circuit's decision in *Asher v. Baxter* [143] suggests that it could be difficult for a defendant to prevail on a motion to dismiss in such a circumstance. In *Asher*, the court ruled that before a motion to dismiss can be granted, at least some discovery may be required to determine whether the defendant had actually disclosed the important risks that it "objectively faced when it made its forecasts." [144] At the pleadings stage, the court found no basis to conclude that the defendant had disclosed the "principal or important risks." [145] Courts following *Asher* may conclude that discovery is nearly always necessary where the contingency that causes worse-than-predicted results is not identical to the risks described in the forward-looking statement. [146]

In contrast, the Eleventh Circuit Court of Appeals in *Harris v. IVAX Corp*. [147] affirmed a ruling on motion to dismiss in the defendant's favor. The plaintiff had alleged that the safe harbor would not protect a press release that disclosed an anticipated quarterly loss of $43 million when the defendant's actual loss turned out to be $179 million, of which $104 million was a "goodwill write-down" that the company had never disclosed. The court concluded that the "failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor. [W]hen an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the investment to make an intelligent decision about it." [148] While the *Harris* analysis permits a broader application of the safe harbor at the pleading stage, companies can increase their chances of qualifying for the safe harbor by updating their risk disclosures to follow corporate developments. [149]

The Litigation Reform Act sets forth specific procedures for complying with the safe harbor with respect to oral forward-looking statements. Pursuant to these procedures, it is sufficient for an issuer (or its director, officer or employee) making an oral forward-looking statement to (i) state that the discussion or presentation will contain forward-looking statements, (ii) state that actual results could differ materially from those projected in such forward-looking statements and (iii) refer the audience to a "readily available" written document where the "meaningful cautionary statements" can be found. [150] Documents filed with the SEC or publicly disseminated are considered "readily available." [151]

While the Litigation Reform Act safe harbor has generally been an effective safe harbor from liability for forward-looking statements in certain contexts, it has a number of qualifications. First, it applies only in private civil suits [152] alleging liability under the Securities Act or the Exchange Act. [153] Second, as previously mentioned, it is available only for issuers that are subject to the reporting

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requirements of the Exchange Act. [154] Third, it does not apply to statements made in the context of an initial public offering, a tender offer or a going private transaction, in financial statements or in beneficial ownership reports under § 13(d) of the Exchange Act. [155]

Finally, the language of the safe harbor does not affect the scope of any duty to update specific forward-looking statements that fall within it. [156] The Litigation Reform Act explicitly declined to resolve the question whether an issuer making projections must update them when they appear no longer to be accurate, providing only that nothing in the Act shall impose such a duty. [157] In the absence of clarity on the extent and scope of a duty to update that may be imposed by the courts, issuers have continued to be cautious about making public projections, despite the safe harbor, in light of the significant possibility that they will be compelled to update them in circumstances in which they would otherwise prefer to refrain from making additional public disclosures. [158]

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Other factors may also dissuade issuers from offering more forward-looking disclosure. In a report to the President and Congress summarizing the practical impact of the Litigation Reform Act a year after its enactment, the SEC indicated that the "quality and quantity of forward-looking disclosure [had] not significantly improved," despite the formal safe harbor. [159] The SEC identified a number of factors underlying corporate reluctance to increase disclosure, including:

- the lack of judicial guidance as to the sufficiency of the required "meaningful" cautionary language;
- the potential exposure to liability under state law, where comparable safe harbors may not exist;
- fear of liability in SEC enforcement actions, where the federal safe harbor is unavailable;
- a concern that including a complete list of cautionary statements might prove cumbersome or "water down" the company's disclosures; and
- fear of damaged credibility should projections prove wrong. [160]

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Some commentators have suggested that more recent developments have addressed at least some of the concerns outlined by the SEC. [161] For example, case law has offered some guidance on the definition of "meaningful" disclosures, and the Securities Litigation Uniform Standards Act ("SLUSA") has precluded most state law securities class actions. [162] The SEC staff indicated that it would continue to study the safe harbor and consider whether additional steps might be desirable to encourage more disclosure and improve the quality of the accompanying cautionary language, but it has not released any updated reports to date. [163]

[6] State Securities Laws

In addition to federal securities laws, state "blue sky" laws also prohibit sales of securities by means of material misstatements or omissions. The Uniform Securities Act disclosure provision is patterned after § 12(a)(2) of the Securities Act, proscribing the use of untrue statements and material omissions in connection with an offer or sale of securities. [164] The civil damages remedies in the Uniform Securities Act likewise are modeled on those in the Securities Act. [165] In 1996, Congress expressly reaffirmed its intention that state remedies with respect to securities fraud or misrepresentation should remain intact, despite recent legislation pre-empting state law with respect to registration and related matters. [166] Two years later, however, Congress severely limited the ability of private parties to bring securities fraud class actions in state court by passing SLUSA. [167]

Footnotes

28 *See* §§ 3.02 and 3.04.

29 Liabilities connected with deficient disclosure in private offerings and secondary market transactions are discussed in §§ 11.04 and 11.05[1], respectively.

30 As discussed in Chapter 3, sales of securities to the public require preparation of a prospectus, which is part of a registration statement filed with, and declared effective by, the SEC. The prospectus must contain detailed financial and other information specified by the SEC.

31 *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (applying the *TSC Industries* standard of materiality to action brought under § 10(b) of the Exchange Act and Rule 10b-5 thereunder). For a discussion of the "bespeaks caution" doctrine, under which cautionary language in a prospectus may render alleged misstatements or omissions immaterial as a matter of law, *see* § 11.03[1][c]. For a discussion of certain qualitative considerations in assessing materiality, *see* § 11.04[2][a].

32 *See Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); *see also DeMaria v. Andersen*, 318 F.3d 170, 178 (2d Cir. 2003) (finding § 11 standing for aftermarket purchasers).

33 *See In re Global Crossing, Ltd. Securities Litigation*, 313 F. Supp. 2d 189 (S.D.N.Y. 2003) (plaintiffs in aftermarket purchaser suits pursuant to § 11 were required to plead and to prove that their shares were traceable to the initial distribution, although a mere good faith allegation that the shares were traceable was sufficient); *see also Krim v. Pcorder.com, Inc.*, 402 F.3d 489 (5th Cir. 2005) (rejecting investors' attempt to satisfy the tracing requirement through statistical evidence that demonstrated the high probability (over 99%) that at least some of their stock was traceable to the tainted public offering, and reasoning that this type of statistical standing would expand the scope of potential § 11 claimants beyond the statutory language or intent); *In re FleetBoston Financial Corp. Securities Litigation*, 253 F.R.D. 315, 347–51 (D.N.J. 2008) (following *Global Crossing* and *Krim* and holding that plaintiff has no standing to bring a § 11 claim unless he can satisfy the tracing requirement, and further holding that this showing must be made with respect to a sufficient number of plaintiffs to satisfy the numerosity requirement for class action certification).

34 *See Westinghouse Electric Corp. v. ‘21' International Holdings, Inc.*, 821 F. Supp. 212, 218 (S.D.N.Y. 1993). A statutory exception exists for situations in which the purchaser bought the securities after the issuer made available to its securities holders an earnings statement covering at least 12 months after the effective date of the registration statement. *See* § 11(a) of the Securities Act. Under these circumstances, the plaintiff must show actual reliance on the alleged misstatements or omissions in the registration statement. *See In re Petrobras Securities Litigation*, 116 F. Supp. 3d 368, 386 (S.D.N.Y. 2015). For this reason, it has become customary practice for underwriting agreements to include an issuer commitment to make such an earnings statement generally available. *See* § 3.02[5][b], Note 323. Reasoning based on this exception, and disagreeing with the general statements in *Westinghouse*, the Eleventh Circuit in *APA Excelsior III L.P. v. Premiere Technologies, Inc.*, 476 F.3d 1261, 1271–77 (11th Cir. 2007), held that a plaintiff who entered into a binding agreement to purchase securities before a defective registration statement was issued had to prove that it had in fact relied on the defective registration statement.

35 The defendant may limit a plaintiff's damages by showing that the decline in the value of the security is due to something other than the material misstatement or omission. *See* § 11(e) of the Securities Act.

36 § 11(a) of the Securities Act.

37 § 11(a)(1) of the Securities Act. Generally, the registration statement must be signed by the issuer, its principal executive officer, its principal financial officer, its controller or principal accounting officer and a

majority of its directors. For a foreign issuer, the registration statement also must be signed by the issuer's authorized representative in the United States. *See* § 6(a) of the Securities Act.

38 *See* § 11(a)(2) and (3) of the Securities Act.

39 The term underwriter is broadly defined, but does not include brokers "whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors'or sellers'commission." § 2(a)(11) of the Securities Act. An underwriter's liability is generally limited by § 11(e) to the total offering price of securities that it underwrites unless the underwriter receives a benefit that is disproportionate to the amount of securities it underwrites and is not shared by the other underwriters. Unlike their European counterparts, U.S. underwriters will not agree to joint and several liability in public offerings because, in the event of litigation, they could be found liable for the entire amount of the offering and then would have to seek contribution from those who were also at fault. *See* § 3.02[1][a].

Although § 11(e) generally has been interpreted to limit an underwriter's liability in an offering to the securities it has agreed to underwrite in that offering, *see Special Situations Fund, III v. Cocchiola*, Fed. Sec. L. Rep. (CCH) ¶94,459 (D.N.J. Aug. 3, 2007) (holding that, as a matter of law, § 11(e) of the Securities Act limits the liability of an individual underwriter to the securities underwritten by that underwriter, and rejecting the contention that § 11(e) limits "the liability of an underwriter to the shares that particular underwriter personally distributed to the public"), in *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,139 n.8 (S.D.N.Y. Mar. 14, 2005), the court speculated *in dictum* that, in light of the broad definition of "underwriter" under the Securities Act, the amount of securities "underwritten" by a lead underwriter in an offering for purposes of § 11(e) "may be greater than the amount formally allocated to that underwriter" and refused to interpret § 11(e) to exempt underwriters from the joint and several liability provisions of the Securities Act.

Issuers and sellers outside the United States sometimes provide a "success fee" that may only be for the benefit of the global coordinators or lead managers of the offering. In the context of a U.S. registered offering, an underwriter's limitation of liability under § 11(e) could be lost unless all the underwriters receive the fee on a *pro rata* basis or non- *pro rata* fees are distributed by the syndicate rather than by the issuer or other seller. *See* § 3.02[4][h].

In addition to the statutory liability to which underwriters may be exposed under § 11 and the other sections discussed in this chapter, they may be subject to fiduciary duty claims by issuers in connection with their role in the pricing of securities. *See* § 3.06[2][b], Note 662.

Plaintiffs in some of the recent MBS litigation have sued rating agencies and argued that they were "underwriters" of the offerings based on the view that the evaluations and ratings were necessary steps in the distribution of the MBS. Courts have rejected the argument and held that rating agencies do not fit the statutory definition of underwriters. *See In re Lehman Brothers Mortgage-Backed Securities Litigation*, 650 F.3d 167 (2d Cir. 2011). The court in *Lehman Brothers* concluded that underwriter liability under § 11 only extends to those who participate in purchasing securities with a view towards distribution, or in offering or selling securities for an issuer in connection with a distribution, but did not extend to other persons who merely provide services that facilitate the participation of others in such undertakings.

40 Liability of such experts (including accountants, engineers and appraisers) extends only for material misstatements and omissions in the report or valuation prepared or certified by them for inclusion in the registration statement (an "expertized" part of the registration statement). § 11(a)(4) of the Securities Act.

There is no question that Congress, in repealing Rule 436(g) under the Securities Act (which provided that a credit rating was not part of a registration statement within the meaning of the Securities Act) intended § 939G of the Dodd-Frank Act to bring rating agencies into the scope of § 11 as "experts." The response of the rating agencies has been to refuse to consent to the use of their ratings in registration statements.

41 *See* § 15 of the Securities Act. Control person liability under § 15 is actually secondary or derivative liability; a claim against a control person must be predicated upon an underlying violation of the securities laws by a primary violator who was under the control of the § 15 defendant.

42 *See* § 15 of the Securities Act and Rule 405 thereunder.

43 Note that this is a statutory defense under § 15 of the Securities Act, not a defense to the primary § 11 violation. *See generally Donohoe v. Consolidated Operating & Products Corp.*, 30 F.3d 907, 911 (7th Cir. 1994) (noting that § 20(a) of the Exchange Act and § 15 of the Securities Act are "parallel, though control person liability is limited [in § 15] to actions under sections 11 and 12 of that Act"). *See infra* Notes 221 and 222 for a discussion of control person liability in the context of § 20(a) of the Exchange Act.

44 *See, e.g.*, *Bresson v. Thomson McKinnon Securities, Inc.*, 641 F. Supp. 338, 342 (S.D.N.Y. 1986); *Anderson v. Clow (In re Stac Electronics Securities Litigation)*, Fed. Sec. L. Rep. (CCH) ¶97,807 (S.D. Cal. Sept. 17, 1993), *withdrawn*, 89 F.3d 1399 (9th Cir. 1996), *cert. denied*, 520 U.S. 1103 (1997).

45 *See* § 11(a) of the Securities Act.

46 *See, e.g.*, *Greenwald v. Integrated Energy, Inc.*, 102 F.R.D. 65, 71 (S.D. Tex. 1984) ("[W]hat investors knew or should have known on a particular date is a matter for proof at trial.").

47 Defendants other than the issuer may also invoke two other statutory defenses, which are rarely used: (i) that the defendant had resigned prior to the effective date and advised the SEC and the issuer that he or she would not be responsible for the registration statement or (ii) that the registration statement became effective without his or her knowledge and he or she so advised the SEC and gave "reasonable public notice." §§ 11(b)(1) and 11(b)(2) of the Securities Act.

48 [Reserved.]

49 § 11(b)(3)(A) of the Securities Act. A similar standard applies for a due diligence defense by an expert with respect to an expertized portion of a registration statement. *See* § 11(b)(3)(B) of the Securities Act.

50 § 11(c) of the Securities Act.

51 *See* § 3.06 for a discussion of the investigation conducted in order to establish the due diligence defense.

52 *See* § 11(b)(3)(C) of the Securities Act. The same showing is necessary with respect to portions of the registration statement that purport to be made on the authority of official government documents or statements of U.S. or foreign government officials. *See* § 11(b)(3)(D) of the Securities Act. In the context of international securities transactions, such information is most commonly included in the registration statements of non-U.S. issuers that are government related or government owned, including in particular, registration statements of foreign governments or political subdivisions thereof registered under Schedule B of the Securities Act. Such information is also sometimes included in foreign private issuer offerings where U.S. investors are believed to require background information about the domestic context in which the issuer functions. *See* § 3.05[1].

53 *See In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 673 (S.D.N.Y. 2004) (stating that a red flag consists of "[a]ny information that strips a defendant of his confidence in the accuracy of those portions of a registration statement premised on audited financial statements"). In *WorldCom*, the court refused to grant the defendant underwriters summary judgment on claims brought under §§ 11 and 12 of the Securities Act. The underwriters had argued that their reliance defense under § 11 entitled them to summary judgment on claims alleging that WorldCom's audited financial statements contained materially misleading information. In rejecting their argument, the court found that disputed facts suggested red flags existed that should have caused the underwriters to question the reliability of WorldCom's audited financial statements and conduct a further investigation. In particular, the court noted that certain cost ratios reported by WorldCom were significantly lower than equivalent ratios at its two closest competitors and that WorldCom's reported assets may have been doubtful in light of the general telecommunications downturn and asset impairments that its competitors had taken to their core networks during the period under review. *See In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 678–81 (S.D.N.Y. 2004).

Unaudited financial information is not considered to be expertized, and therefore the defendant must have conducted a reasonable investigation to establish the higher threshold due diligence defense. *See In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004). In *WorldCom*, the court confirmed that a comfort letter does not expertize unaudited interim financial statements and rejected the underwriters' contention, on a motion for summary judgment, that an underwriter's due diligence investigation of accounting issues is *per se* reasonable when it rests on an auditor's review of unaudited interim financial statements and a SAS 72 comfort letter (at least in the absence of any red flags and in the context of integrated disclosure for shelf registration statements). The court acknowledged, however, that receipt of a comfort letter would constitute "important evidence" at trial of the reasonableness of an underwriter's investigation. *In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 682–83 (S.D.N.Y. 2004); *see also* Rule 436(c) under the Securities Act. For a further discussion of due diligence in the context of the SEC's integrated disclosure framework and the guidance provided by Rule 176 under the Securities Act, *see infra* Note 58 and accompanying text.

54 *See Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

55 *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

56 *See Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 697 (S.D.N.Y. 1968). Other courts have also indicated that an inside director (who has or should have intimate knowledge of the issuer) would have difficulty in establishing a due diligence defense. *See, e.g.*, *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,137 (S.D.N.Y. Mar. 21, 2005) (noting more searching inquiry is required by inside directors, in contrast to outside directors, to establish a due diligence defense under § 11 of the Securities Act); *In re Livent, Inc. Noteholders Securities Litigation*, 355 F. Supp. 2d 722, 733 (S.D.N.Y. 2005) ("As inside directors, with intimate knowledge of corporate affairs and the transactions that were accounted for in a materially misleading manner, [defendants] must put forward evidence that the misleading information was incorporated notwithstanding their reasonable efforts to ensure the Registration Statement's accuracy."); *Laven v. Flanagan*, 695 F. Supp. 800, 811–12 (D.N.J. 1988); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 577–78 (E.D.N.Y. 1971). Clearly, no director could establish his or her defense by proof that he or she simply read the registration statement, and reliance on other professionals such as auditors and underwriters will not absolve a director of the director's obligation to conduct his or her own due diligence inquiry. *See In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,137 (S.D.N.Y. Mar. 21, 2005) (noting that "[t]he SEC has clarified that directors are not excused from performing a meaningful due diligence investigation due to the involvement of professionals, such as underwriters and auditors, in a given securities offering"). Outside directors may be able to rely on the due diligence investigation and the related "negative assurance" letter delivered by issuer's counsel to the underwriters, although in appropriate circumstances, directors may be required to question management more closely and consult the company's auditors and underwriters. *See In re WorldCom, Inc*. *Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,137 (S.D.N.Y. Mar. 21, 2005); *see also SEC v. Chancellor Corp.*, SEC Litigation Release No. 19177 (Apr. 11, 2005) (announcing a settlement with a number of defendants, including an outside director who allegedly failed in his responsibility to address fraud at the Chancellor Corporation by ignoring clear warning signs of ongoing improprieties and failing to ensure the accuracy of the company's public filings).

57 *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 685 (S.D.N.Y. 1968).

58 Rule 176 was promulgated to address due diligence in the context of a shelf registration, *see* § 3.02[6], but it can be analogized to other circumstances in which a reasonable investigation is required. The introduction of the integrated disclosure framework and shelf registration greatly accelerated the timetable on which securities offerings could be completed, increasing the pressure on underwriters to complete their diligence on issuers within a compressed timeframe. Some had asked the SEC to create a diligence safe harbor to alleviate concerns over the ability of underwriters to conduct a reasonable investigation under these conditions. In proposing Rule 176, however, the SEC declined to create a safe harbor and made clear its view that the new disclosure framework had not substantively altered the diligence obligations of underwriters. *See* SEC Release No. 33-6335 (Aug. 6, 1981); *see also In re WorldCom, Inc. Securities Litigation*, 346 F. Supp. 2d 628, 685 (S.D.N.Y. 2004) (stating that as a result of the introduction of the integrated disclosure framework and shelf registration "[t]he processes through which and the timing in which due diligence is performed have changed, but the ultimate test of reasonable conduct in the specific circumstances of an offering remains unchanged").

59 An advisory committee appointed by the SEC to study various issues arising under the Securities Act and its rules noted the limitations of Rule 176 in providing meaningful guidance regarding the respective due

diligence responsibilities of underwriters, outside directors and other "monitors," and recommended additional elaboration upon the factors courts may consider as indicia of "reasonable investigation" and/or "reasonable care." SEC, REPORT OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES, Appendix B, at 95–100 (July 24, 1996). The SEC proposed in its so-called Aircraft Carrier Release, which has since been withdrawn, an expansion of Rule 176 that would have addressed the "reasonableness" standards under §§ 12(a)(2) and 11 for underwriters' due diligence investigation when conducting an expedited offering. SEC Release No. 33-7606 (Nov. 3, 1998), *as amended*, SEC Release No. 33-7606A (Nov. 13, 1998). In 1992, a report prepared by a task force of the American Bar Association recommended changes to Rule 176 on the ground that the listed factors were not sufficient to protect underwriters. *See Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, as submitted to the ABA, Sec. of Bus. L., Comm. on Federal Regulation of Securities (July 10, 1992), which is discussed in § 3.02[6].

60 *See also* § 11.03[5] discussing certain safe harbors for forward-looking statements principally under the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (the "Litigation Reform Act").

61 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318 (2015).

62 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1326 (2015).

63 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1327 (2015).

64 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1328-29 (2015).

65 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1328 (2015).

66 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1329 (2015).

67 *Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund*, 135 S. Ct. 1318, 1330 (2015).

68 *Tongue v. Sanofi*, 816 F.3d 199 (2d Cir. 2016).

69 *Tongue v. Sanofi*, 816 F.3d 199, 211–13 (2d Cir. 2016).

70 *Tongue v. Sanofi*, 816 F.3d 199, 212 (2d Cir. 2016).

71 *See* § 11.03[5] for discussion of the qualified safe harbor for forward-looking statements enacted as part of the Securities Litigation Reform Act.

72 *See In re Amdocs Ltd. Securities Litigation*, 390 F.3d 542 (8th Cir. 2004) (affirming dismissal of plaintiffs' complaint, holding that the "bespeaks caution" doctrine rendered Amdoc's representations about its customer demand immaterial as a matter of law because of the accompanying warnings about market erosion); *see also In re Worlds of Wonder*, 814 F. Supp. 850, 866 (N.D. Cal. 1993) (noting, in context of § 10(b) of the Exchange Act, that adequate cautionary language will negate an inference of *scienter*); *Halperin v. eBanker USA.COM, Inc.*, 295 F.3d 352, 357–59 (2d Cir. 2002) (holding statements in an offering memorandum as to the issuer "intend[ing] to endeavor" to register securities were rendered not misleading as a matter of law by the numerous cautionary statements that the securities were subject to restrictions and that registration could not be assured). By contrast, in *Hunt v. Alliance North American Government Income Trust, Inc.*, 159 F.3d 723, 724–25 (2d Cir. 1998), the Second Circuit held that the prospectus's cautionary language as to the fund manager's intention to use hedging techniques did not provide an affirmative defense to fraudulent misrepresentation claims as a matter of law because the lack of liquidity made it impossible to use the hedging techniques. *See also Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 5 (2d Cir. 1996), *cert. denied*, 520 U.S. 1264 (1997); *Gasner v. Board of Supervisors*, 103 F.3d 351, 358 (4th Cir. 1996); *In re Westinghouse Securities Litigation*, 90 F.3d 696, 707 (3d Cir. 1996); *Anderson v. Clow (In re Stac Electronics Securities Litigation)*, 89 F.3d 1399, 1408 (9th Cir. 1996), *cert. denied*, 520 U.S. 1103 (1997); *Saltzberg v. TM Sterling/Austin Associates, Ltd.*, 45 F.3d 399 (11th Cir. 1995); *cf. Livid Holdings v. Salomon Smith Barney*, 403 F.3d 1050 (9th Cir. 2005) (declining to apply the bespeaks caution doctrine to alleged misrepresentations of historical fact in a notice statement to a potential investor).

73 *See, e.g.*, *Rubinstein v. Collins*, 20 F.3d 160, 169 (5th Cir. 1994).

74 *See, e.g.*, *P. Stolz Family Partnership L.P v. Daum*, 355 F.3d 92, 96–97 (2d Cir. 2004).

75 *Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137 (2d Cir. 2010).

76 *Rubin v. MF Global, Ltd.*, 634 F. Supp. 2d 459, 468–72 (S.D.N.Y. 2009), *rev'd sub nom. Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137 (2d Cir. 2010).

77 *Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137, 142 (2d Cir. 2010).

78 *Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137, 143 (2d Cir. 2010). For further discussion of what constitutes a forward-looking statement under statutory safe harbors, *see* § 11.03[5].

79 *In re Facebook, Inc., IPO Securities & Derivative Litigation*, 986 F. Supp. 2d 487, 511 n.23 (S.D.N.Y. 2013).

80 In a recent decision interpreting the disclosure obligations imposed by Item 303 of Regulation S-K, the Second Circuit has held that "Item 303 requires the registrant to disclose only those trends, events, or uncertainties that it actually knows of when it files the relevant report with the SEC" and "[i]t is not enough that it should have known of the existing trend, event, or uncertainty." *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85, 95 (2d Cir. 2016).

81 *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,857 (S.D.N.Y. June 28, 2004).

82 *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,857 (S.D.N.Y. June 28, 2004).

83 *See, e.g.*, *Police Retirement System of St. Louis v. Intuitive Surgical, Inc.*, 759 F.3d 1051, 1060 (9th Cir. 2014) ("Statements of mere corporate puffery, vague statements of optimism like ‘good,’ ‘well-regarded,’ or other feel good monikers, are not actionable because professional investors, and most amateur investors as well, know how to devalue the optimism of corporate executives."); *Indiana State District Council of Laborers & Hod Carriers Pension & Welfare Fund v. Omnicare, Inc.*, 583 F.3d 935, 944 (6th Cir. 2009) ("Courts have consistently found immaterial a certain kind of rosy affirmation commonly heard from corporate managers and numbingly familiar to the marketplace—loosely optimistic statements that are so vague, so lacking in specificity, or so clearly constituting the opinions of the speaker, that no reasonable investor could find them important.").

84 *Indiana Public Retirement System v. SAIC, Inc.*, 818 F.3d 85, 97–98 (2d Cir. 2016); *but see In re Goldman Sachs Group, Inc. Securities Litigation*, 868 F. Supp. 2d 261, 279–80 (S.D.N.Y. 2012) (declining to dismiss claims as puffery where issuer allegedly made "repeated assertions that it complies with the letter and spirit of the law, values its reputation, and is able to address ‘potential’ conflicts of interest" because "they involve ‘misrepresentations’ of existing facts").

85 *See* § 11(e) of the Securities Act. Under no circumstances can the plaintiff recover more than the price at which the security was offered to the public. *See* § 11(g) of the Securities Act.

86 *See NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145 (2d Cir. 2012). In *NECA-IBEW*, the court further held that a plaintiff could recover the loss in value of a debt security—in that case, a residential mortgage-backed security—under § 11 even where no scheduled coupon payments on the security had been missed.

87 *See* § 11(e) of the Securities Act; *see, e.g.*, *Collins v. Signetics Corp.*, 605 F.2d 110, 114 (3d Cir. 1979); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 586 (E.D.N.Y. 1971).

88 *See* § 11(f) of the Securities Act.

89 *See* § 11(e) of the Securities Act; *supra* Note 39. However, in *In re WorldCom, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶93,139 (S.D.N.Y. Mar. 14, 2005), the court rejected the objection of JP Morgan Securities Inc. (an underwriter defendant) to a settlement agreement between the lead plaintiff and the other defendants that would both bar any post-settlement contribution from settling defendants and also included a judgment reduction formula that could require a nonsettling defendant to pay more than the value of its allocated share of securities after judgment was entered after trial. The court found the judgment reduction formula was permissible, particularly in light of the fact that the Litigation Reform Act replaced joint and several liability with proportionate liability in the case of § 11 violations by outside directors, but did not do so for underwriters. *See infra* Note 94. According to the court, adoption of JP Morgan Securities Inc.’s judgment reduction proposal to limit the liability of underwriters to merely a proportionate share of underwriter liability would serve to reduce the plaintiff's rightful recovery. Further, the court held that the bar on subsequent

contribution claims, despite the existence of contractual provisions enabling contribution, provided an important incentive for defendants to settle.

90 *See* § 11.03[1][e][ii].

91 *See* § 11(f) of the Securities Act; § 11.03[1][e].

92 *See, e.g.*, *In re Continental Airlines*, 203 F.3d 203, 215–16 (3d Cir. 2000); *First Golden Bancorp. v. Weiszmann*, 942 F.2d 726, 728 (10th Cir. 1991); *Riverhead Savings Bank v. National Mortgage Equity Corp.*, 893 F.2d 1109, 1116 (9th Cir. 1990); *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1104–06 (4th Cir. 1989).

93 Item 512(h) of Regulation S-K under the Securities Act; *see* § 3.02[4][c].

94 *See, e.g.*, *Lucas v. Hackett Associates, Inc.*, 18 F. Supp. 2d 531, 535–36 (E.D. Pa. 1998); *Eichenholtz v. Brennan*, 52 F.3d 478, 483 (3d Cir. 1995); *In re Professional Financial Management, Ltd.*, 683 F. Supp. 1283, 1285 (D. Minn. 1988 *); Kilmartin v. H.C. Wainwright & Co.*, 637 F. Supp. 938, 940 (D. Mass. 1986); *Laventhol, Krekstein, Horwath & Horwath v. Horwitch*, 637 F.2d 672, 676 (9th Cir. 1980), *cert. denied*, 452 U.S. 963 (1981); *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946 (S.D.N.Y. 1975); *see also In re Healthsouth Corp. Securities Litigation*, 572 F.3d 854, 860 (11th Cir. 2009) (Litigation Reform Act case recognizing holdings of *Eichenholtz* and related cases).

95 Such indemnification is commonplace in underwriting agreements involving registered offerings. The contractual indemnifications generally also run to officers, directors and controlling persons of the underwriters because of the potential liability of these parties under the Securities Act.

96 The practice with respect to such indemnification varies. Where securityholders are affiliates of the issuer, and thus subject to the registration requirements of the Securities Act, they frequently negotiate a contractual right to cause the issuer to register their securities for sale (so-called "registration rights"). Such registration rights agreements frequently require the related underwriting agreement to include the issuer's indemnification not only of the underwriters, but also of the selling securityholders, against liabilities arising out of material misstatements or omissions in the registration statement.

97 *See Globus v. Law Research Services, Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970) (underwriter not entitled to indemnification where it had actual knowledge of misstatement in registration statement and showed "wanton indifference" to its obligations); *see also Nelson v. Quimby Island Reclamation District Facilities Corp.*, 491 F. Supp. 1364, 1381 (N.D. Cal. 1980) (indemnification against actual wrongdoing, as contrasted with negligent conduct, is considered void). In some foreign jurisdictions, such as England and Germany, indemnification agreements are enforceable. Thus, in drafting cross-border agreements, some parties choose to have their contracts governed by the laws of these countries. U.S. courts, however, still may be reluctant to enforce indemnification provisions in the context of U.S. public offerings. The agreement, therefore, should contain a forum selection clause providing for enforcement of the agreement in another jurisdiction.

98 *Compare Eichenholtz v. Brennan*, 52 F.3d 478, 484 (3d Cir. 1995), *In re Olympia Brewing Co. Securities Litigation*, 674 F. Supp. 597, 610–14 (N.D. Ill. 1987), *Stratton Group, Ltd. v. Sprayregen*, 466 F. Supp. 1180, 1185 n.4 (S.D.N.Y. 1979), *Odette v. Shearson, Hammill & Co., Inc.*, 394 F. Supp. 946, 956–57 (S.D.N.Y. 1975), and *Columbia Savings & Loan Association v. American International Group, Inc.*, Fed. Sec. L. Rep. (CCH) ¶98,179 (S.D.N.Y. Mar. 18, 1994) (no indemnification) *with Adalman v. Baker, Watts & Co.*, 599 F. Supp. 752, 754 (D. Md. 1984), *McLean v. Alexander*, 449 F. Supp. 1251, 1266 n.49 (D. Del. 1978), *rev'd on other grounds*, 599 F.2d 1190 (3d Cir. 1979), and *In re Motel 6 Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶90,927 (S.D.N.Y. Mar. 28, 2000) (indemnification might be permitted under certain circumstances).

99 This section is the only provision in the Securities Act that expressly provides for contribution. Contribution rights are expressly provided under §§ 9(e) (manipulation of security prices) and 18(b) (liability for misleading statements in filings) of the Exchange Act and have been judicially implied in connection with liability under other provisions of the securities laws, notably Rule 10b-5 under the Exchange Act. *See Musick, Peeler & Garrett v. Employers Insurance of Wausau*, 508 U.S. 286, 294–98 (1993).

100 § 11(f) of the Securities Act. The Litigation Reform Act, Pub. L. No. 104-67, § 201(a), 109 Stat. 737 (1995),

added § 21D(g)(2) of the Securities Act.

101 *See* Item 511 of Regulation S-K under the Securities Act. The SEC has taken the position that insurance policies' indemnification of officers and directors that includes coverage for disgorgement and other fines is against public policy, and since April 2003, the SEC has included language in its settlement agreements with individuals who were alleged to have committed fraud to prevent those individuals from using insurance or indemnification policies to pay civil fines. Deborah Solomon, *SEC Considers Stronger Sanctions—Companies Urge Panel Not to Let Holder Nominees Be in Official Proxy Data*, WALL ST. J., June 16, 2003. In 2004, the SEC levied a $25 million fine against Lucent Technologies for failure to cooperate with a fraud investigation, the then-largest penalty ever imposed against a corporation for failure to cooperate. Ken Belson, *Lucent Fined $25 Million by SEC in Fraud Case*, N.Y. TIMES, May 18, 2004. The noncooperation penalty was levied in part because after reaching a settlement agreement in connection with the fraud investigation, Lucent expanded the scope of employees that could be indemnified against the SEC enforcement action. The SEC stated that such conduct is contrary to the public interest. *SEC v. Lucent Technologies Inc.*, SEC Litigation Release No. 18715 (May 17, 2004). Although not an SEC enforcement proceeding, members of the WorldCom board of directors who agreed to settle class-action claims arising out of the WorldCom accounting scandal were required, as a condition of the settlement, to pay a significant portion of the settlement amount personally. They were prevented from relying exclusively on their directors' liability insurance. *See In re WorldCom, Inc. Securities Litigation*, Master File No. 02 Civ. 3288 (S.D.N.Y. Mar. 21, 2005) (order granting preliminary approval of settlement with 12 WorldCom directors). Directors settling class-action claims arising out of the Enron litigation also agreed to pay a portion of their agreed settlement amount personally. *See In re Enron Corp. Securities Litigation*, Civil Action No. H-01-3624 (Feb. 7, 2005) (order granting preliminary approval of settlement with outside directors of Enron). These developments indicate that a greater effort is being made to hold directors personally responsible for financial irregularities at the companies they oversee.

102 § 13 of the Securities Act.

103 *See In re Adelphia Communications Corp. Securities & Derivative Litigation*, No. 03 MD 1529 (LMM), 2005 WL 1278544, at *18 (S.D.N.Y. May 31, 2005); *Westinghouse Electric Corp. v. '21' International Holdings, Inc.*, 821 F. Supp. 212, 222 (S.D.N.Y. 1993); *but see Pension Trust Fund for Operating Engineers v. Mortgage Asset Securitization Transactions, Inc.*, 730 F.3d 263 (3d Cir. 2013) (holding that a plaintiff need not plead compliance with § 11's statute of limitations because it is an affirmative defense).

104 *See In re Adelphia Communications Corp. Securities & Derivative Litigation*, No. 03 MD 1529 (LMM), 2005 WL 1278544, at *18 (S.D.N.Y. May 31, 2005); *In re Integrated Resources Real Estate Ltd. Partnerships Securities Litigation*, 815 F. Supp. 620 (S.D.N.Y. 1993).

105 *See Chapman v. ChoiceCare Long Island Term Disability Plan*, 288 F.3d 506, 512 (2d Cir. 2002); *Wasco Products, Inc. v. Southwall Technologies, Inc.*, 435 F.3d 989, 991 (9th Cir. 2006).

106 *See Lampf, Pleva, Lifkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). In *Lampf*, the Court held that "[t]he 1-year period, by its terms, begins after discovery of the facts constituting the violation, making tolling unnecessary [and] [t]he 3-year limit is a period of repose inconsistent with tolling." Courts have generally followed *Lampf* in declining to apply equitable tolling doctrines to securities law claims. *See, e.g.*, *Whirlpool Financial Corp. v. GN Holdings, Inc.*, 67 F.3d 605, 610 n.3 (7th Cir. 1995) (rejecting plaintiff's argument that the statute of limitations for its claims under § 12(a)(2) should be equitably tolled because "the plain import of the Supreme Court's decision in [*Lampf*] is that 'when knowledge or notice is required to start the statute of limitations running, there is no room for equitable tolling'"); *Sterlin v. Biomune Systems*, 154 F.3d 1191 (10th Cir. 1998) (discussing *Lampf* and acknowledging its holding that equitable tolling does not apply to the limitations periods contained in the securities laws); *Gardner v. Investors Diversified Capital, Inc.*, 805 F. Supp. 874 (D. Colo. 1992) (holding that equitable tolling of statute of limitations is inapplicable to claims under § 12(a)(1)); *Arioli v. Prudential-Bache Securities, Inc.*, 792 F. Supp. 1050 (E.D. Mich. 1992) (holding that doctrine of equitable tolling does not apply to claims under §§ 12(a)(2) and 15 of the Securities Act); *Del Sontro v. Cendant Corp., Inc.*, 223 F. Supp. 2d 563, 573 (D.N.J. 2002) ("It is clearly established that equitable tolling is inapplicable to the one-and-three year limitation

periods of securities fraud actions."). Some post- *Lampf* courts, however, have continued to suggest that equitable tolling may be available with respect to the statute of limitations periods applicable to claims under the Securities Act. *See, e.g.*, *Dodds v. Cigna Securities, Inc.*, 12 F.3d 346, 350, 352 (2d Cir. 1993) (stating, in an action asserting claims under both § 12(a)(2) of the Securities Act and § 10(b) of the Exchange Act, that "[i]f the defendants actively prevented [plaintiff] from discovering the basis of her claim, then the statute would be tolled for the period of concealment," but that the doctrine of "[e]quitable tolling will stay the running of the statute of limitations only so long as the plaintiff has 'exercised reasonable care and diligence in seeking to learn the facts which would disclose fraud'") (citation omitted). The case law is also clear that equitable tolling is *not* available with respect to the statute of repose period. *See Ma v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 597 F.3d 84, 88 n.4 (2d Cir. 2010) (holding that in contrast to statutes of limitations, which are "often subject to tolling principles," "a statute of repose *extinguishes* a plaintiff's cause of action after the passage of a fixed period of time, usually measured from one of the defendant's acts"); *Caviness v. Derand Resources Corp.*, 983 F.2d 1295, 1301 (4th Cir. 1993) (holding that to apply "tolling principles to extend the three-year period of § 13 would require [a court] to ignore the plain meaning of the language that says 'in no event' and defeat the very purpose of a statute of repose"). Courts have disagreed, however, concerning whether class action tolling applies to the statute of repose. *Compare Police & Fire Retirement System of Detroit v. IndyMac MBS, Inc.*, 721 F.3d 95, 101 (2d Cir. 2013) (holding class action tolling does not apply to the three-year statute of repose) *and Stein v. Regions Morgan Keegan Select High Income Fund, Inc.*, 821 F.3d 780 (6th Cir. 2016) *with Joseph v. Wiles*, 223 F.3d 1155, 1168 (10th Cir. 2000) (holding class action tolling is a form of legal tolling that can apply to the statute of repose).

107 *P. Stolz Family Partnership L.P. v. Daum*, 355 F.3d 92, 99 (2d Cir. 2004).

108 *P. Stolz Family Partnership L.P. v. Daum*, 355 F.3d 92, 103–04 (2d Cir. 2004); *see also* Rule 430B(f)(1), (2), (4) under the Securities Act (providing effective dates, for purposes of § 11 liability, for shelf registration statements for offerings made pursuant to a prospectus supplement).

109 Section 12(a)(2) establishes a cause of action (other than in offerings exempt from registration under §§ 3(a)(2) or 3(a)(14)) against sellers who make material misstatements or omissions "by means of a prospectus." Interpreting this language in light of the Securities Act's other references to prospectuses, the Supreme Court in *Gustafson v. Alloyd Co., Inc.*, held that § 12(a)(2) only applies to public offerings of securities by an issuer or controlling shareholder, and not to private offerings. *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995); *see also* § 11.04[1].

110 By contrast with § 11, under which investors' rights turn on when information is deemed part of the relevant registration statement and the time of the registration statement's effectiveness, liability for § 12(a)(2) purposes is based on the information conveyed to investors at or prior to the time of sale (*i.e.*, at or prior to the time the investment decision is made). As a result, even if information is deemed part of the registration statement as of the time of sale and thus subject to § 11, the information will not be taken into account for § 12(a)(2) purposes unless it was conveyed to investors at or prior to the time of sale. *See* Rule 159 under the Securities Act. Conversely, information conveyed to investors at or prior to the time of sale that is not deemed a part of the registration statement at the time of its effectiveness will not be subject to § 11. *See* SEC Release No. 33-8591 (July 19, 2005).

As part of the Securities Offering Reforms, the SEC clarified that information contained in a prospectus supplement is deemed part of the registration statement to which it relates. Outside the shelf registration statement context, pricing information filed under Rule 430A under the Securities Act is deemed part of the relevant registration statement as of the time it was declared effective. For shelf takedowns, the date on which the information is deemed included in the relevant registration statement is the earlier of the date the supplement is first used (*i.e.*, first made available to an underwriter or any prospective purchaser) and the date and time of the first contract of sale of securities to which the supplement relates. In all other cases, the supplement is deemed included in the registration statement, pursuant to Rule 430B or Rule 430C under the Securities Act, as applicable, on the day it is first used.

For purposes of § 11 liability in a shelf takedown, the date on which a prospectus supplement is deemed part of the registration statement constitutes a new effective date for issuers and underwriters. Unless a registration statement is updated by a prospectus supplement filed to provide updating information pursuant to § 10(a)(3) of the Securities Act or by a prospectus supplement reflecting fundamental changes in the information set forth in the registration statement, a prospectus supplement will not create a new effective date for directors or signing officers of the issuer. *See Federal Housing Finance Agency v. HSBC North America Holdings Inc.*, 987 F. Supp. 2d 369, 375, at *4 (S.D.N.Y. 2013) (holding that "a prospectus supplement containing information representing a fundamental change in the information provided in the registration statement creates § 11 liability for directors based on that new information"). Similarly, the effective date for auditors and other experts will not change with the filing of a prospectus supplement, unless it contains new audited financial statements, a new report or opinion or other information requiring the filing of a consent under § 7 of the Securities Act.

111 The term "prospectus" is defined in § 2(a)(10) of the Securities Act to include virtually every written offer for the purchase of a security, and therefore any offering document used in connection with a public offering may give rise to § 12(a)(2) liability. It is unclear whether § 12(a)(2) liability may arise in connection with public offerings outside the United States exempt from Securities Act registration under Regulation S. *Cf. Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*, 941 F. Supp. 1369, 1376 (S.D.N.Y. 1996); *see also* § 11.10[3] & Note 677 for a discussion of the extraterritorial scope of the Securities Act.

112 § 12(a)(2) of the Securities Act; *cf*. § 11 of the Securities Act, which creates liability for omissions without the limiting language concerning the applicable circumstances.

113 *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

114 Where the alleged misstatement or omission is made prior to distribution of the final prospectus or offering document (whether orally or in preliminary offering documents), the fact that the errors were corrected in the final documents will not be sufficient to defeat liability if the defendants made no special efforts to bring the corrected information to the purchaser's attention before the sale. Courts have repeatedly stated that purchasers are not charged with constructive knowledge in a § 12(a)(2) claim, and must only show that they had no actual knowledge of the misstatements or omissions. *See MidAmerica Federal Savings & Loan Association v. Shearson/American Express, Inc.*, 886 F.2d 1249, 1256 (10th Cir. 1989) (broker-dealer liable despite distribution of corrected prospectus, where plaintiff did not actually read prospectus until after sale); *see also Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989) ("[C]onstructive knowledge cannot bar a purchaser's recovery under section 12[(a)](2)" where plaintiffs relied on oral representations of the seller that were contrary to statements contained in the offering memorandum, which the plaintiffs had not read and of which the plaintiffs did not have actual knowledge.).

115 *See Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1227 n.8 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981). The court noted that more proof might be required if the disclosure violation was oral and made to an individual purchaser, because spoken words "lack continuing vitality and are unlikely to affect the general market price of a security."

116 This definition of "seller" derives from *Pinter v. Dahl*, 486 U.S. 622, 647 (1988), which construed that term under § 12(a)(1). *See Maher v. Durango Metals, Inc.*, 144 F.3d 1302, 1307 (10th Cir. 1998); *In re NationsMart Corp. Securities Litigation*, 130 F.3d 309, 319 (8th Cir. 1997); *In re Westinghouse Securities Litigation*, 90 F.3d 696, 715–16 (3d Cir. 1996); *Commercial Union Assurance Co. v. Milkin*, 17 F.3d 608, 616 (2d Cir. 1994). In *In re Deutsche Telekom AG Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91, 703 (S.D.N.Y. Feb. 20, 2002), a district court found that a selling shareholder in an initial public offering was not a "seller" for purposes of § 12(a)(2) because it neither passed title to the plaintiffs nor solicited the plaintiffs' purchases. *See* § 4.12[5], Note 461.

117 *See, e.g.*, *In re Chaus Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶95,646 (Nov. 20, 1990), *dismissed on other grounds*, 801 F. Supp. 2d 1257 (S.D.N.Y. 1992) (reasoning that such facts, if true, would support a conclusion that the defendants solicited sales, and thus were "sellers").

118 § 15 of the Securities Act; *see* § 11.03[1][b].

119 *See, e.g.*, *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1127 (2d Cir. 1989) (aiding and abetting liability under § 12(a)(2) would be anomalous in light of rejection of such liability under § 12(a)(1) in

Pinter v. Dahl, 486 U.S. 622 (1988)).

120 *See Davis v. Avco Financial Services, Inc.*, 739 F.2d 1057, 1068 (6th Cir. 1984), *cert. denied*, 470 U.S. 1005, *cert. denied*, 472 U.S. 1012 (1985). The court identified five factors relevant to the issue of what care is required: (i) the nature and extent of the seller's participation in the offering, (ii) whether the seller had access to information that would permit examination of the statements made in the offering, (iii) the seller's relative skill in testing such statements, (iv) its financial interest in the transaction and (v) the relationship, if any, between the seller and the purchaser.

121 *See, e.g.*, *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228 (7th Cir. 1980) (defense required underwriter to investigate issuer's books and records and accountants' work papers, where such an investigation would have uncovered a fraud by both parties). This result has been criticized by many who argue that the standard of care under § 12(a)(2) was intended to be less demanding than that required by § 11. *See John Nuveen & Co., Inc. v. Sanders*, 450 U.S. 1005, 1009 (1981) (Powell, J., dissenting from denial of *certiorari*); *Report of Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws*, as submitted to the ABA, Sec. of Bus. L., Comm. on Federal Regulation of Securities (July 10, 1992) (urging that *Sanders* be confined to its facts and the courts recognize the "significant distinction between ‘reasonable investigation’ and ‘reasonable care’ that the words of the statute imply" in §§ 11 and 12(a)(2) of the Securities Act, respectively).

122 *See* § 11.03[1][e].

123 The Securities Litigation Reform Act. Most of the provisions of the Litigation Reform Act have been incorporated into the Exchange Act as §§ 21D and 21E and into the Securities Act as §§ 27 and 27A, as well as into various liability provisions of the Exchange Act and the Securities Act.

124 *See* § 12 of the Securities Act.

125 *See* § 13 of the Securities Act; *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

126 However, the definition of "*bona fide* offering" is not germane to the period of repose for § 12(a)(2) claims, which is simply three years after the sale of the security in question. *See* § 13 of the Securities Act; *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

127 *See* § 8(b) of the Securities Act. This is largely a theoretical issue in the context of public offerings, because in most cases companies include a "delaying legend" on the cover page of the registration statement that delays the effective date until the SEC declares the registration statement effective.

128 *See* § 8(d) of the Securities Act. The SEC takes the position that it may issue a stop order even if the registrant has abandoned the proposed securities offering and has sought to withdraw the registration statement. *See In re Matter of Advanced Chemical Corp.*, 47 S.E.C. 1012 (Feb. 9, 1984).

129 A plaintiff may pursue simultaneously his or her remedies under Rule 10b-5 under the Exchange Act and §§ 11 and 12(a)(2) of the Securities Act *. See Herman & MacLean v. Huddleston*, 459 U.S. 375, 380–87 (1983).

130 *See* § 4.10[4] for a discussion of the duty to correct or update previous communications. Liability for forward-looking statements, like liability for other statements or omissions concerning an issuer, can attach not only in the context of a registered public offering under §§ 11 and 12(a)(2) of the Securities Act, but also in the context of a private placement or secondary market transaction under § 10(b) of the Exchange Act and Rule 10b-5 thereunder, § 18 of the Exchange Act and § 17(a) of the Securities Act. Forward-looking statements also are subject to liability under state antifraud law. *See* §§ 11.03[6] and 11.04[4].

131 *See* § 4.10[6]. Although Regulation FD does not apply to foreign private issuers, they sometimes comply with it both as a matter of best practice and to reduce the risk that selective disclosure would be challenged as a violation of the insider trading prohibitions under the Exchange Act.

132 *See* §§ 11.03[1][c].

133 A "forward-looking statement" is defined as:

> A statement containing a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other

financial items;
A statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer;
A statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the SEC;
Any statement of the assumptions underlying or relating to any statement described in subparagraph (A), (B) or (C);
Any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
A statement *containing* a projection or estimate of such other items as may be specified by rule or regulation of the SEC.

See § 27A(i)(1) of the Securities Act and § 21E(i)(1) of the Exchange Act. This definition of forward-looking statement is substantially the same as that set forth in Rule 175(c) under the Securities Act and Rule 3b-6(c) under the Exchange Act. Certain courts have taken an expansive view of what constitutes a forward-looking statement. *See, e.g.*, *Harris v. Ivax Corp.*, 182 F.3d 799 (11th Cir. 1999) (holding that (i) a statement grammatically in the present tense can be forward-looking if its truth or falsity is discernible only after it is made and (ii) a list of statements meant to explain an economic forecast should be treated as entirely forward-looking even if it includes both forward-looking and non-forward-looking (factual) items); *In re Columbia Laboratories, Inc. Securities Litigation*, 144 F. Supp. 2d 1362, 1368 (S.D. Fla. 2001) (Present-tense statements reflecting optimism and expectations about a future event are forward-looking statements under the Litigation Reform Act because they are "'assumptions underlying or relating to' the 'plans and objectives of management.'") (citations omitted); *In re Splash Technology Holdings, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91,250 (N.D. Cal. Sept. 29, 2000) ("A present-tense statement can qualify as a forward-looking statement as long as the truth or falsity of the statement cannot be discerned until some point in time after the statement is made."); *see In re SeaChange International, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,682 (D. Mass. Feb. 6, 2004) (holding that statements were "clearly forward-looking in nature and therefore [fell] squarely within the safe harbor provisions of the [Litigation Reform Act]" despite a news release issued two days after the offering revealing an award to a competitor of a material contract and a material decline in segment sales of a key product; and despite issuer knowledge of meritorious patent infringement suit against key product revealed one month after the offering). *See also Iowa Public Employees' Retirement System v. MF Global, Ltd.*, 620 F.3d 137 (2d Cir. 2010), discussed in § 11.03[1][c], for an analysis of the distinction between forward-looking statements and statements of historical fact.

134 In practice, because specifically identifying each forward-looking statement is impractical, issuers generally include in their disclosure documents a disclaimer (i) stating that such documents contain forward-looking statements and (ii) containing a brief description of what constitutes a forward-looking statement.

135 Issuers have generally sought to meet the "accompanied by" requirement by including in their disclosure documents a risk factors section containing specific cautionary language and by including cross-references to such section in other parts of the same document. While there has been little guidance from the courts, commentators on the Litigation Reform Act generally agree that the use of a cross-reference in one document containing forward-looking statements to another document containing cautionary language is not sufficient to meet the "accompanied by" requirement.

136 Materiality in this context refers to the difference between predicted results and the actual results (*i.e.*, "differ materially"), the materiality of the falsity (*i.e.*, "materially false or misleading") and the materiality of the forward-looking statement itself. *See Rosenzweig v. Azurix Corp.*, 332 F.3d 854 (5th Cir. 2003); *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004).

137 § 27A(c)(1) of the Securities Act and § 21E(c)(1) of the Exchange Act; *see, e.g.*, *Slayton v. American Express Co.*, 604 F.3d 758, 773–77 (2d Cir. 2010) (noting that this inquiry is "case-specific" and applying doctrine to facts of the case to affirm dismissal of complaint).

138 At least four circuit courts have held that dismissal under the first prong may be appropriate without any inquiry into the defendant's knowledge of the risks associated with the forward-looking statements—even where the defendant had actual knowledge of the statements' falsity. *See Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 795 (11th Cir. 2010) (holding that "an allegation of actual knowledge of falsity will not deprive a defendant of protection by the statutory safe harbor if his forward-looking statements are accompanied by meaningful cautionary language"); *Employers Teamsters Local Nos. 175 and 505 Pension Fund Trust v. Clorox*, 353 F.3d 1125, 1133 (9th Cir. 2004); *Southland Securities Corp. v. INSpire Insurance Solutions Inc.*, 365 F.3d 353 (5th Cir. 2004); *Miller v. Champion Enterprises, Inc.*, 364 F.3d 660 (6th Cir. 2003); *Harris v. Ivax Corp.*, 182 F.3d 799, 803 (11th Cir. 1999) ("[I]f a statement is accompanied by 'meaningful cautionary language,' the defendants' state of mind is irrelevant."); *see also Slayton v. American Express Co.*, 604 F.3d 758, 771–72 (2d Cir. 2010).

139 *See In re Nash Finch Co. Securities Litigation*, 502 F. Supp. 2d 861 (D. Minn. 2007) ("[C]autionary language cannot be 'meaningful' when defendants know that the potential risks they have identified in fact already occurred, and the positive statements they are making are false."); *Limantour v. Cray Inc.*, 432 F. Supp. 2d 1129, 1147 (W.D. Wash. 2006) ("However, a forward looking statement may be actionable if it was made with actual knowledge that the statement was false or misleading."); *Schaffer v. Evolving Systems, Inc.*, 29 F. Supp. 2d 1213, 1224 (D. Colo. 1998) (holding that press release could not benefit from safe harbor even though it was accompanied by adequate cautionary language because "the safe harbor provision provides no refuge for [d]efendants who make statements with 'actual knowledge' of their falsity"). This position, however, appears inconsistent with the statute, because it treats the two prongs of the safe harbor as if they were conjunctive. The Committee Report accompanying the Litigation Reform Act clearly contemplates that the two prongs create "alternative analys[e]s." H.R. Conf. Rep. 104-369, at 44 (1995). On its face, the first prong of the Litigation Reform Act allows issuers and their officers, directors, employees and underwriters to obtain summary judgment in private civil suits based on false projections because the factual question of whether the projections were made with actual knowledge of their falsity is not determinative of liability. *See* H.R. Conf. Rep. No. 104-369, at 44 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 (stating that for the purposes of the first prong of the safe harbor "[c]ourts should not examine the state of mind of the person making the statement"); *see, e.g.*, *In re Splash Technology Holdings, Inc. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶91,250 (N.D. Cal. Sept. 29, 2000).

140 *See, e.g.*, *Slayton v. American Express Co.*, 604 F.3d 758, 772 (2d Cir. 2010) (recognizing Congress instructed courts not to look at intent for the first prong, but noting ambiguity as to how to determine which statements convey substantive information); *Lormand v. U.S. Unwired, Inc.*, 565 F.3d 228, 246–47 (5th Cir. 2009) (cautionary language is not meaningful if it is only "very vague and general" and did not "disclose the specific risks and their magnitude"); *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 256 (3d Cir. 2009) (affirming dismissal of certain allegations protected by the safe harbor, after noting that cautionary language must be "extensive and specific" and "substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge" (citations omitted)).

141 The "bespeaks caution" doctrine is "shorthand for the well-established principle that a statement or omission must be considered in context, so that accompanying statements may render it immaterial as a matter of law." *In re Donald J. Trump Casino Securities Litigation*, 7 F.3d 357, 364 (3d Cir. 1993), *cert. denied*, 510 U.S. 1178 (1994); *see* § 11.03[1][c]. In order to qualify cautionary statements as "meaningful" under the bespeaks caution doctrine, issuers must disclose any assumptions on which their projections are based and make the statements specific, prominent, easy to find and specifically tailored to the issuer's business—general boilerplate warnings not specifically tailored to an issuer's business will not suffice. *See, e.g., Slayton v. American Express Co.*, 604 F.3d 758, 772 (2d Cir. 2010); *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 256 (3d Cir. 2009); *Southland Securities Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 372 (5th Cir. 2004). *See* § 11.03[1][c].

142 H.R. Conf. Rep. No. 104-369, at 43–46 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730. Nevertheless, "[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor." H.R. Conf. Rep. No. 104-369, at 44 *; see*

Ehlert v. Singer, 245 F.3d 1313 (11th Cir. 2001); *In re XM Satellite Radio Holdings Securities Litigation*, 479 F. Supp. 2d 165 (D.C. Cir. 2007) (calling the "bespeaks caution" doctrine the "judicially-created counterpart" of the statutory safe harbor).

Although some courts have stated that the safe harbor provision codified the "bespeaks caution" doctrine and that the two doctrines are essentially coextensive, the Congressional Record belies this conclusion. *Compare In re Dura Pharmaceuticals, Inc. Securities Litigation*, 452 F. Supp. 2d 1005, 1033 (S.D. Cal. 2006) ("The Ninth Circuit has held the [Litigation Reform Act]'s safe harbor provision codified the judicially-created bespeaks caution doctrine.") (citing *Employers Teamsters Local Nos. 175 & 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1132 (9th Cir. 2004)) *with* H.R. Conf. Rep. No. 104-369, at 43–46 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730 ("The Conference Committee does not intend for the safe harbor provisions to replace the judicial 'bespeaks caution' doctrine or to foreclose further development of that doctrine by the courts."). *See also Payne v. DeLuca*, 433 F. Supp. 2d 547, 561 (W.D. Pa. 2006) ("Enactment of the [Litigation Reform Act's] safe harbor provision did not do away with the judicially created 'bespeaks caution' doctrine.").

143 *Asher v. Baxter*, 377 F.3d 727 (7th Cir. 2004).

144 *Asher v. Baxter*, 377 F.3d 727, 734 (7th Cir. 2004).

145 *Asher v. Baxter*, 377 F.3d 727, 734 (7th Cir. 2004).

146 *Asher* has been followed by courts in the Seventh Circuit as well as in other circuits. *See, e.g.*, *Central Laborers' Pension Fund v. SIRVA, Inc.*, No. 04 C 7644, 2006 WL 2787520, at *23 (N.D. Ill. Sept. 22, 2006); *State of New Jersey and its Division of Investment v. Sprint Corp.*, No. 03-207-JWL, 2004 WL 1960130, at *10 (D. Kan. Sept. 3, 2004); *Ong v. Sears, Roebuck & Co.*, 388 F. Supp. 2d 871 (N.D. Ill. 2004).

147 *Harris v. IVAX Corp.*, 182 F.3d 799 (11th Cir. 1999). On the surface, the Seventh Circuit's decision in *Asher* contains some language that echoes *Harris*, as the court in *Asher* acknowledged that the safe harbor provision does not require "prescience" or "prevision" or allow plaintiffs to plead "fraud by hindsight" based on circumstances that could not have been known at the time of the disclosure. The difference between the two opinions is not necessarily in the scope of the safe harbor, but how the court should apply the safe harbor at the pleadings stage.

148 *Harris v. IVAX Corp.*, 182 F.3d 799, 807 (11th Cir. 1999) (internal quotations omitted).

149 *See, e.g.*, *In re AMDOCS Ltd. Securities Litigation*, 390 F.3d 542 (8th Cir. 2004); *see also Asher v. Baxter*, 377 F.3d 727 (7th Cir. 2004).

150 § 27A(c)(2) of the Securities Act and § 21E(c)(2) of the Exchange Act. It should be noted that these cross-reference procedures available for oral forward-looking statements may not be sufficient for the purposes of invoking the safe harbor if the oral statements later are put in writing and such writing is not "accompanied by meaningful cautionary statements." Accordingly, where an issuer posts a transcript or audio recording of a conference call on its website, the cross-referenced document containing the meaningful cautionary statements also should be available on the website.

151 § 27A(c)(3) of the Securities Act and § 21E(c)(3) of the Exchange Act.

152 The safe harbor does not protect against civil or criminal enforcement actions brought by the SEC or the DOJ. *See* § 27A(c)(1) of the Securities Act and § 21E(c)(1) of the Exchange Act (limiting the safe harbor to "private actions").

153 The safe harbor does not protect against actions alleging fraud under state law, although in some jurisdictions similar results may be obtained under the "bespeaks caution" doctrine developed by the federal courts and adopted by some state courts. This doctrine shields defendants from liability based on projections and other "soft" or forward-looking statements if accompanied by meaningful disclaimers or disclosures of risk; the doctrine generally does not shield those who make statements with knowledge of their falsity. The Congressional Conference Committee Report for the Litigation Reform Act states that the safe harbor is not intended to replace the "bespeaks caution" doctrine or to foreclose further development of that doctrine by the courts. S. Rep. No. 104-98, at 15–18 (1995). *See* § 11.03[1][c] for a further

discussion of the "bespeaks caution" doctrine. SLUSA mitigates the risk of securities fraud actions in state court by requiring most class action securities fraud suits based on state law to be brought in federal court under federal law. *See* § 11.09[1][a].

154 *See* § 27A(a)(1) of the Securities Act and § 21E(a)(1) of the Exchange Act.

155 *See* § 27A(b) of the Securities Act and § 21E(b) of the Exchange Act. Forward-looking disclosures provided pursuant to Item 11 of Form 20-F (Quantitative and Qualitative Disclosures About Market Risk), however, are within the statutory safe harbors for all types of issuers and transactions. *See* § 3.08[7].

Where the Litigation Reform Act does not apply in the contexts referred to above, issuers can rely on Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act. Under those rules, a forward-looking statement that proves to be incorrect will not be considered a material misstatement or omission under the securities laws unless the plaintiff can show that it "was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." The plaintiff bears the burden of proving that the statement does not fall within the Rule 175(a) or Rule 3b-6(a) safe harbor. *See, e.g.*, *Roots Partnership v. Land's End, Inc.*, 965 F.2d 1411 (7th Cir. 1992); *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509 (7th Cir. 1989). This safe harbor is available for forward-looking statements contained in any document filed with the SEC made (i) by or on behalf of an issuer that is subject to the reporting requirements of the Exchange Act or that is filing a registration statement under the Securities Act or §§ 12(b) or 12(g) of the Exchange Act or (ii) by an outside reviewer retained by such an issuer.

156 *See* § 4.10[4] for a discussion of circuit courts' disagreement concerning whether a duty to update previous communications exists.

157 *See* § 27A(d) of the Securities Act and § 21E(d) of the Exchange Act.

158 Several studies have examined whether the quantity or quality of written forward-looking disclosures increased after the enactment of the Litigation Reform Act. The studies reached different conclusions. In the first study, the SEC staff analyzed litigation conducted in the first year after the passage of the Litigation Reform Act. Although the staff cautioned that the lack of substantial jurisprudence interpreting the Act made it "too soon to draw definitive conclusions about the impact of the Reform Act on the effectiveness of the securities laws and on investor protection," the report concluded that the quality and quantity of disclosures had not significantly improved since the enactment of the safe harbor provision. *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 26–27 (Apr. 1997). The second study, published by the New York City Bar Association, concluded that while cautionary language has become standard in corporate disclosures, the substantive quantity or quality of disclosures had not increased. *See* Committee on Securities Regulation *, A Study of Current Practices: Forward Looking Statements and Cautionary Language After the 1995 Private Securities Litigation Reform Act*, RECORD OF THE NEW YORK CITY BAR ASSOC., Vol. 53, No. 6, Nov. (Dec. 1998) at 723, 726. The third study, published in the Journal of Accounting Research, reached the opposite conclusion, finding that the quantity of disclosures had increased without any significant decrease in their accuracy. Marilyn F. Johnson et al., *The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information By High-Technology Firms*, 39 J. ACCT. RES. 297, 318, 322 (2001) ("[T]he evidence presented above indicates that there was a significant increase in the level of voluntary disclosure during the post-Act period, and that this increase appears to be a direct response to the reduced legal exposure for forward-looking statements. [W]e find that the safe harbor had no adverse impact on the quality of forward-looking information released by management.").

Studies have also tracked the number of securities class actions filed over recent years. In January 2016, NERA Economic Consulting released its assessment of securities class action filing activity in 2015. The 234 securities class action filings in 2015 represented the highest level since 2008, and an increase of 8% from 2014. The study further noted that the number of publicly listed companies in the United States has decreased substantially over time, meaning that an average company was almost 70% more likely to be the target of a securities class action between 2010 and 2015 than in the first five years after the passage of the Litigation Reform Act. *See* NERA Economic Consulting, *Recent Trends in Securities Class Action Litigation: 2015 Full-Year Review*.

159 *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 3 (Apr. 1997).

160 *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 26–27 (Apr. 1997).

161 *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 928 (2003). *See also* § 11.09[1][a].

162 *See* Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 928 (2003).

163 *See* SEC, Office of the General Counsel, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 28 (Apr. 1997).

164 *See* § 101(2) of the Uniform Securities Act.

165 *See* § 410(a)(2) of the Uniform Securities Act. Control persons are liable under the Uniform Securities Act to the same extent as those they control, subject to the same basic defenses set forth in § 15 of the Securities Act. *See* § 410(b) of the Uniform Securities Act.

166 *See* § 18(c)(1) of the Securities Act, *as amended* by the NSMIA; *see also* § 11.02[3].

167 *See* § 11.09[1][a]. On the other hand, in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, the Supreme Court held that a defendant could not remove to federal court an action asserting state law claims based in part on an alleged breach of a duty imposed by a regulation under the Exchange Act, notwithstanding that § 27 of the Exchange Act provides that federal courts have exclusive jurisdiction "of all suits … brought to enforce any liability or duty created by [the Exchange Act] or the rules or regulations thereunder," because the plaintiff in that case could "prevail on those [state law] claims without proving that the alleged breach of an Exchange Act duty … actually occurred" and those [state law] claims therefore did not "necessarily raise a federal issue." *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1568, 1575 (2016). Instead, the Supreme Court held that state law claims are removable to federal court under § 27 of the Exchange Act only if they "arise under" the Exchange Act, meaning that the "state-law action necessarily depends on a showing that the defendant breached the Exchange Act." *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1567–69 (2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.04, LIABILITIES CONNECTED WITH DISCLOSURE IN PRIVATE 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 § 11.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Like the registered public offerings discussed in the preceding section, private offerings of securities in the United States (including offerings under Rule 144A under the Securities Act) also can give rise to liability for improper disclosures under U.S. federal and state securities laws, with remedies ranging from actions by private parties for damages to injunctive actions by the SEC and criminal prosecutions by the DOJ. In general, however, the legal standards under federal law for imposing such liability are higher in the private offering context than for registered public offerings: in the case of private suits, the plaintiff must demonstrate that the defendant acted recklessly or with fraudulent intent, and must also prove that he or she relied on the defendant's wrongful conduct to his or her detriment. The distinctions between the standards applicable to public and private offerings were clarified by the Supreme Court in *Gustafson v. Alloyd Co., Inc.*, [168] which—as discussed in § 11.04[1]—held that § 12(a)(2) of the Securities Act, with its lower burden of proof required for liability, [169] does not apply outside the public offering context. The two federal provisions that do apply to disclosure violations in private offerings, § 10(b) of the Exchange Act and Rule 10b-5 thereunder and § 17 of the Securities Act, are examined below in § 11.04[2] and [3], respectively. The relevant provisions of state securities law are addressed in § 11.04[4].

[1] *Gustafson* and Securities Act § 12(a)(2)

Although a purchaser in a private placement does not have any rights under § 11 of the Securities Act (relating to misstatements or omissions in a registration statement), [170] it was believed widely that such purchasers could take advantage of the remedies afforded by § 12(a)(2) of the Securities Act, which imposes

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liability on securities sellers for misstatements or omissions in prospectuses or oral communications made in the offer or sale of a security. (Indeed, many had thought that § 12(a)(2) also applied to secondary market transactions.) The

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Supreme Court's 1995 decision in *Gustafson* held the opposite, that § 12(a)(2) does not apply at all to private placements or secondary market transactions. [171] The breadth of the Court's holding was unexpected, particularly as applied to private placements. As a result of the *Gustafson* decision, a plaintiff who purchases securities in a private placement or in a secondary market transaction will be forced to pursue its claims based on federal law under the more rigorous standards of Rule 10b-5 (discussed in § 11.04[2])—which applies to private and secondary market transactions as well as public offerings—as well as under any applicable state securities laws. [172]

The *Gustafson* decision went a long way toward addressing concerns of securities market participants about inadvertent liability in connection with private placements and secondary market transactions. Although consideration still will have to be given to reputational issues, state securities laws and the common law, the potential remedies under state and common law are less likely to provide the basis, especially in the context of international offerings, for the nationwide class actions and other large-scale proceedings that have marked securities law litigation under the federal securities laws. [173]

By changing the standards for liability in private placements and secondary market transactions, *Gustafson* led some participants to reexamine the nature of the documentation used in these transactions or the procedures employed in executing them. However, the core business reasons that motivate due diligence (*e.g.*, reputational concerns and investor expectations), as well as the desire to be able to protect against possible evolution of liability standards under, for example, Rule 10b-5, and to dispose quickly of litigation alleging defective disclosure, have combined to result in continued substantial due diligence in Rule 144A offerings. [174]

Despite *Gustafson's* expansive holding, some courts have nonetheless left open the possibility of § 12(a)(2) liability in Rule 144A and Regulation S offerings. [175] Notably, in the Enron civil litigation, the court denied an underwriter's

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motion to dismiss the § 12(a)(2) claim, holding that notwithstanding exemption from registration under Regulation S or Rule 144A, there were circumstances whereby an offering could be found public for the purposes of § 12(a)(2). [176] The court, in particular, noted the absence of a statutory definition of "public offering," the wide distribution (although limited to qualified institutional buyers in the United States) and the listing of the securities on the Luxembourg Stock Exchange as factors that made it inappropriate to dismiss the underlying claim since there was a possibility that, through the admission of further evidence, the

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plaintiffs could establish that the offering was a public offering, actionable under § 12(a)(2). [177]

[2] Exchange Act § 10(b) and Rule 10b-5

The catch-all antifraud provisions of the Exchange Act, § 10(b) and Rule 10b-5 thereunder, have become by far the most significant remedy for disclosure violations in securities transactions, both for the SEC and for private litigants. The provisions themselves do not create a private right of action; the Exchange Act speaks only of civil and administrative remedies by the SEC, and possible criminal prosecution. However, the courts have long held that buyers or sellers of securities have an implied right to recover damages based on violations of § 10(b) and Rule 10b-5. [178] The elements of a claim under these provisions are discussed below, as are the parties who may be held liable as defendants and the remedies that may be available.

[a] Elements of Claim

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder are broadly written: § 10(b) proscribes the use of "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of any security, and Rule 10b-5 specifies three categories of conduct that qualify as violations. These are (i) employing any "device, scheme, or artifice to defraud," (ii) making any untrue statement of material fact or failing to state a material fact "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" [179] and (iii) engaging in any "act, practice, or course of business" that operates as a "fraud or deceit."

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Information is deemed material for purposes of the second prong if there is a substantial likelihood that a reasonable investor would have viewed its disclosure as significantly altering the "total mix" of available information, and would consider it important in deciding whether to purchase or sell stock. [180] Whether or not misstatements or omissions are material may involve qualitative as well as quantitative judgments. In Staff Accounting Bulletin No. 99, the SEC offered guidelines to registrants and independent auditors in evaluating the materiality of misstatements identified in the audit process or preparation of financial statements. [181] The SEC emphasized that registrants should not assume that the misstatement or omission of items that fell below a certain quantitative threshold (*e.g.*, 5%) was immaterial for disclosure purposes. [182] While a numerical threshold can provide a starting point for determining the materiality of an item, such an assessment also must include "the factual context in which the user of financial statements would view the financial statement item." [183] Thus, some of the qualitative factors that must be considered are:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate, and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement masks a change in earnings or other trends;
- whether the misstatement hides a failure to meet the consensus expectations of the analysts for the enterprise;
- whether the misstatement changes a loss into income or *vice versa*;

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- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- whether the misstatement affects the registrant's compliance with regulatory requirements;
- whether the misstatement affects the registrant's compliance with loan covenants or other contractual requirements;
- whether the misstatement has the effect of increasing management's compensation—for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation;
- whether the misstatement concerns a segment or other portion of the registrant's operations or profitability; and
- whether the misstatement involves concealment of an unlawful transaction. [184]

The SEC also cautioned that where financial statements contained multiple misstatements, registrants should consider first each misstatement separately and second the aggregate effect of all misstatements. The effect of the misstatement of an individual amount that causes the financial statements as a whole to be materially misstated cannot be eliminated by the inclusion of other misstatements whose effect diminishes the impact of the original misstatement. Conversely, financial statements may be rendered materially misleading even though no individual misstatement is material. [185]

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Courts have also found that the alleged misstatement or omission of items falling below a certain quantitative threshold can be qualitatively material if those items concern a particular product, division, or segment of an issuer's business that has independent significance for investors, such as a product or segment that is the company's original niche, its iconic or eponymous business, or that is critical to its reputation, revenue or growth. [186]

More recently, the Supreme Court rejected the contention that the materiality of adverse event reports in the pharmaceutical context can be reduced to the binary question of whether an issuer knew of a statistically significant number of such event reports. In *Matrixx Initiatives v. Siracusano*, [187] the plaintiffs challenged as materially misleading a drug manufacturer's statements touting the safety of its anti-cold medication, because the manufacturer knew of a large number of reports concerning adverse health effects of such medication. The drug manufacturer argued that plaintiffs did not adequately plead the materiality of the alleged misstatements because the complaint did not allege that the manufacturer knew of a statistically significant number of such adverse health reports. The Supreme Court, relying on *Basic*, rejected this contention and affirmed the Ninth

Circuit's refusal to dismiss the complaint, noting that a bright-line rule that would turn on the existence of a statistically significant number of adverse effect reports would "artificially exclude information that would otherwise be considered significant to the trading decision of a reasonable investor." [188] The Court instead reaffirmed that assessing the materiality of an adverse event report is a "fact-specific inquiry that requires consideration of the source, content, and context of the reports." [189]

The disclosure standard under Rule 10b-5 is identical to that under § 12(a)(2) of the Securities Act: liability is predicated upon a misstatement or upon omission of a material fact that makes an included statement misleading. [190] The remaining elements of the claim differ, however, in significant ways. Unlike under § 12(a)(2), where the defendant must establish that it acted with reasonable care, [191] a plaintiff bringing a claim under Rule 10b-5 must plead conduct by

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the defendant giving rise to "a *strong inference* of *scienter*." [192] For Rule 10b-5 purposes, "*scienter*" is defined as an intent to defraud, deceive or manipulate, [193] with courts generally agreeing that recklessness constitutes "*scienter*" as well. [194]

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Mere negligence is not sufficient to state a cause of action under Rule 10b-5. [195] Recklessness has been defined as "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." [196] Under this definition, which has been adopted by the majority of circuits and applied to claims of material misstatements as well as omissions, [197] the danger of "misleading buyers must be actually known or so obvious that any reasonable man would be legally bound …[and that the conduct in question must be] more egregious than even ‘white heart/empty head’ good faith." [198]

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In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court addressed the level of specificity that a plaintiff must plead in order to satisfy the "strong inference of *scienter*" standard on a motion to dismiss. [199] The Court held that a complaint must meet a two-pronged test: its allegations of *scienter* must be both "cogent" and "at least as compelling as any opposing inference of nonfraudulent intent." In applying this test, the reviewing court must consider not only the inferences urged by the plaintiff, but also competing inferences rationally drawn from the facts of the complaint and any other sources that a court may consider on a motion to dismiss. By requiring courts to consider competing inferences of *scienter* (*i.e.*, "innocent" or "nonculpable" inferences), the effect of the Court's ruling will be to trigger more rigorous scrutiny of plaintiffs' pleadings and, in some cases, earlier dismissal.

The decision in *Tellabs* was also significant for its discussion of the analytical approach that a reviewing court should take when determining whether the "strong inference of *scienter*" is adequately pled. The Court stated that the allegations of the complaint should be assessed "holistically," rather than in isolation. In other words, the Court rejected approaches that afforded determinative significance to specific allegations of the complaint (*e.g.*, motive and opportunity) and instructed lower courts to review complaints in their entirety to determine "whether all the facts alleged, taken collectively, give rise to a strong inference of *scienter*," not whether any individual allegation, scrutinized in isolation, meets that standard.

The plaintiff in a private action under Rule 10b-5 (as contrasted with an SEC enforcement action) also must show that he or she relied on the defendant's wrongful conduct and that the conduct was the proximate cause of the investment loss. [200] These elements of a Rule 10b-5 claim are sometimes referred to as transaction causation and loss causation.

Transaction causation is akin to reliance, and requires only an allegation that "but for the defendant's wrongdoing, the plaintiff would not have incurred the harm of which he complains." [201] There are two important exceptions, however, to the need for a plaintiff to prove reliance.

The first exception applies only in cases alleging material omissions. In such a case, courts have held that proof of the materiality of the omission gives

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rise to a presumption of the plaintiff's reliance. [202] This exception to proving reliance originates from the U.S. Supreme Court's decision in *Affiliated Ute v. United States*. [203] That case involved a failure to disclose material information in a context in which there were face-to-face transactions between the defendant-bankers and the plaintiff-investors. Based on these transactions, and the relationship between the bankers and the investors, the Court found that the bankers had a duty to disclose material information to the investors. The Court held that, in light of this duty, "positive proof of reliance is not a prerequisite to recovery. This obligation to disclose and the withholding of a material fact establish the requisite element of causation in fact." [204]

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The second exception—the so-called "fraud-on-the-market" theory—applies to transactions in securities that trade in the open market. In circumstances where there is an organized and efficient market for the securities—*i.e.*, the securities trade on a major stock exchange, are heavily traded, are followed by a number of analysts, and generally move in response to the release of material information about the issuer—the court may presume that the market price reflects the information available about the issuer, and a material misstatement or omission will be deemed to have affected the market price of the stock. [205] This presumption allows those who traded on the basis of the artificially inflated or depressed market price to recover the difference between the price paid or received and the price at which the stock would have been trading in the absence of the defendant's material misstatement or omission. [206] If the defendant can establish that the plaintiff in fact did not rely on the misstatement or omission or that the defendant's misstatement or omission did not affect the market price of the security, then the presumption of reliance is rebutted. [207] In an important decision in *In re Initial Public Offering Securities Litigation*, [208] the Second Circuit

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concluded that the "fraud-on-the-market" theory is inapplicable to initial public offerings because the market for IPO shares is not efficient.

In *Halliburton Co. v. Erica P. John Fund, Inc.*, the Supreme Court considered whether to overrule or substantially modify the "fraud-on-the-market" theory, in light of recent scholarship that called into question the economic underpinnings of the theory. [209] The Court ultimately reaffirmed the theory under the principle of *stare decisis*, but noted that the presumption of reliance could be rebutted by a showing that the alleged misrepresentation had no "price impact," and held that "defendants must be afforded an opportunity before class certification to defeat the presumption [of reliance] through evidence that an alleged misrepresentation did not actually affect the market price of the stock." [210] On remand, the district court in *Halliburton* concluded that the defendants successfully defeated the presumption of reliance with respect to certain alleged misstatements by submitting an event study that showed there was no statistically significant price reaction on particular days when the truth about those alleged misstatements was revealed to the market. [211]

The Eighth Circuit has further held that a defendant can rebut the fraud-on-the-market presumption by demonstrating that the allegedly misleading statements did not affect the price of the issuer's securities at the time of the alleged misstatements. [212] Other courts, however, have rejected attempts to rebut the presumption of reliance unless defendants "demonstrate a complete lack of price impact." [213]

Loss causation, unlike transaction causation, is concerned primarily with causation instead of reliance. It is a fact-based inquiry akin to common law proximate cause. In order for a private plaintiff under Rule 10b-5 to show loss causation, he must demonstrate that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security. [214]

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In 2005, a unanimous Supreme Court raised the bar in Rule 10b-5 suits, holding that given the common law roots of this implied private right of action and the pleading requirements under the Litigation Reform Act, private plaintiffs pursuing Exchange Act fraud claims must plead and prove more than just price inflation at the time of purchase in order to satisfy the "loss causation" element. The Supreme Court expressly rejected the Ninth Circuit's "inflated share price approach" to proving causation and loss, pursuant to which the mere allegation in a complaint that the price of a security "on the date of purchase was inflated because of the misrepresentation" was sufficient to plead and, when later established, also sufficient to prove loss causation because the injury was understood to occur at the time of the transaction. [215] The Supreme Court found this approach to be at odds with the logic and the policies behind the securities laws, because under the "inflated share price approach," private securities actions would operate largely as a "partial downside insurance policy," [216] since an initially inflated purchase price would not invariably lead to an economic loss. The Supreme Court held that to prevail in a 10b-5 suit, a private plaintiff must plead and prove that the defendant's fraud caused "an economic loss." [217]

Thus, given the foregoing discussion of the elements required for the successful prosecution of a 10b-5 claim, issuers organizing private placements in the United States, or investment bankers participating in such placements, should consider a number of factors in determining what level of disclosure is appropriate to avoid liability. First, because the *scienter* standard includes reckless as well as intentional disclosure violations, an underwriter is unlikely to be able to

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avoid liability by doing no investigation and therefore not "knowing" of the misstatement or omission. Investment bankers associated with a private placement may be found to have impliedly represented that they have performed a customary "business diligence" investigation. [218] This investigation would probably be required to include pursuing internal inconsistencies or "red flags" that become apparent, but in all likelihood does not require the full "legal" or "documentary" diligence necessary for public offerings where proof of *scienter* is not required for disclosure liability. [219]

Second, issuers and sellers should examine the circumstances of the particular private placement to determine what level of disclosure is necessary. In some cases, such as a private placement associated with an initial offering in the capital markets by a non-U.S. issuer, the scope of disclosure appropriately may be quite close to that for an offering registered with the SEC. In other cases, involving for example an offering of debt securities under Rule 144A by a seasoned, "world-class" non-U.S. company that has been a frequent issuer in the international markets, disclosure that substantially follows the issuer's prior practice in the international markets might be appropriate. In particular, less detailed disclosure may be required for offerings of investment-grade debt than for equity. For debt offerings, investors generally are willing to place as much reliance on rating agencies as on the underwriters.

[b] Who May Be Liable

[i] *Standing and Contribution*

Although the plaintiff in a Rule 10b-5 action must demonstrate that it was an actual purchaser or seller of the security to have standing to sue, it may sue defendants other than the purchaser or seller with whom it dealt. [220] There is no requirement of privity in Rule 10b-5 actions. Rather, the Rule extends liability to

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"any person, directly or indirectly" who commits fraud or intentionally or recklessly provides misleading disclosure "in connection with the purchase or sale of any security."

In addition, § 20(a) of the Exchange Act imposes control person liability for violations of its provisions. The control person is liable to the same extent as those who directly committed the offense, [221] unless it can show that it "acted in good faith and did not induce the act or acts constituting the violation or cause of action." [222]

Section 10(b) and § 20(a) claims must be pled in the alternative because a party cannot be held liable under both sections for the same conduct. [223]

Further, Congress amended the Exchange Act to provide that in cases in which more than one person violated the Exchange Act and contributed to the plaintiff's damages, each person is liable only for a portion of the total damages based on the percentage of responsibility that the jury attributes to that person. This provision, which carves out an exception for cases of "knowing" securities fraud, is discussed in § 11.03[1][e][ii].

[ii] *Secondary Actor Liability*

The SEC may bring enforcement actions against parties (often called "secondary actors") who "aid and abet" violations of Rule 10b-5 or other provisions of the Exchange Act, meaning that they provide substantial assistance to others in accomplishing the securities violation despite knowledge that the others' conduct violates the law. [224] The SEC staff has said that using an aiding and abetting

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theory to pursue "enablers" of fraud—secondary actors such as lawyers, accountants, bankers and non-management directors—is an important part of the Commission's enforcement program, and it has brought enforcement actions accordingly. [225]

By contrast, the Supreme Court has held that private investors may not bring suit against aiders and abettors under Rule 10b-5. [226] The Court's elimination of aiding and abetting liability in private actions also calls into question private investors' previously accepted ability to sue employers under the doctrine of "*respondeat superior*," [227] which permits the imposition of strict liability on employers for the fraudulent acts of their employees if the employees were acting within the scope of their employment. [228] This issue may arise not only in the

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context of actions against employers, but also actions against parent corporations on the basis of the actions of their subsidiaries. [229]

In a pair of more recent decisions, the Supreme Court has further curtailed the ability of private plaintiffs to pursue claims against secondary actors as primary violators rather than as aiders and abettors. In *Stoneridge Investment v. Scientific-Atlanta, Inc.*, the Supreme Court considered whether secondary actors can be liable under a "scheme" liability theory. [230] Following *Central Bank*, private litigants seeking to reach secondary actors attempted to pursue claims using the previously untapped "scheme to defraud" prongs of Rule 10b-5—namely Rule 10b-5(a) and (c). [231] Although initial district court decisions suggested that

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this "scheme" theory may support broad Rule 10b-5 liability against secondary actors such as lawyers, accountants and financial institutions, subsequent decisions narrowed the application of Rule 10b-5(a) and (c) to circumstances in which the defendant actually made use of an allegedly deceptive device or contrivance. [232] In *Stoneridge*, while the Supreme Court stopped short of completely eliminating scheme liability in the case of secondary actors, it established a test that may be difficult for plaintiffs to meet as a practical matter. The Court held that plaintiffs bringing Rule 10b-5(a) and (c) claims must demonstrate that they specifically relied on the defendants' acts or statements when making their investment decisions. It went on to reject liability against secondary actors (here, counterparties to sham transactions) where the secondary actors did not make it "necessary or inevitable" that the primary actor would defraud investors by issuing false financial statements. [233] As the Court explained, it was the primary actor, not the secondary actors, "that misled its auditor and filed fraudulent statements; nothing [the secondary actors] did made it necessary or inevitable for [the primary actor] to record the transactions as it did."

In *Stoneridge*, the shareholder-plaintiff had brought claims against two equipment vendors who allegedly participated with Charter Communications in a fraudulent "wash sale" scheme. The complaint alleged that the vendor-defendants had sold equipment (cable television set-top boxes) to Charter with the understanding that Charter would pay an extra $20 per unit and the vendors would return the extra funds to Charter through advertising fees. Even though the complaint alleged that the vendor-defendants were aware that they were engaged in a scheme with the purpose of inflating Charter's apparent revenues, the Eighth Circuit held that no violation of any subsection of Rule 10b-5 could be pled against defendants who "did not issue any misstatement relied upon by the investing public" and were not "under a duty to Charter investors and analysts to disclose information useful in evaluating Charter's true financial condition." The Supreme Court affirmed this decision. [234] Following *Stoneridge*, a number of circuit courts adopted or reaffirmed their prior holdings that a primary violation only exists if the actor makes a false or misleading statement and it was publicly attributable to him at the time of dissemination. [235]

Expanding on its decision in *Stoneridge*, the Supreme Court has further narrowed the reach of the § 10(b) private cause of action in *Janus Capital Group, Inc. v. First Derivative Trader*. [236] In *Janus*, the Court held that the investment adviser to a mutual fund could not be liable in a private action under § 10(b) for allegedly false statements contained in prospectuses issued by the mutual fund, even though the investment adviser wrote the allegedly misleading prospectuses. In *Janus*, the Court described the issue as what it means to "make" a statement under Rule 10b-5(b), and held that the "maker" of a statement is "the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." [237] Applying this test, the Court held that the mutual fund, not the investment adviser, was the "maker" of the challenged statements, because the fund was the entity with "ultimate authority" over the prospectuses, bore the statutory obligation to (and did) file the prospectuses with the SEC and the prospectuses were attributed to the fund and not the adviser.

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Since *Janus*, lower courts have disagreed on whether *Janus* forecloses liability against investment banks acting as placement agents or underwriters for statements attributed to the issuer in offering documents. [238] Courts have also disagreed concerning whether the Supreme Court's reasoning in *Janus* only applies to legally independent third parties, or also extends to corporate officers. [239]

[c] Remedies

A private party prevailing in an action under Rule 10b-5 is entitled to recover its out-of-pocket loss, [240] generally the difference between the "true" value of the securities (the price at which they would have traded absent the fraud) and the price paid or received by the plaintiff. [241] Alternatively, some courts permit plaintiffs to recover subsequent price declines that were a foreseeable materialization of the risk concealed by the fraudulent statement, even if

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those losses would exceed the price inflation that existed on the original transaction date, which would have reflected only the *risk* of an adverse development rather than its actual occurrence. [242] The determination of damages under these principles can be quite complicated, often requiring the use of economic models and expert testimony to distinguish between losses caused by the fraud and those attributable to other factors, including factors generally affecting the economy and the company's industry or those specifically affecting the company but not related to the fraud. [243] In response to the difficulty of making this distinction, and the potential for thus greatly overestimating plaintiff damages, Congress established an upper limit, or cap, on damages for claims arising under the Exchange Act "in which the plaintiff seeks to establish damages by reference to the market price." [244] The recovery limit is calculated as the difference between the price paid or received by the plaintiff for the securities and the mean trading price of the same securities during the three months following corrective disclosure to the market. [245] Moreover, pursuant to a 1995 amendment to the Exchange Act, a system of "proportionate liability" that apportions liability based on "the percentage of responsibility" of each violator applies to virtually all violations of the Exchange Act, essentially eliminating joint and several liability for such violations except where statements or omissions were made with actual knowledge of falsity, rather than mere recklessness. [246]

The SEC may sue for injunctive relief under § 10(b) and Rule 10b-5, or to prohibit (permanently or temporarily) any person who violated these provisions from acting as an officer or director of any public company. [247] The SEC may also seek civil penalties in amounts ranging from $8,156 to $178,156 for natural persons or $81,559 to $890,780 for corporations, depending on the egregiousness of the defendant's conduct, or disgorgement of the defendant's gain from its actions, whichever is greater. [248] Finally, the DOJ may seek criminal sanctions (including substantial fines or imprisonment in the case of natural persons) for willful violations of the antifraud or other provisions of the Exchange Act. [249]

[d] Statutes of Limitations and Repose

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There is no statute of limitations applicable to actions brought by the SEC under § 10(b) of the Exchange Act and Rule 10b-5 thereunder for injunctive relief or disgorgement. [250] As discussed in § 11.07[1][a], the Sarbanes-Oxley Act created new statutes of limitations and repose for private claims under § 10(b) and Rule 10b-5—the earlier of two years from the date of "discovery of the facts constituting the violation" or five years from the date of the violation. [251]

In *Merck & Co., Inc. v. Reynolds*, the Supreme Court interpreted the text of this statute of limitations and rejected the notion that § 1658's limitations period begins to run at the point that plaintiffs should begin investigating their claim, as opposed to the date when plaintiffs should actually discover their claim. [252] *Merck* involved a Rule 10b-5 allegation that pharmaceutical company Merck knowingly misrepresented the risk of heart attack associated with its drug Vioxx. Relying on Second Circuit precedent, the district court dismissed the complaint on statute of limitations grounds, holding that the plaintiffs should have been alerted by three events constituting "inquiry notice" to the possibility of the misrepresentations more than two years prior to the filing of the complaint, but failed to undertake a reasonably diligent investigation at that time. The Third Circuit reversed, holding that although the three events constituted "storm warnings," they did not suggest that Merck had acted with *scienter*, and therefore they did not put plaintiffs on "inquiry notice," triggering a duty to investigate further. Rejecting the applicability of "inquiry notice," the Supreme Court noted that while "terms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating.…the limitations period does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation,' including *scienter*—irrespective of whether the actual plaintiff undertook a reasonably diligent investigation." [253]

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The Court further held that *scienter* is among the "facts constituting the violation" that plaintiffs must actually or constructively discover before the statute of limitations begins to run on their Rule 10b-5 claims. In so holding, the Court pointed out the special heightened pleadings requirements applicable to the *scienter* element in Rule 10b-5 cases under the Litigation Reform Act. Specifically, plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," and the complaint will give rise to such a "strong inference" only where it demonstrates that it is "at least as likely" as not that the defendant acted with the relevant knowledge or intent. [254] Accordingly, the Court held that "[i]t would therefore frustrate the very purpose of the discovery rule in this provision—which, after all, specifically applies only in cases 'involv[ing] a claim of fraud, deceit, manipulation, or contrivance,'—if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter." [255] The Court rejected Merck's argument that this holding would give life to stale claims or subject defendants to liability for acts taken long ago, pointing to the five-year repose period as adequately addressing these concerns. The Court specifically declined to address whether or what other elements of a Rule 10b-5 claim, such as reliance, loss and loss causation, qualify as "facts constituting the violation" for purposes of determining when the limitations period begins to run.

Building on *Merck*, the Second Circuit has held that a fact is not deemed "discovered" for purposes of commencing the statute of limitations until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint. [256] Therefore, the statute of limitations on a Rule 10b-5 claim does not begin to run until a reasonably diligent plaintiff would have uncovered enough information about the defendant's knowledge or intent to establish a strong inference of *scienter*.

[3] Securities Act § 17(a)

The Securities Act contains a broad antifraud provision, § 17(a), which closely mirrors the language of Rule 10b-5 under the Exchange Act. [257] Although

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the Securities Act is primarily concerned with the regulation of new public offerings, the Supreme Court has held that § 17(a) is applicable to the seller in private placements and secondary market trading as well. [258]

Though the language of § 17(a) is very similar to that of Rule 10b-5, [259] most actions under its provisions do not require proof of the defendant's *scienter*, a significant burden in Rule 10b-5 actions. Instead, negligence in disclosure generally will suffice as a basis for imposing liability under § 17(a). [260] To prevent § 17(a) from being used as an end-run around Rule 10b-5's requirements, however, almost all courts have held that § 17(a) does not provide a private right of action. [261] Therefore, only the SEC may enforce § 17(a) provisions [262] and only the DOJ may institute criminal proceedings for willful, as opposed to negligent, violations.

[4] State Securities Laws

State securities laws—the so-called "blue sky" laws—are another possible source of liability with respect to offering documents used in private placements. All U.S. states (other than New York) have statutes that allow investors to sue to rescind transactions or recover damages when securities are sold by means of

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materially misleading offering documents. [263] In approximately 35 states, including a number with a significant institutional investor base, the standard of actionable conduct is comparable to the reasonable care standard under § 12(a)(2) of the Securities Act. However, state securities laws are unlikely to provide a basis for the nationwide class actions or other large-scale proceedings that have marked securities law litigation under the federal securities laws. [264]

Footnotes

168 *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

169 *See* § 11.03[2] for discussion § 12(a)(2) of the Securities Act.

170 Courts have affirmed that there is no § 11 liability in the case of a Rule 144A offering. *See In re Levi Strauss & Co. Securities Litigation*, 527 F. Supp. 2d 965, 975 (N.D. Cal. 2007); *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 258 F. Supp. 2d 576, 619 (S.D. Tex. 2003) (holding that there is no liability under § 11 for a Rule 144A offering because (i) a registration statement is an essential element of a § 11 claim and (ii) a Rule 144A offering is expressly exempt from the requirement that a registration statement be filed in connection with an offering); *In re Livent, Inc. Noteholders Securities Litigation*, 151 F. Supp. 2d 371, 430 (S.D.N.Y. 2001) (holding that in the case of a Rule 144A offering, the offering memorandum, although similar on its face to a prospectus, is not a registration statement within the meaning of the Securities Act and therefore no § 11 liability attaches). Courts have also held that the banks acting as initial purchasers in Rule 144A offerings have no § 11 liability for registered A/B exchanges effected subsequent to the Rule 144A offerings because they are not "directly involved in the preparation of the registration statement or in the subsequent exchange for registered securities of unregistered securities

that the initial purchasers no longer held." *In re Livent, Inc. Noteholders Securities Litigation*, 151 F. Supp. 2d 371, 432 (S.D.N.Y. 2001); *see also American High-Income Trust v. AlliedSignal*, 329 F. Supp. 2d 534, 541–42 (S.D.N.Y. 2004) ("To import underwriter liability for entities that serve as initial purchasers prior to an [A/B exchange] would render Rule 144A ineffective for a very substantial number of securities transactions, and defeat the capital market financing objectives the Rule 144A exemption was designed to achieve." (internal quotations and citations omitted)); *In re Safety-Kleen Corp. Bondholders Litigation*, No. C/A 3:00-1145-17, 2002 WL 32349819 (D.S.C. Mar. 27, 2002) (rejecting plaintiff's contention that both the Rule 144A offering and the subsequent A/B exchange should be seen as one "integrated transaction" subject to § 11 liability, holding that as outlined in the SEC's *amicus curiae* brief to the court, this proposed integration would undercut the policy behind the provision of a 144A exemption). The *Safety-Kleen* court also found no basis for damages in an A/B exchange, because the securities being exchanged are identical. *See In re Safety-Kleen Corp. Bondholders Litigation*, No. C/A 3:00-1145-17, 2002 WL 32349819 (D.S.C. Mar. 27, 2002).

The district court in *In re HealthSouth Securities Litigation* asked the SEC to submit an *amicus curiae* brief addressing whether an underwriter that participates in a Rule 144A offering and a subsequent A/B exchange should continue to enjoy an exemption from the registration process if the transaction is structured as a Rule 144A offering and A/B exchange for the purpose of obtaining the registration exemption and avoiding potential § 11 liability for a Rule 144A offering statement that they knew to be fraudulent or otherwise misleading. *See* Brief of *Amicus Curiae* of the SEC, *In re HealthSouth Securities Litigation*, No. 03-CV-1500 (N.D. Ala. Nov. 28, 2006). The SEC reiterated the position it took in *Safety-Kleen*, rejecting the plaintiffs' "integration" argument. The SEC went on to argue that the applicability of the registration exemption should turn on the substance of the transaction (*i.e.*, whether it meets the qualifications for Rule 144A or "is a sham designed to create the illusion that it should be exempt"). *See* Brief of *Amicus Curiae* of the SEC at 8, *In re HealthSouth Securities Litigation*, No. 03-CV-1500 (N.D. Ala. Nov. 28, 2006). The purported reason that the defendants sought the exemption would not be controlling because there is "nothing inherently nefarious about seeking to avoid Commission review or the possibility of Section 11 or 12(a)(2) liability." *See* Brief of *Amicus Curiae* of the SEC at 9, *In re HealthSouth Securities Litigation*, No. 03-CV-1500 (N.D. Ala. Nov. 28, 2006). The SEC argued that examining such intent would defeat the expectations of capital market participants, lead to uncertain standards and apply an erroneously broad interpretation to Preliminary Note 3 to Rule 144A, which provides that the Rule 144A exemption "is not available with respect to any transaction or series of transactions that, although in technical compliance with this section, is part of a plan or scheme to evade the registration provisions of the Act." Preliminary Note 3 to Rule 144A under the Securities Act. Thus, the SEC argued that Preliminary Note 3 requires courts to look beyond the structure of the transaction to its substance (to see, *i.e.*, whether the QIBs are "mere conduits for unregistered sales to the public") but "there is no precedent for making the exemption question turn solely on offeror motives that are independent of the substance of the transaction."

See also Randall W. Bodner & Peter L. Welsh, *Institutional Buyer Beware: Recent Decisions Reinforce Narrow Range of Remedies Available to QIBs in Rule 144A Offerings*, 36 SEC. REG. & L. REP. (BNA) 38, 1728 (Sept. 27, 2004); § 11.03[1] for discussion of § 11 of the Securities Act.

171 *See Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 562 (1995). Specifically, the Court held that the term "prospectus" as used in § 12(a)(2) means a prospectus used in a public offering by an issuer or a controlling person, not offering documents used in private offerings or secondary market transactions.

172 *See* § 11.04[4].

173 *See* § 11.09[1][a] for a discussion of class action lawsuits.

174 *See* § 7.02[3].

175 In the context of Rule 144A offerings, some courts have rejected a bright-line rule that a Rule 144A offering memorandum is never a "prospectus" soliciting the public purchase of securities. *See AAL High Yield Bond Fund v. Ruttenberg*, No. Civ. A. 00-C-1404-S, 2001 WL 34372980 (N.D. Ala. Sept. 30, 2001) (holding that an inquiry into the marketing strategies involved, the scope of the offering and the "sophistication of the

offerees" is warranted because the line between public offerings and private placements is unclear); *see also Steed Finance LDC v. Nomura Securities International, Inc.*, Fed. Sec. L. Rep. (CCH) ¶91,552 (S.D.N.Y. Sept. 20, 2001) (denying defendant's motion to dismiss the complaint and holding that it is not suitable at the pre-discovery stage to determine whether a private placement with a simultaneous public offering could be considered an integrated offering because factors such as the sophistication of the offerees and the actual information provided to them are crucial in making that determination).

However, several more recent decisions have questioned whether § 12(a)(2) liability can arise out of a Rule 144A offering. *See In re Merrill Lynch Auction Rate Securities Litigation*, Nos. 09 MD 2030 (LAP), 10 Civ. 0124 (LAP), 2012 WL 1994707, at *7 (S.D.N.Y. June 4, 2012) ("Because Rule 144A provides a safe harbor from the registration requirements of the 1933 Act for private resales of restricted securities to QIBs, Plaintiff's Section 12 claim must be dismissed with prejudice as a matter of law."); *In re Refco, Inc. Securities Litigation*, 503 F. Supp. 2d 611, 626 (S.D.N.Y. 2007) (holding that "offerings under Rule 144A are by definition nonpublic, and offering memoranda distributed in connection with such offerings cannot give rise to Section 12(a)(2) liability" (citing *American High-Income Trust v. AlliedSignal*, 329 F. Supp. 2d 534, 543 (S.D.N.Y. 2004)); *AIG Global Securities Lending Corp. v. Banc of America Securities LLC*, 254 F. Supp. 2d 373, 389 (S.D.N.Y. 2003) ("There is no dispute that both the 1998-1 and 1998-2 securities were sold through private offerings, made pursuant to Rule 144A. Consequently, the defendants cannot be held liable under § 12(a)(2) of the Securities Act, and the plaintiffs' claim under § 12(a)(2) is dismissed.").

In the context of Regulation S offerings, *see Sloane Overseas Fund, Ltd. v. Sapiens International Corp.*, 941 F. Supp. 1369 (S.D.N.Y. 1996) (denying defendant's motion to dismiss the complaint and holding that despite the applicability of Regulation S, the "wide distribution of the Offering Circular" made an offering public and hence subject to § 12(a)(2) liability). The *Sapiens* decision, however, may be distinguishable because it was unclear whether the offering in fact was eligible for the Regulation S exemption.

Without initially ruling on the ultimate issue of whether § 12(a)(2) liability can lie in a Rule 144A or Regulation S offering, the court in *In re Enron Corporation Securities, Derivative & ERISA Litigation* noted that plaintiffs seeking to pursue such claims on behalf of a class must, at a minimum, meet certain threshold standing requirements. *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 529 F. Supp. 2d 644, 718–20 (S.D. Tex. 2006). In *Enron*, the court dismissed the plaintiff's § 12(a)(2) claims based on Rule 144A and Regulation S offerings because the lead plaintiff had not produced a party with standing to sue the defendants. The court noted that § 12(a)(2) requires privity between the seller and the investor, which means that a class representative can only represent other investors who bought the same securities from the same seller. In a subsequent decision, however, the court in *In re Enron Corporation Securities, Derivative & ERISA Litigation* held that "[b]ecause no prospectus is required" for offerings pursuant to Rule 144A and Regulation S, "such offerings cannot give rise to Section 12(a)(2) liability." *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 761 F. Supp. 2d 504, 532 (S.D. Tex. 2011).

176 *See In re Enron Corp. Securities, Derivative & ERISA Litigation*, 310 F. Supp. 2d 819 (S.D. Tex. 2004).

177 *See In re Enron Corp. Securities, Derivative & ERISA Litigation*, 310 F. Supp. 2d 819, 864 (S.D. Tex. 2004).

178 *See Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) ("The existence of [an] implied remedy [under § 10(b) and Rule 10b-5] is simply beyond peradventure.").

179 Because the Rule 10b-5 standard is defined in terms of active misstatements or omissions, it is generally inapplicable to situations in which no affirmative disclosure statements are made at all (other than in the context of a duty to update challenge, as discussed in § 11.03[5]). In such situations, the investors'remedies are limited more, for example, to pursuing claims against broker-dealers under the "shingle theory." *See* § 11.05[3][b] (discussing liability based on implied representations underlying broker-dealer recommendations). In the context of undocumented offerings, investors generally are required to sign letters explicitly disavowing reliance on any such recommendations. *See* § 10.04. Note, though, that once a statement is made, the speaker may be liable for omitting material information that would have been necessary to make the statement not misleading.

180 *See Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *see also Cooperman v. Individual Inc.*, 171 F.3d 43, 49 (1st Cir. 1999). It is unclear whether the market's failure to react to a disclosure of a misrepresentation is determinative of whether that misrepresentation is material. The Ninth Circuit has held that materiality cannot be determined as a matter of law solely based upon the market's failure to react, and it requires a fact specific inquiry, *see No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003), whereas the Third Circuit has held that the failure of a disclosed misrepresentation to affect the stock price permits a court to determine that the misrepresentation is immaterial as a matter of law, *see Merck & Co., Inc. Securities Litigation*, 432 F.3d 261 (3d Cir. 2005); *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000).

181 SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563. Although the SEC has been willing to opine on the materiality of misrepresentations, for the purposes of liability under the Exchange Act courts will determine materiality by asking whether a piece of information was important to a reasonable investor, not to the SEC. *United States v. Berger*, 473 F.3d 1080 (9th Cir. 2007) (applying "reasonable investor" materiality standard to § 32(a) action); *United States v. Tarallo*, 380 F.3d 1174, 1182 (9th Cir. 2004) (same under § 10(b)).

182 For a discussion of the history of quantitative versus qualitative approaches to making materiality decisions, *see* John M. Fedders, *Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard*, 48 CATH. U. L. REV. 41 (1998).

183 *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, at 64,219-4.

184 *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, at 64,219-4.

185 Even if a misstatement is immaterial, the inaccurate recording of such an item may, under certain circumstances, constitute a violation of the securities laws. *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563, at 64,219-4; *see also* Letter from Donald T. Nicolaisen, Chief Accountant, SEC, to AICPA (Feb. 7, 2005) (providing SEC guidance on lease accounting and disclosures). In the letter the SEC staff states that, with respect to lease accounting, if a registrant has not been in compliance with the standards of the Financial Accounting Standards Board, it must "assess the impact of the resulting errors" and restate its financial statements if the error was material or disclose that the "errors were immaterial to prior periods." Moreover, in a speech on May 3, 2005 before the American Academy of Actuaries, the SEC Chief Accountant stated that the SEC will require companies to restate their financial statements for all structured transactions that are aimed at improving the appearance of earnings and that do not have an otherwise legitimate business purpose, regardless of whether the improper accounting is material or not. *See* Rachel McTague, *SEC's Nicolaisen Says Restatement Required for Transactions Without Business Purpose*, BANKING REPORT (BNA) (May 9, 2005).

186 *Hutchinson v. Deutsche Bank Securities Inc.*, 647 F.3d 479 (2d Cir. 2011).

187 *Matrixx Initiatives v. Siracusano*, 131 S. Ct. 1309 (2011).

188 *Matrixx Initiatives v. Siracusano*, 131 S. Ct. 1309, 1319 (2011) (quoting *Basic v. Levinson*, 485 U.S. 224, 236 (1988)).

189 *Matrixx Initiatives v. Siracusano*, 131 S. Ct. 1309, 1321 (2011) (quoting *Basic v. Levinson*, 485 U.S. 224, 236 (1988)).

190 As a result of the amendments to the Exchange Act enacted by the Litigation Reform Act, plaintiffs now must specify at the outset of litigation precisely which statements are alleged to be misleading and the reasons why they are misleading. *See* § 21D(b)(1)(B) of the Exchange Act.

191 *See* § 11.03[2][b].

192 The Litigation Reform Act requires that plaintiffs plead specific facts "giving rise to a strong inference that the defendant acted with the required state of mind"; conclusory assertions of intent will no longer suffice to survive a motion to dismiss. § 21(D)(b)(2) of the Exchange Act.

193 *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

194 *See, e.g.*, *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970, 977 (9th Cir. 1999) (interpreting the

Litigation Reform Act to require "that the evidence must create a strong inference of, at a minimum, ‘ *deliberate recklessness*'" (emphasis added)); *Citibank, N.A. v. K-H Corp.*, 968 F.2d 1489 (2d Cir. 1992); *Akin v. Q-L Investments, Inc.*, 959 F.2d 521 (5th Cir. 1992); *see also In re Lernout & Hauspie Securities Litigation*, 208 F. Supp. 2d 74 (D. Mass. 2002) (holding that "alleged GAAP violations combined with the magnitude of overstatement of revenue are sufficient to create a strong inference of *scienter* via recklessness").

Although courts generally agree that an allegation of recklessness will suffice under the Litigation Reform Act, the precise definition of the plaintiff's burden remains the subject of a split among the Circuits. The Second Circuit has held that the Litigation Reform Act did not change pre-Act pleading requirements followed in that Circuit. Under those requirements, a plaintiff could satisfy his or her burden by showing that a defendant had either a "motive and opportunity" to commit fraud or "strong circumstantial evidence of conscious misbehavior or recklessness." *See, e.g.*, *Novak v. Kasaks*, 216 F.3d 300 (2d Cir.), *cert. denied*, 531 U.S. 1012 (2000) (discussing plaintiff's burden of pleading *scienter* under the Litigation Reform Act and holding that the Act did not change the pre-existing Second Circuit standard). Although the Third Circuit had agreed with the Second in *In re Advanta Corp. Securities Litigation*, 180 F.3d 525, 534 (3d Cir. 1999), the Third Circuit reversed course in light of the Supreme Court's opinion in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), and held that allegations of motive and opportunity "may no longer serve as an independent route to scienter." *Institutional Investors Group v. Avaya*, 564 F.3d 242, 277 (3d Cir. 2009). This reasoning was based on the Seventh Circuit's approach to the question in *Makor Issues & Rights, Ltd. v. Tellabs*, 437 F.3d 588, 601 (7th Cir. 2006), which the Supreme Court did not address. The Second Circuit has reaffirmed the *Novak* approach even after *Tellabs. See, e.g.*, *ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 198–99 (2d Cir. 2009).

The Ninth and Eleventh Circuits, by contrast, have held that the Litigation Reform Act did not merely codify the Second Circuit's standard, and those courts have held that mere "motive and opportunity" will not satisfy the plaintiff's burden. *In re Silicon Graphics, Inc. Securities Litigation*, 183 F.3d 970 (9th Cir. 1999) (representing the strictest interpretation among the circuits of the Litigation Reform Act's *scienter* pleading standard and concluding that the Act raised the *scienter* pleading standard to now require deliberate recklessness); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1285–86 (11th Cir. 1999); *see also Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1034 n.13 (9th Cir. 2002) (citing cases discussing the standard). *But see No. 84 Employer-Teamster Joint Council Pension Trust Fund v. American West Holding Corp.*, 320 F.3d 920 (9th Cir. 2003) (reinstating a securities fraud case after finding that the plaintiff adequately pled materiality and reliance despite the dissenting judge's comments that the holding improperly lowers plaintiffs' burdens under the Litigation Reform Act). Other courts have followed a case-by-case analysis that may consider a showing of motive and opportunity persuasive, depending on the circumstances of the case. *See, e.g.*, *Ottmann v. Hangar Orthopedic Group, Inc.*, 353 F.3d 338, 343 (4th Cir. 2003); *Florida State Board of Administration v. Green Tree Financial Corp.,* 270 F.3d 645, 659–60 (8th Cir. 2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550–52 (6th Cir. 2001) (*en banc*); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195–96 (1st Cir. 1999).

Plaintiffs in some cases have attempted to plead *scienter* by demonstrating that the defendants made erroneous certifications in connection with the preparation of the company's periodic reports containing financial statements. However, the circuit courts that have considered whether such certifications (required by §§ 302 and 906 of the Sarbanes-Oxley Act) are, by themselves, sufficient to plead *scienter* have uniformly concluded that they are only "probative of *scienter* if the person signing the certification was severely reckless in certifying the accuracy of the financial statements." *Garfield v. NDC Health Corp.*, 466 F.3d 1255 (11th Cir. 2006); *see also Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981 (9th Cir. 2009); *In re Ceridian Corporation Securities Litigation*, 542 F.3d 240 (8th Cir. 2008); *Central Laborers' Pension Fund v. Integrated Electrical Services Inc.*, 497 F.3d 546 (5th Cir. 2007).

195 *See Aaron v. SEC*, 446 U.S. 680, 690, 695 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976).

196 *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977) (quoting *Franke v. Midwestern Oklahoma Development Authority*, 428 F. Supp. 719 (W.D. Okla.

1976)).

197 *See, e.g.*, *In re Daou Systems, Inc.*, 411 F.3d 1006 (9th Cir. 2005) (severe recklessness in which the danger of misleading buyers or sellers is known or should have been known satisfies *scienter)*; *City of Monroe Employees Retirement System v. Bridgestone Corp.*, 399 F.3d 651 (6th Cir. 2005) (strong inference of recklessness by a manufacturer was sufficient to plead *scienter*); *Ferris, Baker Watts, Inc. v. Ernst & Young, LLP*, 395 F.3d 851 (8th Cir. 2005) (*scienter* is satisfied by an extreme departure from standards of ordinary care); *SEC v. U.S. Environmental Inc.,* 114 F. App'x 426 (2d Cir. 2004) (finding that the defendant violated § 10(b) because he knew or should have known of a windfall scheme); *In re Alpharma Inc. Securities Litigation*, 372 F.3d 137 (3d Cir. 2004) (plaintiffs did not sufficiently allege that executives acted recklessly in violation of Rule 10b-5); *Southland Securities Corp. v. INSpire Insurance Solutions, Inc.*, 365 F.3d 353 (5th Cir. 2004) (*scienter* was not established because the plaintiffs could not establish that the company representatives knew or should have known of fraud); *Ottman v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338 (4th Cir. 2003) (recklessness suffices in pleading *scienter* in a § 10(b) claim).

198 *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

199 *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

200 Reliance, however, is not a required element of SEC enforcement actions for violations of Rule 10b-5 under the Exchange Act. *See United States v. Vilar,* 729 F.3d 62, 88–89 (2d Cir. 2013) ("the long-established law of our Circuit, and nearly every other circuit, is that, when the government (as opposed to a private plaintiff) brings a civil or criminal action under Section 10(b) and Rule 10b-5, it need only prove, in addition to scienter, materiality … and not actual reliance").

201 *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 685 (7th Cir.), *cert. denied*, 496 U.S. 906 (1990); *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157 n.1 (2d Cir. 2007).

202 The contrary also is true: When abundant disclaimers and other cautionary language render alleged misstatements or omissions immaterial under the "bespeaks caution" doctrine, *see* § 11.03[1][c], the courts generally consider that reliance on the misstatements or omissions would be unreasonable.

The courts have generally held that it would be inconsistent with § 29(a) of the Exchange Act, which precludes anticipatory waivers of Exchange Act protections such as § 10(b), to find a nonreliance provision to bar, as a matter of law, the assertion of a 10b-5 claim. Instead, a nonreliance provision should be taken into account as one evidentiary factor in determining whether the plaintiff reasonably relied on the accuracy of information provided to it. Whether reliance by the plaintiff was "reasonable" depends on a number of factors, including (i) whether the plaintiff had the opportunity to detect the fraud, (ii) the sophistication of the plaintiff, and (iii) the plaintiff's access to the relevant information. *Staub v. Vaisman and Co., Inc.*, 540 F.2d 591, 598 (3d Cir. 1976). Courts have reached different results in applying this analysis. *Compare AES v. Dow Chemical Co.*, 325 F.3d 175 (3d Cir. 2003) (finding § 29(a) of the Exchange Act precludes contractual waiver of duties imposed by Rule 10b-5; parties had agreed seller had no responsibility for materials furnished in connection with the sale of a business, only with respect to representations and warranties in the purchase and sale agreement and attached exhibits), *and Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966) (stating a party cannot contract to avoid Rule 10b-5 responsibilities because it would defeat the purpose of the Exchange Act and undermine Rule 10b-5 and § 29(a)), *with Harsco v. Segui*, 91 F.3d 337 (2d Cir. 1996) (disclaimer of Rule 10b-5 obligations related to oral representations was effective where the parties explicitly stated in the contract to only be bound by the contract terms because the waiver did not eviscerate the contracting parties' Rule 10b-5 duties). *Cf. Vacold LLC v. Cerami*, 545 F.3d 114, 122 (2d Cir. 2008) (refusing to give effect to contractual language purportedly waiving Rule 10b-5 liability altogether).

203 *Affiliated Ute v. United States*, 406 U.S. 128 (1972).

204 *Affiliated Ute v. United States*, 406 U.S. 128, 153–54 (1972); *see also Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 384 (5th Cir. 2007) ("For us to invoke the Affiliated Ute presumption of reliance on an omission, a plaintiff must (1) allege a case primarily based

on omissions or non-disclosure and (2) demonstrate that the defendant owed him a duty of disclosure."). In *Regents*, the plaintiffs, who were Enron investors, brought Rule 10b-5(a) and (c) claims against certain banks, alleging that the banks had entered into transactions with Enron that allowed Enron to misstate its financial condition. Despite the fact that the plaintiffs made no allegation that the banks owed them a fiduciary duty, the district court held that the *Affiliated Ute* presumption should apply because the bank had a "duty not to engage in a fraudulent 'scheme.'" *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 529 F. Supp. 2d 644, 683 (S.D. Tex. 2006). The Fifth Circuit reversed, holding that the Affiliated Ute presumption does not apply because "where the plaintiffs had no expectation that the banks would provide them with information, there is no reason to expect that the plaintiffs were relying on their candor." *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007).

205 Whether the market for the security was actually "efficient" is a threshold question for a court considering whether to apply this presumption. If the market is not efficient, then the market price cannot be presumed to reflect all material information—including material misinformation—about an issuer and its securities. *See Freeman v. Laventhol & Horwath*, 915 F.2d 193, 198 (6th Cir. 1990). The First Circuit has defined an efficient market as "one in which the market price of the stock *fully reflects all* publicly available information." *In re PolyMedica Corp. Securities Litigation*, 432 F.3d 1 (1st Cir. 2005). In its decision, the First Circuit acknowledged that this can be a difficult determination for a court to make, but further counseled that an efficient market responds "so quickly to new information that ordinary investors cannot make trading profits on the basis of such information." Further, in *Gariety v. Grant Thornton, LLP*, 368 F.3d 356 (4th Cir. 2004), the Fourth Circuit held that a district court cannot certify a class under the "fraud-on-the-market" theory until the court conducts a "rigorous analysis" and finds that the doctrine actually applies. *See also In re American International Group Inc. Securities Litigation*, 265 F.R.D. 157, 181 (S.D.N.Y. 2010) (holding that *In re Initial Public Offering Securities Litigation*, 471 F.3d 24, 42 (2d Cir. 2006), "requires a district court to make a 'definitive assessment'…[regarding the applicability of] the fraud-on-the-market presumption"), *rev'd on other grounds*, 689 F.3d 229 (2d Cir. 2012).

206 The U.S. Supreme Court adopted this "fraud-on-the-market" theory in *Basic, Inc. v. Levinson*, 485 U.S. 224, 243–44 (1988) (selling shareholders satisfied reliance requirement by claim that they sold their shares into a market artificially depressed by Basic's false statements that no merger negotiations were underway).

207 *See, e.g.*, *In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1115–16 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) (no liability under Rule 10b-5 for the defendant's omission because the nondisclosed information had been made available to the market through widespread press reports, so the market price was not affected by the defendant's omission), *overruled on other grounds by Rubke v. Capitol Bancorp*, 551 F.3d 1156 (9th Cir. 2009).

208 *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006).

209 *See Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014).

210 *See Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2417 (2014).

211 *See Erica P. John Fund, Inc. v. Halliburton Co.*, 309 F.R.D. 251 (N.D. Tex. 2015).

212 *See IBEW Local 98 Pension Fund v. Best Buy Co.*, 818 F.3d 775 (8th Cir. 2016).

213 *In re Goldman Sachs Group, Inc. Securities Litigation*, 2015 WL 5613150, at *6 (S.D.N.Y. Sept. 24, 2015); *see also Strougo v. Barclays PLC*, 312 F.R.D. 307, 323–27 (S.D.N.Y. 2016) (holding the defendant did not "me[e]t their burden of proving *lack of* price impact" despite identifying evidence that the securities' prices did not "show a statistically significant increase … on any of the alleged misstatement dates" and that "other factors contributed to the price decline").

214 In the research analyst context, in order to adequately plead loss causation the plaintiff must demonstrate that corrective disclosure regarding the falsity of stock recommendations was the cause of the decline in stock value that the plaintiff claims as his loss. *See Lentell v. Merrill Lynch & Co. Inc.*, 396 F.3d 161 (2d Cir. 2005), *cert. denied*, 546 U.S. 935 (2005) (holding that nonclient investors had failed to establish loss causation in suit against investment bank analysts over allegedly misleading research reports because they did not demonstrate that the loss was both foreseeable and that it was caused by the "materialization of the

concealed risk"); *Swack v. Credit Suisse First Boston*, 230 F.R.D. 250 (D. Mass. 2005) (granting motion for class certification for claims alleging violations of §§ 10(b) and 20(a) of the Exchange Act based on allegedly false and misleading research reports that, in the court's analysis, were tied to the artificial inflation of the price of the company's stock); *DeMarco v. Lehman Bros., Inc.*, 222 F.R.D. 243 (S.D.N.Y. 2004) (denying defendant's motion to dismiss and holding that the plaintiff had sufficiently pled loss causation by alleging that the disclosure of negative information led to stock decline); *In re Merrill Lynch Tyco Research Securities Litigation*, No. 03 CV 4080 (MP), 2004 WL 305809 (S.D.N.Y. Feb. 18, 2004) (granting defendant investment banks' motion to dismiss and holding that the plaintiff-investor failed to adequately plead loss causation because no evidence was proffered to show that statements in an analyst report were the foreseeable cause of a decline in the stock price); *In re Salomon Analyst AT&T Litigation*, 350 F. Supp. 2d 455 (S.D.N.Y. 2004) (holding that plaintiff adequately pled loss causation because he demonstrated not only artificial price inflation but also a "causal chain linking their losses to the alleged fraud"), *vacated on other grounds, In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474 (2d Cir. 2008).

215 *See Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 938 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005) ("[L]oss causation does not require pleading a stock price drop following a corrective disclosure or otherwise. It merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.").

216 *See Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336 (2005).

217 *See Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336 (2005).

218 *See* § 11.05[3][b] for a discussion of the so-called "shingle theory" under which this implied duty to investigate arises.

219 Business diligence generally involves meetings with the issuer's senior management to learn about the business, meeting with the issuer's independent accountants to discuss the issuer's accounts and its internal control systems and review and discussion of the offering document while it is being drafted. In contrast, legal or documentary diligence consists of an all-encompassing review of the corporate and other documents relating to the issuer and its business. Whereas business diligence is designed in large part to facilitate an understanding of the issuer and to determine what disclosure is necessary or appropriate for both marketing and legal reasons, a substantial portion of legal or documentary diligence is undertaken principally for verification purposes, *i.e.*, to establish that there is nothing in the issuer's files to suggest inaccuracies in the offering document or to indicate a need for additional disclosure.

220 *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754–55 (1975). The standing requirement bars three principal groups of potential plaintiffs from suit: (i) potential purchasers, except for those holding a contractual right to purchase the security, (ii) securities holders who allegedly decided not to sell because of some fraud, and (iii) shareholders, creditors and others related to an issuer who suffered loss in the value of their investment due to the alleged fraud. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737–38 (1975).

Additionally, in *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks Corp.*, 369 F.3d 27 (2d Cir. 2004), the Second Circuit effectively added a fourth class to the group of potential plaintiffs that lack the requisite standing under Rule 10b-5. The court held that the shareholders of one company, JDS, did not have standing to sue another company, Nortel, under Rule 10b-5 for material misstatements that affected JDS. Pursuant to *Blue Chip Stamps*, shareholders were barred from pursuing a securities fraud claim against a company of which they were not (or had not been) equity holders. However, Nortel and JDS had a strong business relationship and announced in press releases during early 2001 that they would be engaging in a $2.5 billion asset-for-stock sale (JDS's laser business for Nortel stock). Plaintiffs, who were holders of JDS stock, alleged that Nortel knowingly made materially misleading statements in the press releases that led to a significant loss in revenue for JDS. Nonetheless, the court held that the implied private right of action under Rule 10b-5 is not an unfettered right, but has limitations that are aimed at protecting companies from abusive litigation. The plaintiffs argued that the phrase "in connection with the purchase or sale of *any* security" includes securities of companies affected by the offending company's misrepresentation. The court rejected this expansive construction of Rule 10b-5, reasoning instead that "any security" refers to all types of securities that are owned by (in this case) equity holders and not "*any affected company's* securities."

221 Courts take different approaches to the question whether § 20(a) of the Exchange Act requires a person to exercise, or simply possess, the power to control. *Compare Harrison v. Dean Witter Reynolds, Inc.*, 79 F.3d 609, 614 (7th Cir. 1996) (using a two-part test according to which the plaintiff "must establish, first, that the defendant … actually participated in (*i.e.*, exercised control over) the operations of the corporation in general; then he or she must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he or she need not prove that this later power was exercised") *with Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000) ("[I]n order to prove [as opposed to simply make out] a *prima facie* case under § 20(a), a plaintiff must prove … that the defendant exercised actual power or control over the primary violator.…"). The Second Circuit's standard, which simply requires the plaintiff to show "control of the primary violator by the plaintiff," *Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1990), has been interpreted by one district court not to require proof that control was exercised. *See Dietrich v. Bauer*, 126 F. Supp. 2d 759 (S.D.N.Y. 2001).

In addition, all of the circuit courts to consider directly the issue have held that the group pleading doctrine has not survived the enactment of the Litigation Reform Act. Under the court-created doctrine, group published information, such as annual reports and press releases, are attributable to the officers and directors with day-to-day control in the company, regardless of their participation in the actual documents. *Winer Family Trust v. Queen*, 503 F.3d 319 (3d Cir. 2007); *Financial Acquisition Partners, L.P. v. Blackwell*, 440 F.3d 278, 287 (5th Cir. 2006); *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602–03 (7th Cir. 2006), *vacated on other grounds*, *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308 (2007). These courts have held that the presumption created by the group pleading doctrine is inconsistent with the heightened pleading standards of the Litigation Reform Act. Despite these rulings, the group pleading doctrine continues to survive in some districts. *See Loreley Financing (Jersey) No. 3 Ltd. v. Wells Fargo Securities, LLC*, 797 F.3d 160, 172 n.7 (2d Cir. 2015) (recognizing that "numerous district courts in our Circuit" have concluded that the doctrine remains viable after the Reform Act, but declining to resolve the issue).

222 § 20(a) of the Exchange Act. Courts are split over whether the plaintiff has the burden of proving culpable participation or whether the defendant has the burden of proving good faith. *Compare Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000) (the plaintiff does not have the burden of proof; the defendant may assert a good faith defense) *with SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (the plaintiff must "show that the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person," and the burden only shifts to the defendant once the plaintiff has made out a *prima facie* case (internal quotation marks and citation omitted)).

223 *See In re Adelphia Communications Corp. Securities & Derivative Litigation*, 398 F. Supp. 2d 244, 261–62 (S.D.N.Y. 2005) (citing *In re Scholastic Corp. Securities Litigation*, 252 F.3d 63, 72 (2d Cir. 2001)).

224 The SEC's authority to pursue aiders and abettors was codified explicitly in § 104 of the Litigation Reform Act, which amended § 20 of the Exchange Act to provide that the SEC could bring an action against "any person that knowingly provides substantial assistance" to a primary violator of the securities laws. In response to several decisions holding that secondary actors could only be liable for aiding and abetting securities fraud to the extent that they had actual knowledge of the fraud, the Dodd-Frank Act further amended § 20 of the Exchange Act to cover persons who either "knowingly or recklessly" provide substantial assistance to primary violators of the securities laws. *See* § 929O of the Dodd-Frank Act.

225 *See* Stephen M. Cutler, then-Director of SEC Enforcement, The Themes of Sarbanes-Oxley as Reflected in the SEC's Enforcement Program (Sept. 20, 2004); *SEC v. Steckler*, SEC Litigation Release No. 19385 (Sept. 21, 2005). In one demonstration of the Division of Enforcement's increased use of aiding and abetting charges against "enablers," the SEC has filed aiding and abetting actions against 30 individuals who allegedly assisted U.S. Foodservice, Inc. (a subsidiary of Royal Ahold) in a scheme to overstate

revenues by as much as $700 million. The complaints against these individuals, who were vendors who supplied U.S. Foodservice, allege that they assisted the fraudulent scheme by submitting false confirmation letters to the company's auditors. *See SEC Charges Seven Individuals with Aiding and Abetting Financial Fraud at Royal Ahold's U.S. Foodservice Subsidiary for Signing and Returning False Audit Confirmations*, SEC Litigation Release No. 19454 (Nov. 2, 2005); *Nine Individuals Charged by the Securities and Exchange Commission with Aiding and Abetting Financial Fraud at Royal Ahold's U.S. Foodservice Subsidiary for Signing and Returning False Audit Confirmations*, SEC Litigation Release No. 19034 (Jan. 13, 2005). As part of a $22 million settlement agreement, the SEC found that KPMG LLP caused and willfully aided and abetted Xerox Corp.'s fraud, reporting and recordkeeping violations. *SEC v. KPMG LLP*, SEC Litigation Release No. 19191 (Apr. 19, 2005). Time Warner Inc. agreed to a $300 million penalty to settle charges by the SEC of fraud and aiding and abetting fraud by others in connection with its use of fraudulent "round-trip" transactions that boosted its online advertising revenue. *SEC v. Time Warner Inc.*, SEC Litigation Release No. 19147 (Mar. 21, 2005). J.P. Morgan Chase & Co. settled charges by the SEC for $135 million that it aided and abetted Enron's manipulation of its reported financial results through a series of complex structured financing transactions called "prepays." *SEC v. J.P. Morgan Chase & Co.*, SEC Litigation Release No. 18252 (July 28, 2003). Citigroup Inc. also paid $120 million to settle similar charges brought by the SEC that it aided and abetted violations by Enron and Dynegy Inc. *In re Citigroup*, SEC Admin. Proc. 3-11192 (July 28, 2003).

226 *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 178, 190–92 (1994).

227 *See, e.g.*, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576–77 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991) (pre- *Central Bank v. First Interstate Bank* case holding that the control person provision of the Exchange Act was "intended to supplement, not to supplant, the common law theory of ' *respondeat superior*' as a basis for vicarious liability in securities cases").

228 *Compare In re Parmalat Securities Litigation*, 594 F. Supp. 2d 444, 450 (S.D.N.Y. 2009); *Seolas v. Bilzerian*, 951 F. Supp. 978 (D. Utah 1997), and *Pollack v. Laidlaw Holdings*, *Inc.*, Fed. Sec. L. Rep. (CCH) ¶98,741 (S.D.N.Y. May 3, 1995) (holding that *respondeat superior* theory survives *Central Bank v. First Interstate Bank*), *with In re Prudential Insurance Co.*, 975 F. Supp. 584 (D.N.J. 1996), *ESI Montgomery County, Inc. v. Montenay International Corp.*, Fed. Sec. L. Rep. (CCH) ¶99,345 (S.D.N.Y. Jan. 23, 1996), and *Pitten v. Jacobs*, 903 F. Supp. 937, 950 (D.S.C. 1995) (holding that *Central Bank v. First Interstate Bank's* elimination of private aiding and abetting suits also eliminated private actions for *respondeat superior*).

Courts have also reached differing conclusions on the related question of whether the fraudulent intent of an employee acting for his own benefit can be attributed to his employer. Some courts have applied the common law adverse interest exception to prevent imputation of *scienter* under those circumstances. *See, e.g.*, *Kaplan v. Utilicorp United, Inc.*, 9 F.3d 405, 407 (5th Cir. 1993) ("the knowledge and actions of employees acting adversely to the corporate employer cannot be imputed to the corporation"). The Ninth Circuit, however, has cast doubt on whether the adverse interest exception is viable in securities litigation, by concluding that an employer cannot benefit from the exception when facing claims filed by an innocent third-party investor. *In re ChinaCast Education Corporation Securities Litigation*, 809 F.3d 471 (9th Cir. 2015).

229 *See In re Alstom SA Securities Litigation*, 454 F. Supp. 2d 187, 213–16 (S.D.N.Y. 2006). In *Alstom*, plaintiffs brought securities law claims against Alstom S.A. and several of its subsidiaries based on an alleged accounting fraud and related misleading public statements. The plaintiffs argued that the corporate parent should be liable for the acts of its subsidiaries under a *respondeat superior* or agency theory, but the court decided that it did not need to reach these arguments. Instead, the court found that the plaintiffs had pled facts to support a veil-piercing theory of liability based on the allegations of dominion and control exercised by the parent over its subsidiaries. *See also In re Parmalat Securities Litigation*, 375 F. Supp. 2d 278 (S.D.N.Y. 2005) (allowing plaintiffs to proceed under agency theory of liability).

230 *Stoneridge Investment v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

231 The provisions of Rule 10b-5(a) and (c) state, in relevant part, that it is unlawful for "any person, directly or indirectly …(a) to *employ any device, scheme, or artifice to defraud*… or (c) to *engage in any act, practice or course of business which would operate as a fraud or deceit* upon any person, in connection with the purchase or sale of any security." Rule 10b-5 under the Exchange Act (emphasis added); *see, e.g.*, *In re Enron Securities, Derivatives & ERISA Litigation*, 439 F. Supp. 2d 692 (S.D. Tex. 2006) (dismissing claims brought under Rule 10b-5(a) and (c)); *In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005) (rejecting defendants' argument that Rule 10b-5(a) and (c) can only apply to "manipulative" acts and holding that these subsections only require the plaintiff to plead that a defendant's specific deceptive act was part of a scheme that had an effect on the plaintiff-investors); *In re AOL Time Warner, Inc. Securities & ERISA Litigation*, 381 F. Supp. 2d 192 (S.D.N.Y. 2004) (allowing plaintiff to proceed under Rule 10b-5(a) and (c)); *Cooper v. Pickett*, 137 F.3d 616 (9th Cir. 1997) (reversing district court's dismissal of complaint, holding that *Central Bank* does not preclude secondary actor liability for participation in a fraudulent scheme); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398 (N.D. Cal. 1995) (refusing to dismiss suit pursuant to Rule 10b-5(c) against accountants for their involvement in misrepresentations made by issuer).

232 The early trend, in which courts were reluctant to grant summary judgment in favor of defendants facing "scheme" allegations, is typified by *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 581–688 (S.D. Tex. 2002) ("*Enron I*"). The court refused to dismiss claims against lawyers, accountants and financial institutions and adopted the position taken by the SEC in its *Amicus Curiae* brief that secondary actors can be held liable as primary violators if they create a misrepresentation, for example, by writing documents or portions of documents containing misrepresentations that will be given to investors. The court held that *Central Bank's* preclusion of aider and abettor liability did not shield all secondary actors from liability, particularly given the broader provisions of Rule 10b-5(a) and (c). *See also Pioneer Insurance Co. v. Chase Securities*, 2002 U.S. Dist. LEXIS 7562 (N.D. Okla. Mar. 28, 2002) (adopting report and recommendation of the magistrate judge that a law firm could be a primary violator if its negative assurance letters, which were addressed to investors, contained misrepresentations); *In re Lernout & Hauspie Securities Litigation*, 208 F. Supp. 2d 74 (D. Mass. 2002) (holding that Belgian auditor's drafting, signing and publication of clean audit report included in corporate filings with the SEC was sufficient to trigger primary liability when those filings were "rife with false and misleading information"); *see also In re Parmalat Securities Litigation*, 376 F. Supp. 2d 472 (S.D.N.Y. 2005) (denying a motion to dismiss 10b-5(a) and (c) claims).

More recent decisions have suggested that these earlier decisions improperly exposed secondary actors to liability for conduct that amounted to no more than aiding and abetting. In fact, in one of these more recent decisions, the same district court that denied a defendant's motion for summary judgment in *Enron I* noted that the case law and legal standards had evolved in the intervening years. *See In re Enron Securities, Derivative & ERISA Litigation*, 439 F. Supp. 2d 692 (S.D. Tex. 2006). Here, the court granted defendant's motion and dismissed Rule 10b-5(a) and (c) claims against a secondary actor (here, a bank that had been a counterparty to various transactions that Enron had used to misstate its financial condition). In fact, the court explicitly repudiated its ruling in *Enron I* insofar as that ruling would permit securities fraud claims to be brought against those who only aid and abet the fraud. The court distinguished between secondary actors who are counterparties to economically substantive transactions with primary violators (even if the transactions may become "deceptive" because of the way the primary violator characterizes or discloses them) and parties who engage in inherently deceptive conduct.

233 *Stoneridge Investment v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 161 (2008).

234 *Stoneridge Investment v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 161 (2008).

235 *See In re DVI, Inc. Securities Litigation*, 639 F.3d 623, 648–49 (3d Cir. 2011) (holding, in a "decision … guided by *Stoneridge*," "that a plaintiff cannot invoke the fraud-on-the-market presumption of reliance in a private action under Rule 10b-5(a) and (c) unless the deceptive conduct has been publicly disclosed and attributed to the actor"); *Affco Investments 2001, L.L.C. v. Proskauer Rose, L.L.P.*, 625 F.3d 185, 193–195 (5th Cir. 2010) (concluding, after analyzing *Stoneridge*, that "explicit attribution is required to show reliance under section 10(b)"); *Pacific Investment Management Co. LLC v. Mayer Brown LLP*, 603 F.3d 144, 152–

58 (2d Cir. 2010) (reaffirming prior "attribution" standard as "consistent with *Stoneridge*").

236 *Janus Capital Group, Inc. v. First Derivative Trader*, 131 S. Ct. 2296 (2011).

237 *Janus Capital Group, Inc. v. First Derivative Trader*, 131 S. Ct. 2296, 2302 (2011).

238 *Compare In re Fannie Mae 2008 Securities Litigation*, 891 F. Supp. 2d 458, 484 (S.D.N.Y. 2012), *aff'd*, 525 F. App'x 16 (2d Cir. 2013) (holding underwriter did not "make" alleged misstatements in the offering materials under Janus because "[a]ny role [the underwriter] served in the drafting process, or in preparing and publishing the offering materials, is insufficient to impose primary liability under Janus" and "it is absolutely clear that [the issuer], not [the underwriter], had ultimate authority over statements made in its SEC filings incorporated by reference in the offering materials") with *In re Puda Coal Securities Inc., Litigation*, 30 F. Supp. 3d 261, 267 (S.D.N.Y. 2014) (holding underwriters could be liable under Janus based on allegations they "actively participated in creating" the prospectus and "draft[ed] it jointly with [the issuer's] management," had a formal agreement with the issuer requiring the prospectus to be "in a form approved by" the underwriter, and "communicated their involvement with the prospectus to the investing public" by prominently displaying their names on the prospectus, soliciting investors for the offering and distributing the prospectus).

239 *Compare Glickenhaus & Co. v. Household International Inc.*, 787 F.3d 408, 425 (7th Cir. 2015) ("[n]othing in Janus limits its holding to legally independent third parties" and "[t]he Court's interpretation [in Janus] applies generally, not just to corporate outsiders") with *City of Pontiac General Employees' Retirement System v. Lockheed Martin Corp*., 875 F. Supp. 2d 359, 374 (S.D.N.Y. 2012) (stating *Janus* "addressed only whether third parties can be held liable for statements made by their clients … and has no bearing on how corporate officers who work together in the same entity can be held jointly responsible on a theory of primary liability").

240 The plaintiff also may seek to rescind the contract or defend against an action by the other party for the contract's enforcement. *See* § 29(b) of the Exchange Act (contracts made in violation of the Exchange Act are voidable under certain conditions); *Aimis Art Corp. v. Northern Trust Securities, Inc.*, 641 F. Supp. 2d 314, 319 (S.D.N.Y. 2009) (noting that "appropriate grounds for damages in § 10(b) actions are not limitless, and courts have required plaintiffs to choose between rescinding a transaction and being paid restitution on the one hand and holding the defrauder to the bargain and recovering out-of-pocket losses resulting from the fraudulent transaction on the other hand" (citation omitted)); *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 558 (5th Cir. 1982).

241 In *Acticon AG v. China North East Petroleum Holdings Ltd.*, 692 F.3d 34 (2d Cir. 2012), the Second Circuit held that a plaintiff's out-of-pocket losses under Rule 10b-5 are not eliminated where the share price rebounds to the plaintiff's purchase price after the final alleged corrective disclosure. The court indicated, however, that any price recovery that represented the market's reactions to the disclosure of the alleged fraud, rather than an unrelated gain, could offset the plaintiff's recoverable loss.

242 *See, e.g.*, *Ohio Public Employees Retirement System v. Federal Home Loan Mortgage Corp.*, 830 F.3d 376 (6th Cir. 2016) (collecting cases). In the securities litigation against BP arising out of the 2010 Deepwater Horizon oil spill, however, the Fifth Circuit held that such materialization of the risk damages could only be awarded to a plaintiff who would not have purchased the relevant security had it known the true nature of the allegedly concealed risk. *See Ludlow v. BP, P.L.C.*, 800 F.3d 674, 690 (5th Cir. 2015). The plaintiffs in that case alleged that BP misstated the efficacy of its safety procedures, which created an impression that the risk of a spill was lower than it actually was, and that this concealed risk materialized when the later spill occurred. The plaintiffs sought damages based on the price declines caused by the spill itself, notwithstanding that the inflation on the dates that they purchased securities only reflected the increased risk of a spill and not the full materialization of that risk. Without addressing the viability of the materialization of the risk measure of damages in general, the Fifth Circuit reasoned that full materialization of the risk damages "would prove a windfall" for an investor who "might have purchased the stock even assuming the true risk," since such an investor would have suffered the same eventual loss had they purchased at a lower price. Instead, the Fifth Circuit held that the appropriate damages measure for such

an investor is "based on the inflated price she paid." The Fifth Circuit thus limited full materialization of the risk damages to investors who would not have purchased the security at all had they known the true risk, in order to compensate them for the materialization of a risk that they otherwise would not have taken.

243 For example, one court has stated that damages based on the gross economic loss in the value of the plaintiff's stock portfolio over the period in which the fraud was perpetrated should be reduced by the average percentage decline in the Standard & Poor's Index or some other well-recognized index, since the defendant should have "no general responsibility for the general decline in economic conditions." *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 49 n.22 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). Another court has approved the jury's valuation of the stock absent the fraud (the issuer's overvaluation of inventory and sales) based on expert testimony, although the "actual response of the market" following the disclosure must be taken into account. *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 577–78 (2d Cir.), *cert. denied*, 459 U.S. 838 (1982). The Seventh Circuit, however, has held that a plaintiff can recover all of the company-specific securities price declines over an extended period of time under a so-called "leakage theory" if its expert "testifies that no firm-specific, nonfraud related information contributed to the decline in stock price during the relevant time period and explains in nonconclusory terms the basis for this opinion." *Glickenhaus & Co. v. Household International, Inc.*, 787 F.3d 408, 422 (7th Cir. 2015).

244 § 21D(e)(1) of the Exchange Act. This provision only limits damages; it does not provide an alternate formulation for calculating damages.

245 *See* § 21D(e) of the Exchange Act. *See generally* Lewis D. Lowenfals & Alan R. Bromberg, *Compensatory Damages in Rule 10b-5 Actions: Pragmatic Justice or Chaos?*, 30 SETON HALL L. REV. 1083, 1113 (2000) ("This allowance for a 'bounce back' in price should yield a more accurate and fairer estimate of the stock's true value and therefore a more accurate measure of the deviation from this true value and the resulting damages caused by the fraud.").

246 *See* § 21D(f)(2) of the Exchange Act. Defendants who settle an action under the Exchange Act are insulated from contribution claims by nonsettling defendants, and nonsettling defendants receive a credit against any adverse judgment at trial for the greater of the amount of any settlements or the percentage of responsibility of the settling defendants. The system of proportionate liability should reduce the exposure of defendants, such as accounting firms, that frequently play relatively insignificant roles in the issuer's misdeeds, but historically risked verdicts in the full amount of the plaintiff's recoverable damages, subject only to the right to seek contribution.

247 *See* § 21(d)(1) and (2) of the Exchange Act.

248 *See* § 21(d)(3) of the Exchange Act; SEC Release No. 33-10104 (June 27, 2016). The SEC, however, has imposed substantial civil penalties on companies and individuals for fraud violations. *See, e.g.*, *SEC v. WorldCom Inc.*, SEC Litigation Release No. 18219 (July 7, 2003) (fining WorldCom Inc. $2.25 billion); Press Release, SEC, SEC and U.S. Attorney Settle Massive Financial Fraud Case Against Adelphia and Rigas Family for $715 Million (Apr. 25, 2005); *SEC v. Time Warner Inc.*, SEC Litigation Release No. 19147 (Mar. 21, 2005) (fining Time Warner Inc. $300 million).

249 *See* § 32(a) of the Exchange Act.

250 *See SEC v. Rind*, 991 F.2d 1486, 1491–92 (9th Cir.), *cert. denied*, 510 U.S. 963 (1993) (reasoning that SEC actions serve the public purpose of deterring wrongdoing, rather than the private purpose of compensating individuals for their losses). However, the SEC is still subject to a five-year statute of limitations for the enforcement of "any civil fine, penalty or forfeiture, pecuniary or otherwise." *See* 28 U.S.C. § 2462; *see also* § 11.09[2][d].

251 28 U.S.C. § 1658(b). Prior to the adoption of the Sarbanes-Oxley Act, private actions were required to be commenced within one year of the discovery of the violation but no later than three years after its occurrence. *See Lampf, Pleva, Lifkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

252 *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784 (2010).

253 *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784, 1798 (2010). Courts have reached different conclusions concerning whether *Merck's* rejection of an "inquiry notice" approach applies equally to the separate statute

of limitations applicable to claims under §§ 11 and 12(a)(2) of the Securities Act. *Compare Pension Trust Fund for Operating Engineers v. Mortgage Asset Securitization Transactions, Inc.*, 730 F.3d 263 (3d Cir. 2013) (applying *Merck* to claims under the Securities Act) *with Lighthouse Financial Group v. Royal Bank of Scotland Group*, PLC, 902 F. Supp. 2d 329 (S.D.N.Y. 2012) (declining to apply *Merck* to claims under the Securities Act).

254 § 21D(b)(2) of the Exchange Act.

255 *Merck & Co., Inc. v. Reynolds*, 130 S. Ct. 1784, 1796 (2010) (citation omitted).

256 *See City of Pontiac General Employees' Retirement System v. MBIA, Inc.*, 637 F.3d 169 (2d Cir. 2011).

257 Section 17(a) of the Exchange Act provides that it is "unlawful for any person in the offer or sale of any securities" to: (i) "employ any device, scheme, or artifice to defraud," (ii) "obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," or (iii) "engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

258 *See United States v. Naftalin*, 441 U.S. 768, 778 (1979).

259 The section differs from Rule 10b-5 in two potentially significant respects. First, it applies only to the "offer or sale" of a security, rather than the purchase or sale. Second, its reference to "offers" as well as "sales" might be read to reach "offerees" in addition to actual purchasers, as required by Rule 10b-5.

260 The sole exception is an action under § 17(a)(1), prohibiting the use of any device, scheme or artifice to defraud, which does require proof of *scienter. See Aaron v. SEC*, 446 U.S. 680, 695–96 (1980).

261 *See, e.g.*, *Maldonado v. Dominguez*, 137 F.3d 1, 7 (1st Cir. 1998); *Finkel v. Stratton Corp.*, 962 F.2d 169, 175 (2d Cir. 1992); *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990); *Newcome v. Esrey*, 862 F.2d 1099, 1107 (4th Cir. 1988); *In re Washington Public Power Supply Systems Securities Litigation*, 823 F.2d 1349, 1358 (9th Cir. 1987); *Brannan v. Eisenstein*, 804 F.2d 1041, 1043 n.1 (8th Cir. 1986); *Landry v. All American Assurance Co.*, 688 F.2d 381, 391 (5th Cir. 1982). The only exception is the Sixth Circuit, which has found § 17(a) to imply a private right of action for purchasers. *See Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 492 (6th Cir. 1990). The Supreme Court has never addressed the issue. *See Aaron v. SEC*, 446 U.S. 680, 689 (1980).

262 Among other things, the SEC has the authority to seek to enjoin any person who violated the antifraud provisions of § 17(a)(1) of the Securities Act from acting as an officer or director of a public company. *See* § 20(e) of the Securities Act.

263 *See* §§ 11.02[3] and 11.03[6]; *see also* § 101(2) of the Uniform Securities Act (proscribing fraudulent acts and incomplete or misleading disclosure in connection with the offer, sale or purchase of "any security, directly or indirectly"). Although some courts had interpreted New York's "blue sky" law, which does not provide a private right of action, as preempting all private common law claims alleging non-intentional misstatements or omissions in the sale of securities, *see, e.g.*, *Castellano v. Young & Rubicam*, 257 F.3d 171 (2d Cir. 2001), the New York Court of Appeals has since held that such claims are not preempted. *See Assured Guaranty (UK) Limited v. J.P. Morgan Investment Management Inc.*, 18 N.Y.3d 341 (2011).

264 Pursuant to SLUSA, most securities fraud class actions can no longer be based on state law. *See* § 11.09[1][a].

U.S. Regulation of the International Securities and Derivatives Markets, § 11.05, LIABILITIES CONNECTED WITH SECONDARY MARKET TRANSACTIONS

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 § 11.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The U.S. securities laws closely regulate a number of different aspects of the secondary market for securities and provide a range of civil, administrative and criminal penalties for market participants who violate federal law. In addition to proscribing false or misleading disclosure in connection with secondary market transactions, as discussed below in § 11.05[1], the securities laws also prohibit trading in securities, in breach of certain fiduciary or similar duties, while knowingly in possession of material nonpublic information ("insider trading"), as well as other types of market conduct aimed at or with the effect of manipulating the price of securities on or off of a national securities exchange. These issues are examined in § 11.05[2] and [3], respectively. Finally, § 11.05[3] also addresses special standards of conduct that have been carved out by the SEC and the courts for broker-dealers and investment advisers as a means of enhancing customer protection under the securities laws.

[1] Disclosure Violations

Liabilities can arise in connection with disclosure in secondary market transactions in a number of situations. First, broker-dealers and other trading participants may be liable for material misstatements or omissions in connection with everyday resales of securities, such as oral misrepresentations about the quality of a security or events likely to affect its value. Second, broker-dealers may be liable for misstatements about securities made prior to a trade, for

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example in research reports circulated to customers. Finally, issuers may be liable for material misstatements or omissions in company filings or press releases.

The statutory provisions from which these liabilities may arise, § 17(a) of the Securities Act and §§ 10(b) and 18 of the Exchange Act, are discussed below.

[a] Securities Act § 17(a)

First, § 17(a) of the Securities Act applies to secondary market offers and sales as well as primary offerings (public or private). As discussed in § 11.04[3], § 17(a) bars conduct by the seller intended to defraud, or with the effect of defrauding, others in the offer or sale of any securities, including but not limited to the making of false statements and material omissions. Disclosure violations under § 17(a) may generally be proved without demonstrating the defendant's *scienter*, but almost all courts have held that enforcement actions are reserved to the SEC and that there is no private right of action under § 17(a) of the Securities Act. [265]

[b] Exchange Act § 10(b) and Rule 10b-5

Liability for deficient disclosure in secondary transactions may also attach by virtue of § 10(b) of the Exchange Act and Rule 10b-5 thereunder, and the vast majority of litigation involving disclosure issues in the secondary markets has been brought under this Rule. [266] This catch-all antifraud provision has been widely used by private parties and the SEC alike as a remedy for misstatements and material omissions, both written and oral, in connection with purchases and sales of securities. [267] As discussed in § 11.04[2][b], there is no privity

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requirement in Rule 10b-5 actions. Thus, a plaintiff is not limited to suing the purchaser or seller with whom he or she dealt. The plaintiff must demonstrate, among other things, that the defendant acted intentionally or recklessly and the plaintiff relied to its detriment on the defendant's actions, although the latter showing has been eased significantly by certain presumptions (such as the "fraud-on-the-market-theory," discussed above) adopted by the courts. A more detailed discussion of Rule 10b-5, including the elements of a claim, the parties who may be liable and the remedies available, is included in § 11.04[2].

[c] Exchange Act § 18

In addition to the implied right of action under Rule 10b-5 for defective disclosure in almost any form, the Exchange Act includes a narrower, but express, right of action for false or misleading statements or omissions [268] in certain applications, reports or documents filed pursuant to the Exchange Act or its associated rules, whether filed with the SEC or with a national securities exchange. [269] As explained in § 4.02, the Exchange Act compels initial

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registration and periodic reporting obligations for many companies, domestic and foreign, [270] including such common filings as annual reports on Form 10-K for U.S. issuers and annual reports on Form 20-F for non-U.S. issuers. The Exchange Act also imposes reporting obligations when a party's voting equity ownership of a public company exceeds 5%. [271]

Under § 18 of the Exchange Act, any person who buys or sells securities in reliance on misstatements or omissions in filed documents may bring a claim against any person responsible for those statements; there is no requirement of privity between plaintiff and defendant. Recovery under § 18 is difficult, however, because although the plaintiff need not prove the defendant's *scienter* to establish a claim (as it must under Rule 10b-5), it must demonstrate that it actually relied on the misstatement or omission. The "fraud-on-the-market" presumption of reliance in Rule 10b-5 litigation, discussed in § 11.04[2][a], has not been extended to claims under § 18. [272] The plaintiff must also show that the price at which it purchased or sold was affected by the defendant's misstatement or omission, and that its loss was caused by such misstatement or omission. Finally, the plaintiff must establish that it did not know of the misstatement or omission at the time it purchased or sold the securities. [273]

The claim is made even more difficult by the availability to the defendant of an affirmative defense against liability, if it can show it acted in good faith and without knowledge of the material misstatement or omission. [274] To rebut this

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defense, the plaintiff in effect may be required to make at least some showing that the defendant acted with *scienter*.

Because of the difficulties in establishing a § 18 claim, the provision is rarely used. [275] Rather, plaintiffs generally opt to pursue their remedy under Rule 10b-5, which remains available to them for disclosure deficiencies in filed documents despite the existence of an express cause of action under § 18. [276] The growth of litigation under Rule 10b-5 and the paucity of cases under § 18 illustrate how U.S. courts have implied statutory rights if express rights prove ineffective, especially in the context of claims for fraud.

[2] Insider Trading

The Exchange Act provides tough sanctions for those guilty of "insider trading," the purchase or sale of securities by certain persons while knowingly in possession of material nonpublic information relating to those securities. Like many other provisions of the U.S. securities laws, the prohibition against insider trading extends to non-U.S. persons trading in U.S. markets, even in the securities of non-U.S. issuers. [277] The SEC and the courts also have made clear that liability extends beyond those who directly trade while possessing material nonpublic information to those who disclose such information to others ("tippers") and in some instances to the recipients of their disclosure ("tippees"). These three categories of potential offenders are discussed in § 11.05[2][a]. Two enforcement provisions, which authorize civil actions by contemporaneous traders and stiff penalties in actions by the SEC, are examined in § 11.05[2][b] and [c], respectively.

[a] Exchange Act § 10(b) and Rule 10b-5

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[i] *Liability of Traders*

A party who trades on material nonpublic information may be liable under certain circumstances under § 10(b) of the Exchange Act and Rule 10b-5 thereunder, which proscribe fraudulent and manipulative conduct in general. [278] In 2000, Congress amended § 10(b) to clarify that insider-trading rules cover trading not just in garden-variety securities, but also in "securities-based swap agreements.…" [279]

An unsettled issue in insider trading law has been what, if any, causal connection must be shown between the trader's possession of inside information and

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his or her trading. The SEC has argued that trading while in "knowing possession" of the information creates liability. The contrary view is that for liability to attach a trader must be shown to have "used" the information for trading.

The Supreme Court has variously described an insider's violations as trading "on" or "on the basis of" material nonpublic information, but has not addressed the use/possession distinction. In recent years, three courts of appeals have addressed the issue, each reaching different results. In *United States v. Teicher*, [280] the Second Circuit suggested that "knowing possession" is sufficient to trigger insider trading liability. In *SEC v. Adler*, [281] the Eleventh Circuit held that in civil enforcement proceedings, the government may rely on a "strong inference" that one who traded while in possession of material nonpublic information actually used such information, and the trader can then attempt to rebut that inference by adducing evidence that the information was not used. Finally, in *United States v. Smith*, [282] the Ninth Circuit held that, in a criminal case, the government must prove that the suspected insider trader actually used material nonpublic information in deciding whether to buy or sell.

In 2000, the SEC adopted Rule 10b5-1, which is designed to address this unsettled issue. [283] Adopting an approach similar to the *Adler* decision, the Rule states the general principle that insider trading liability arises when a person trades while "aware" of material nonpublic information, but also provides two affirmative defenses to liability in circumstances where it is clear that a trade was not made "on the basis of" the material nonpublic information. The first affirmative defense applies if:

- a person had, before becoming aware of material nonpublic information, (i) entered into a binding contract to purchase or sell, (ii) provided instructions to another person to purchase or sell for the instructing person or (iii) adopted a written plan for trading;
- the contract, instruction or plan (i) specified the amount of, price of, and date on which the securities were to be purchased or sold, (ii) provided a written formula or computer program for determining the amount of, price of and date on which the securities were to be purchased or sold or (iii) did not permit the person to exercise any subsequent influence over how, when or whether to effect purchases or sales, and no person exercising such influence was aware of the material nonpublic information when doing so; and

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- the purchase or sale occurred pursuant to the contract, instruction or plan. [284]

This defense would only be available if the contract, instruction or plan was entered into in good faith and not as part of a plan or scheme to evade Rule 10b5-1.

In the wake of scandals involving the back-dating of corporate executives' stock options, Linda Chatman Thomsen, then Director of the SEC's Division of Enforcement, indicated that the SEC would begin looking more closely at trading conducted under plans pursuant to Rule 10b5-1. [285] These comments were prompted by two studies that Thomsen said suggested that "the Rule is being abused" by executives whose Rule 10b5-1 trades are outperforming "control" trades by executives who are not trading under 10b5-1 plans. [286] Calls for the SEC to review 10b5-1 plans have persisted over time in light of the perceived abuse of such plans. [287]

Rule 10b5-1 also provides a separate affirmative defense for entities. This defense, similar to an insider trading defense already available to entities such as broker-dealers in other contexts but not limited to such entities, would be available to an entity that can show that the individual making a decision to trade on behalf of the entity was not aware of the material nonpublic information and that the entity had implemented reasonable policies and procedures, such as information barriers and restricted lists, to prevent insider trading.

In construing whether any particular insider trading conduct is fraudulent under Rule 10b-5, the courts have adopted two theories, [288] each predicated on a

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breach of a duty owed by the defendant by reason of a fiduciary or similar relationship of trust and confidence. Unlike the rules dealing with insider trading in some non-U.S. jurisdictions, including the European Union, a duty to abstain from trading does not arise under Rule 10b-5 from mere possession of material nonpublic information. [289]

The first general theory of liability is that certain insiders of a corporation—directors, officers and key employees—owe a fiduciary duty to the corporation's current and prospective shareholders. [290] That duty is breached when they buy or sell the corporation's securities while knowingly in possession of material nonpublic information. [291] Insiders therefore have a duty to disclose the information or to abstain from trading. [292] Although directors and officers of the corporation whose securities are traded are always insiders, temporary insider status has been accorded to persons such as underwriters, lawyers, accountants and financial advisers who gain access to material nonpublic information in the conduct of the corporation's business, if there is an expectation that the information disclosed to them will be kept confidential. [293]

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Such temporary insiders must also refrain from trading in the absence of disclosure. [294]

The second theory of insider trading liability is one of misappropriation. This theory, which was upheld by the Supreme Court in *United States v. O'Hagan*, [295] "protects the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders." [296] Under the misappropriation theory, a person violates Rule 10b-5 when he or she misappropriates material nonpublic information in breach of a fiduciary or similar relationship of trust and confidence with the person (who may not be the issuer or anyone connected with the issuer) who entrusted him or her with the information, and uses that information, without disclosing such use to the source, for his or her personal benefit in a securities transaction. The "predicate act of fraud may be perpetrated on the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities." [297] Under the misappropriation theory, the courts have found violations of Rule 10b-5 based upon a financial columnist's breach of duty to his newspaper, [298] a copyholder's breach of duty to his employer printing company, [299] an investment banker's breach of duty to his firm, [300] an attorney's breach of duty to his law firm, [301] a wife's breach of "trust and confidence" to her husband [302] and even a psychiatrist's breach of duty to his patient. [303]

A settled insider trading action brought by the SEC against Barclays Bank PLC demonstrates some of the issues that financial institutions must consider in light of their multiple relationships with their clients and customers. [304] In *Barclays*, the bank obtained material nonpublic information about various distressed

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corporations by virtue of its participation in the corporations' creditors' committees. As a commercial lender to the corporations, the bank learned information about the debtors subject to either express or implied promises of confidentiality. As is common, Barclays also traded in the securities of some of these corporations. The SEC's settlement with Barclays suggests that the bank failed to create and enforce adequate information barriers between the individuals who served on the creditors' committees and the individuals who engaged in the securities trading. [305]

Overall, however, the question of what circumstances give rise to the duty of trust or confidence in nonbusiness relationships has remained unsettled. In an effort to clarify this matter, the SEC promulgated Rule 10b5-2 under the Exchange Act, [306] which contains a "nonexclusive list of three situations in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory." [307] The first situation exists when a person has agreed to keep information confidential. The second circumstance is one in which the overall relationship between two persons, taking into consideration their "history, pattern, or practice of sharing confidences," [308] gives rise to an expectation of confidentiality. Third, a person also owes a duty of trust and confidence when that person receives material nonpublic information from a spouse, parent, child or sibling, unless it is shown affirmatively, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality. [309]

The SEC's ability to use Rule 10b5-2 to redefine the scope of the duty owed by outsiders to the person or entity that entrusted them with material nonpublic information, however, was called into question in *SEC v. Cuban*. [310] In

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Cuban, the SEC brought insider trading charges against billionaire Mark Cuban. The SEC alleged that Cuban violated § 10(b) of the Exchange Act when he sold stock in a company (Mamma.com) in which he owned a 6.3% share, after the company informed him that it intended to conduct an equity offering that would dilute Cuban's holdings. Cuban and Mamma.com had entered into an agreement that Cuban would keep information of the upcoming offering confidential, but the agreement did not specify that he would not trade on the information. During a conversation with Mamma.com's CEO, Cuban received more information about the potential sale and allegedly expressed his belief that he could no longer sell the shares after receiving such information. Cuban then sold his shares and avoided losses of about $750,000 when Mamma.com announced the equity offering and the stock price declined.

The SEC argued that an agreement between two parties can give rise to a duty that can be the basis for a misappropriation theory of liability. The district court agreed that, as a theoretical matter, under *Chiarella* and *O’Hagan* an agreement could indeed constitute the basis of a finding of a duty not to trade. In other words, a fiduciary duty is *not* required to establish the misappropriation theory. [311] However, the district court disagreed that the agreement at issue, or the conversation with the CEO, was sufficient to create such a duty because Cuban only promised to keep the information confidential, not to refrain from trading on it, and because his own belief that he could not sell could not give rise to such a promise. [312] Moreover, to the extent the SEC argued that Rule 10b5-2 imposed on Cuban the fiduciary duty to refrain from trading on material nonpublic information based solely on a confidentiality agreement, [313] the district court held the Rule exceeded the SEC's authority because § 10(b) does not allow it to impose liability on the basis of a confidentiality agreement lacking a non-use component. [314]

The SEC then appealed this ruling to the Fifth Circuit, which vacated the opinion of the district court after disagreeing with the district court's reading of the complaint. The Fifth Circuit interpreted Cuban's conversation with the CEO as creating a plausible inference of an agreement not to trade on the information, and thus declined to reach the question of the legality of Rule 10b5-2. [315] Following remand to the district court, the case proceeded to a jury trial, after which Cuban was found not liable for insider trading. [316]

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Another case exemplifies the willingness of the SEC and the courts to look at theories of liability for insider trading that fall outside the traditional scope of the "insider" and "misappropriation" theories. In *SEC v. Dorozhko*, [317] the SEC brought insider-trading charges against a computer hacker who had obtained electronic access to a company's earnings report the day before it was released and traded on that information. Because the defendant was neither an insider nor owed a fiduciary duty to the source of the information or the company whose stock he traded, the Second Circuit found that the case did not fit either the breach of fiduciary duty or misappropriation theories. Thus, the court turned to the "deceptive device" language of § 10(b) of the Exchange Act and concluded that the defendant could be held liable under a so-called "straight-forward theory of fraud" if the district court on remand determined that the computer hacking at issue was "deceptive in that the defendant misrepresented who he was to gain access. Without such a misrepresentation, however, there would be no liability under § 10(b)." [318] Importantly, the court once again reiterated that "a fiduciary duty [is not a] requirement as an element of every violation of § 10(b)." [319]

[ii] *Liability of Tippers and Tippees*

An insider who abstains from trading on the basis of material nonpublic information but "tips" other investors by passing material nonpublic information to them can also be liable under Rule 10b-5 if the insider's disclosure is considered to be fraudulent. The courts have held that tips made in return for a personal benefit [320] are a breach of an insider's duty to his corporation and therefore fraudulent. [321] The benefit may be direct, such as pecuniary gain, or indirect, such

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as a "reputational benefit that will translate into future earnings" [322] or the satisfaction of having bestowed a "gift of confidential information to a trading relative or friend." [323] The "tipper" under these circumstances is liable for the profit made or losses avoided by the "tippee" (the recipient of material nonpublic information) even though the tipper may not have traded at all. [324] The misappropriation theory has also been used against tippers, based on a showing that the tipper owed a duty of confidentiality to the source from whom he or she learned the nonpublic information. [325]

A tippee is liable for insider trading only when (i) the tipper has breached his fiduciary duty to corporate shareholders or to the source of his or her information by disclosing the information to the tippee [326] and (ii) the tippee knows or should know that there has been such a breach. [327] As discussed above, the tipper

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has breached his or her fiduciary duty if he or she will benefit, directly or indirectly, from the disclosure of the information. In order to recover against a tippee, the plaintiff must show that the tippee knew the tipper benefited from the disclosure and so breached the tipper's duty to the corporation or the source of the information. The Supreme Court has rejected the notion that the mere receipt of material nonpublic information by a tippee creates a duty to disclose or abstain similar to that placed on the source of the information. [328]

Recently, the Supreme Court resolved a circuit split concerning the nature of the personal benefit that a tipper must receive to establish liability under the misappropriation theory by reaffirming its ruling in *Dirks* that "a tippee breaches a fiduciary duty by making a gift of confidential information to a 'trading relative.'" [328.1]

Previously, in *United States v. Newman*, the Second Circuit overturned the insider trading convictions of two remote tippees (meaning individuals who received nonpublic information from another tippee, rather than from the original tipper) where the personal benefits identified by the government included that the tippers and initial tippees "had known each other for years," attended business school together and worked together, "sought career advice and assistance" from each other, and/or "were family friends that had met through church and occasionally socialized together." [329] The Second Circuit concluded that "the mere fact of a friendship, particularly of a casual or social nature" is insufficient to establish the requisite personal benefit, which instead requires "proof of a meaningful close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly value nature." [329.1]

In another case involving a remote tippee, however, the Ninth Circuit "decline[d] to follow" *Newman* to the extent it could be read as holding "that evidence of a friendship or familial relationship between tipper and tippee, standing alone, is insufficient to demonstrate that the tipper received a benefit." [330] Instead, relying on the Supreme Court's statement in *Dirks* that "the elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend," the Ninth Circuit affirmed the conviction of a remote tippee where the tipper and initial tippee were relatives.

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The Supreme Court unanimously agreed with the Ninth Circuit's interpretation, concluding that an insider receives a personal benefit by gifting confidential information to a trading relative or friend even if there is no exchange of something of pecuniary or similar value. [331.1] In reaching this conclusion, the Court held that to the extent *Newman* interpreted the personal benefit requirement to include that the tipper receive something of a pecuniary or similarly valuable nature in exchange for the tip, such an interpretation was "inconsistent with *Dirks*." [331.2] While the Court's decision in *Salman* resolved the "narrow issue" of whether a gift of confidential information to a trading relative constitutes a personal benefit, [331.3] the Court reiterated *Dirks'* warning "that [d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts. [331.4]

[b] Exchange Act § 20A

The Insider Trading and Securities Fraud Enforcement Act of 1988 (the "Insider Trading Act") [332] created § 20A of the Exchange Act, which expressly permits a right of action by those trading at the same time as the defendant, even though the defendant owes them no strict legal duty. Congress left it to the courts to decide when trading is contemporaneous within the meaning of § 20A. [333]

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The limitations period for actions under § 20A is five years, running from "the date of the last transaction that is the subject of the violation." [334] Total damages are limited to the profit gained (or loss avoided) by the defendant in the transactions that are the subject of the violation and any recovery will be further reduced by any amount required to be "disgorged" or forfeited to the SEC pursuant to an SEC injunctive action. [335] Control persons may be liable for the actions of those they control, but not solely on the basis of an employment relationship. [336]

[c] Exchange Act § 21A

This provision, also part of the Insider Trading Act and its predecessor statute, the Insider Trading Sanctions Act ("ITSA"), [337] gives the SEC increased power to impose civil penalties with respect to insider trading. Prior to the enactment of § 21A of the Exchange Act, insider traders could receive only the penalties broadly applicable to other violations of the Exchange Act, namely the greater of their pecuniary gain and a flat penalty between $5,000 and $100,000, depending on the egregiousness of their conduct. [338] Under § 21A, the SEC may now seek civil penalties of up to three times the profit gained (or loss avoided) as a result of the violations. [339] Profits or losses are measured by reference to the price at which the securities were trading at the point the material nonpublic information had been digested by the market, without regard to how the price behaved subsequently. [340]

In addition, the SEC may seek civil penalties from control persons [341] up to the greater of $1,978,690 and three times the profits of the person under their

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control, if the controlling person knew of, or recklessly disregarded indications of, the controlled person's violations. [342]

The limitations period for penalty actions under § 21A is five years, running from the date of purchase or sale. [343]

[3] Manipulation

In addition to proscribing misleading disclosure and insider trading, the Exchange Act contains a number of provisions designed to bar manipulative market conduct on or off an exchange. These provisions, and the types of conduct that may constitute violations, are discussed below.

[a] Exchange Act § 9

Under § 9(a) of the Exchange Act, persons are prohibited from manipulating the price of a security listed on a national securities exchange in certain specified ways. These include, among other things, (i) effecting transactions in securities with no change in beneficial ownership, or engaging in "matched" purchases and sales of securities, to create a misleading appearance of active trading (so-called "wash trades"), (ii) effecting a series of transactions in a security to inflate or depress the price of the security in order to induce others to purchase or sell and (iii) effecting a series of transactions for the purpose of "pegging," "fixing" or "stabilizing" the price of securities. [344] The common thread among these prohibited practices is that each is "intended to mislead investors by artificially affecting market activity." [345]

Section 9(e) of the Exchange Act creates an express private right of action for violation of the provisions of § 9(a). Anyone who purchased or sold a security at a price affected by the defendant's manipulations may recover damages. However, the plaintiff is required to prove not only that the manipulative activity occurred, but also that (i) the activity was willfully conducted, [346] (ii) the plaintiff

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relied on such activity [347] and (iii) the price at which the plaintiff purchased or sold the security was affected by the manipulative activity. The statute of limitations for § 9(e) claims is one year from discovery of the facts constituting the cause of action, but in no event more than three years from the violation. [348]

Because of the plaintiff's difficult burden of proof under § 9(e), as well as the court's authority to assess reasonable costs against either party litigant, [349] very few private claims have been brought under § 9(e). The SEC has sought injunctive relief, and criminal proceedings have been instituted, however, for manipulative activities proscribed by § 9(a). The types of activities that the SEC and the DOJ have targeted under § 9(a)—many of which also violate § 10(b) of the Exchange Act and Rule 10b-5 thereunder—include "wash trades," in which a single party controls both sides of the same transaction; [350] "marking the close," which occurs when a party executes the last trade of the day at a price higher than the previous trade, for example to support the stock price in a declining market; [351] reporting of nonexistent trades by stock exchange specialists to create a false appearance of trading activity; [352] and the purchase of a significant block of shares at a premium in order to manipulate the price of a stock. [353]

[b] Exchange Act Rule 10b-5

Part of Rule 10b-5 under the Exchange Act, its catch-all antifraud provision, proscribes the use of "any manipulative or deceptive device" in contravention of SEC rules and regulations in connection with the purchase or sale of any security, whether or not registered on a national exchange. The SEC and private litigants have made broader use of Rule 10b-5 than § 9 of the Exchange Act in

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cases of manipulative conduct because of the slightly lower burden of proof under Rule 10b-5. The rule has been used, for example, in situations [354] involving matched trades and "wash sales," [355] "marking the close," [356] circular trading or other devices to artificially inflate stock prices by creating an appearance of an active market, [357] the entry of artificial bid and ask quotes on Nasdaq to manipulate market prices, [358] the use of large leveraged long positions to drive up prices and squeeze holders of short positions [359] and the paying of kickbacks to brokers for recommending the stock of a company controlled by defendants. [360] The rule has also been used by the SEC and the courts to impose liability on broker-dealers under the so-called "shingle theory," which states that a broker-dealer, by "hanging out a shingle"— *i.e.*, presenting itself as a market professional to potential customers—implicitly represents that it will deal fairly and professionally with its customers. [361] The Second Circuit, however, extended the reasoning of the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivatives Traders* to the manipulation context, and held that a defendant can only be held liable for market manipulation under Rule 10b-5 if he or she communicated misleading information to potential buyers. [362]

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The specific elements of a claim under Rule 10b-5, as well as the remedies available, are discussed in detail in § 11.04[2].

[c] Regulation M

Adopted in 1996 and replacing old Rules 10b-6, 10b-6A, 10b-7, 10b-8 and 10b-21 (known as the "Prior Trading Rules") under the Exchange Act, Regulation M is intended to preclude manipulative conduct by persons with an interest in the outcome of an offering, while easing some of the inefficiencies and unnecessary costs imposed by the far broader Prior Trading Rules (*e.g.*, by eliminating trading restrictions for underwriters of actively traded securities).

As discussed more extensively in § 2.04[10], Rules 101 and 102 of Regulation M restrict, subject to certain exceptions and for certain "restricted periods" pegged to the time of pricing, bids for and purchases of securities in distribution by underwriters, issuers, selling securityholders and their respective broker-dealer affiliates participating in the distribution. [363] Rule 101, which governs underwriters and their affiliates, excludes from its coverage more actively traded securities and other specified securities and transactions, and excuses *de minimis* transactions, provided that a distribution participant had in place written policies and procedures reasonably designed to achieve compliance with the regulation. The rule also recognizes "information barriers" between the underwriter and its affiliates, thereby narrowing the scope of persons subject to its strictures. Rule 102, which covers issuers, selling securityholders and their affiliates, allows these parties to engage in market activities prior to the applicable restricted period and permits (during the restricted period) certain specified transactions, for example, bids and purchases of odd-lots.

Rule 103 of Regulation M governs passive market-making by Nasdaq market-makers participating in a distribution and is designed to maintain liquidity in situations where a market-maker otherwise might be required to withdraw from the market pursuant to Rule 101. Rule 104 of Regulation M prohibits actions to stabilize the price of a security to facilitate an offering, subject to certain specified exceptions. Finally, subject to certain exceptions, Rule 105 of Regulation M prohibits persons who sold equity securities short during a five-day period prior to the pricing of a registered firm commitment offering for securities of the same class from purchasing securities in the offering, regardless of whether the offered securities are intended to be used to cover the prior short sale. [364]

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The SEC monitors compliance and brings proceedings to enforce Regulation M and its associated rules, [365] but like the predecessor Prior Trading Rules it is generally considered that there is no implied private right of action for violations. [366]

Footnotes

265 *See* § 11.04[3].

266 Many of the actions initiated by the SEC and private litigants in response to corporate scandals are predicated on § 10(b) and Rule 10b-5 thereunder. For example, the SEC enforcement action that produced a $500 million settlement payment (reduced from the pre-bankruptcy settlement amount of $1.51 billion) for wrongdoing involving WorldCom's overstatement of its income by $9 billion was brought under § 10(b) and Rule 10b-5. *See SEC v. WorldCom Inc.*, SEC Litigation Release No. 18147 (May 19, 2003); *see also* Press Release, SEC, The Honorable Jed Rakoff Approves Settlement of SEC's Claim for a Civil Penalty Against WorldCom (July 7, 2003). The main Enron-related class action lawsuit also alleged violations of § 10(b) and Rule 10b-5 *. See In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549, 581–688 (S.D. Tex. 2002).

267 Notably, the SEC has brought Rule 10b-5 actions against foreign issuers for making false statements to the U.S. market. *See In re E.ON AG*, SEC Release No. 34-43372 (Sept. 28, 2000), in which the SEC imposed a cease and desist order on E.ON AG (formerly Veba, a German company and a foreign private issuer) for violating "Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by deliberately issuing a series of materially false and misleading statements over a month-long period in which it denied the existence of any merger discussions or negotiations." *In re E.ON AG*, SEC Release No. 34-43372 (Sept. 28, 2000). The order states that "[w]here jurisdictional requirements are met … there is no safe harbor for foreign issuers from violations of the antifraud provisions of the U.S. federal securities laws. The [SEC] will not apply a different standard with respect to foreign issuers commenting on merger discussions or negotiations. When a foreign issuer voluntarily avails itself of the opportunities in the U.S. capital markets, it must adhere to the U.S. federal securities laws." *In re E.ON AG*, SEC Release No. 34-43372 (Sept. 28, 2000); *see also* § 4.10[3]. In addition, foreign issuers have not been entirely immune to the recent wave of corporate scandals. Among other companies, Ahold NV and Vivendi Universal S.A. have faced investigations by the SEC and the DOJ for accounting and related disclosure issues. *See* Deborah Ball, *Ahold Will Shave $880 Million Off Profit Due To Irregularities*, WALL ST. J., May 9, 2003; Martin Peers, *SEC Upgrades Vivendi Probe, Raising Stakes for French Firm*, WALL ST. J., Nov. 20, 2002; John Carreyrou, *U.S. Attorney Opens Vivendi Probe*, WALL ST. J., Nov. 5, 2002. Ahold and Vivendi have settled with the SEC, although the SEC has continued to investigate and charge individuals who participated in the fraudulent schemes. *See SEC v. Royal Ahold*, SEC Litigation Release No. 18929 (Oct. 13, 2004) (stating that Ahold would not be fined by the SEC, in part because of the company's cooperation and in part because of the parallel investigation in the Netherlands, where Ahold eventually paid a $10 million fine); *SEC v. Vivendi Universal, S.A.*, SEC Litigation Release No. 18523 (Dec. 24, 2003) (stating that Vivendi consented to pay a $50 million civil monetary penalty). Section 11.10[1]–[3] discusses jurisdiction over foreign defendants and the extraterritorial scope of the federal securities laws.

268 Although § 18 of the Exchange Act does not refer specifically to omissions, they have been deemed included in its proscription of materially misleading statements. *See, e.g.*, *In re Caesars Palace Securities Litigation*, 360 F. Supp. 366 (S.D.N.Y. 1973).

269 *See Fischman v. Raytheon Manufacturing*, *Co.*, 188 F.2d 783, 788 (2d Cir. 1951). Section 18 does not apply to documents filed pursuant to the Securities Act, rather than the Exchange Act, including Forms F-3 and associated prospectuses. *See In re Alstom SA*, 406 F. Supp. 2d 433, 481 (S.D.N.Y. 2005). Certain Exchange Act filings, including certain types of Forms 8-K, are likewise exempted from Section 18 liability by SEC regulations. *In re Alstom SA*, 406 F. Supp. 2d 433, 481 (S.D.N.Y. 2005).

270 Of specific importance to foreign issuers are Form 20-F registration statements filed, for example, in connection with a stock exchange listing (without making a concurrent primary offering). Section 18 of the Exchange Act would apply not only to an initial Form 20-F filing but also to post-listing (or post-public offering) filings (*i.e.*, the Form 20-F annual report filings of a foreign issuer, *see* § 4.03[2][a]). Under SEC regulations, however, Exchange Act filings on Forms 6-K are generally exempt from § 18 liability. *See In re Alstom SA*, 406 F. Supp. 2d 433, 481 (S.D.N.Y. 2005).

271 *See* § 6.02[2].

272 *See Ross v. A.H. Robins Co.*, 607 F.2d 545, 552–53 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980); *Cohen v. Stevanovich*, No. 09 Civ. 4003, 2010 U.S. Dist. LEXIS 66010, at *41 (S.D.N.Y. July 1, 2010); *In re M.D.C. Holdings Securities Litigation*, 754 F. Supp. 785, 798 (S.D. Cal. 1990).

273 *See* § 18(a) of the Exchange Act. The statute of limitations is one year after discovery of the facts constituting the cause of action, but no more than three years from the violation. § 18(c) of the Exchange Act. Damages are also measured in the same way as under Rule 10b-5. *See Harris v. American Investment Co.*, 523 F.2d 220 (8th Cir. 1975), *cert. denied*, 423 U.S. 1054 (1976); § 11.04[2][c]. Section 18(b) of the Exchange Act expressly recognizes the right of defendants held liable under the provision to seek contribution from others who could likewise have been held liable had they been sued.

274 § 18(a) of the Exchange Act.

275 *See F.N. Wolf & Co. v. Estate of Neal*, Fed. Sec. L. Rep. (CCH) ¶95,805 (S.D.N.Y. Feb. 25, 1991) (citing *Ross v. A.H. Robins Co.*, 607 F.2d 545, 552 (2d Cir. 1975)).

276 *See Ross v. A.H. Robins Co.*, 607 F.2d 545, 556–57 (2d Cir. 1975).

277 Extraterritorial application of the law has been deemed necessary to "protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities." *Schoenbaum v. Firstbrook*, 405 F.2d 200, 206 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969), *abrogated on other grounds by Morrison v. National Australia Bank*, 130 S. Ct. 2869 (2010). The SEC has increasingly pursued overseas parties for insider trading violations. *See, e.g.*, *SEC v. Hui*, SEC Litigation Release No. 16220 (July 26, 1999) (complaint); *SEC v. Heden*, 51 F. Supp. 2d 296 (S.D.N.Y. 1999); *SEC v. Euro Security Fund*, Fed. Sec. L. Rep. (CCH) ¶90,433 (S.D.N.Y. Feb. 16, 1999); *SEC v. Cavanagh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998), *aff'd*, 155 F.3d 129 (2d Cir. 1998); *SEC v. Morris*, SEC Litigation Release No. 14381 (Jan. 17, 1995); *SEC v. Tinajero*, SEC Litigation Release No. 12974 (Sept. 11, 1991) (final judgment); *SEC v. Foundation Hai*, SEC Litigation Release No. 12535 (July 6, 1990) (final judgment). In *Morrison v. National Australia Bank Limited*, however, the Supreme Court limited the extraterroritorial reach of the federal securities laws, *see* § 11.10[3], and lower courts have begun to apply this new approach in the insider trading context. *See, e.g.*, *United States v. Martoma*, No. S1 12 Cr. 973 (PGG), 2013 WL 6632676 (S.D.N.Y. Dec. 17, 2013).

278 *See, e.g.*, *SEC v. Waksal*, SEC Litigation Release No. 19039 (Jan. 19, 2005). Under the terms of the settlement, Sam and Jack Waksal were held jointly and severally liable for disgorgement of over $2 million in illegal loss avoidance and Sam Waksal was liable for a civil penalty of over $3 million and barred from serving as an officer or director of any public company. *See also SEC v. Computer Associates International, Inc.*, SEC Litigation Release No. 18891 (Sept. 22, 2004).

279 *See* Commodity Futures Modernization Act, Appendix E, Pub. L. No. 106-554, § 303(d)(1), 114 Stat 2763, 2763A-454 (2000); 15 U.S.C § 78j(b). Under § 206B of the Gramm-Leach-Bliley Act ("GLBA"), in turn, a "security-based swap agreement" is a swap agreement "of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein." GLBA, Pub. L. No. 106-102, § 206B, 113 Stat. 1338 (1999). The SEC more recently brought a case against a securities analyst who tipped off a client that a company was going to issue debt, which was expected to increase the price of certain credit-default swaps whose reference entity was the company at issue. *See SEC v. Rorech*, 720 F. Supp. 2d 367 (S.D.N.Y. 2010). The defendants argued that the new provisions did not apply to trades in those credit-default swaps, arguing that the price of the CDS was not "based on" the price, yield, value or volatility of the underlying securities, but rather on a basis point negotiation between the buyer and seller of the CDS, and affected by many factors, including the strength of the economy and the market's assessment of the referenced company's credit risk. The district court rejected this argument and held that two material terms of the CDS were "based on" the price, yield, value or volatility of the underlying securities. First, the court noted the price of the CDS was "based on" such factors because it was "clear … that a fundamental part of [the] decision [to purchase the CDS] was the spread or yield (or, inversely, the price) of the deliverable [securities]." *SEC v. Rorech*, 720 F. Supp. 2d 367, 407 (S.D.N.Y. 2010). Generally, the court held, because the price, yield, and value of the underlying securities were

"critical" to the price of the CDSs, trading in such instruments squarely fit within the statutory definition. *SEC v. Rorech*, 720 F. Supp. 2d 367, 407 (S.D.N.Y. 2010). The district court also noted that § 9.9 of the ISDA agreement governing the swaps required the CDS-buyer to deliver the covered securities to the counterparty if a credit event occurred, but also allowed the counterparty to subtract the price of such securities if the CDS-buyer failed to deliver them. *SEC v. Rorech*, 720 F. Supp. 2d 367, 408 (S.D.N.Y. 2010). Thus, the court held, "a material provision" of the CDS was "based on" the price of the underlying security for purposes of § 206B. Note that the charges against Rorech were ultimately dismissed on the grounds that the SEC could not establish the misappropriation theory, which is discussed below.

280 *See United States v. Teicher*, 987 F.2d 112 (2d Cir.), *cert. denied*, 510 U.S. 976 (1993).

281 *See SEC v. Adler*, 137 F.3d 1325, 1337–39 (11th Cir. 1998).

282 *See United States v. Smith*, 155 F.3d 1051, 1066–69 (9th Cir. 1998).

283 SEC Release No. 33-7881 (Aug. 10, 2000).

284 Trading plans permitted by Rule 10b5-1 have proven useful to insiders by allowing them to establish trading programs that do not depend on the availability of window periods. *See* § 5.05[7].

285 *See* Linda Chatman Thomsen, Director, SEC Division of Enforcement, Remarks at the 2007 Corporate Counsel Institute (Mar. 8, 2007).

286 Michael Siconolfi and Jean Eaglesham, *SEC is Pressed to Revamp Executive Trading Plans*, WALL ST. J., May 9, 2013; Alan Jagolinzer, *Do Insiders Trade Strategically Within the SEC Rule 10b5-1 Safe Harbor?* (Stanford Graduate School of Business, Working Paper, Dec. 6, 2006); Jane Sasseen, *A Closer Look at Trades By The Top Brass: Some Execs May Be Abusing An SEC "Safe Harbor" Rule on Insider Stock Sales*, BUS. WEEK, Nov. 13, 2006, at 40; Jane Sasseen et al., *Insiders With A Curious Edge: How Corporate Executives Seem To Be Violating The Spirit, If Not The Letter, Of A Rule Intended To Prevent Insider Trading*, BUS. WEEK, Dec. 18, 2006. Professor Jagolinzer's study found that 10b5-1 plans were regularly initiated in anticipation of negative disclosures and terminated in anticipation of positive disclosures. Trades by 10b5-1 plan participants outperformed those of non-participating colleagues by an average of six percent.

287 *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Elisse B. Walter, Chairman, SEC (Dec. 28, 2012) (requesting that the SEC consider pursuing interpretive guidance or amending Rule 10b5-1 to require Rule 10b5-1 plans to adopt several protocols and guidelines to limit reported abuses).

288 There is no statute that defines "insider trading" or explicitly prohibits it. Insider trading is a common law offense derived from judicial interpretations of several overlapping statutory and regulatory prohibitions, mainly Rule 10b-5. In the United Kingdom and elsewhere in the European Union, the offense has been defined and insider trading banned specifically by statute. *See* EU Regulation 596/2014 on market abuse (market abuse regulation) (Apr. 16, 2014). Although the SEC historically resisted such efforts in the United States, it adopted Rules 10b5-1 and 10b5-2 to clarify and strengthen the law of insider trading, and Regulation FD (Fair Disclosure), which deals with the issue of selective disclosure. *See* SEC Release No. 33-7881 (Aug. 15, 2000). Regulation FD, including recent enforcement activity, is discussed in § 4.10[6].

289 *See Chiarella v. United States*, 445 U.S. 222, 228–29 (1980) (failure to disclose material nonpublic information cannot be fraudulent absent a duty to disclose). *See also* Edward Greene & Olivia Schmid, *Duty Free Insider Trading?*, 2 COLUM. BUS. L. REV. 369 (2013).

290 In an issue of first impression, the Second Circuit recently held that "the fiduciary-like duty against insider trading under section 10(b) is imposed and defined by federal common law" rather than state or foreign law. *See Steginsky v. Xcelera Inc.*, 741 F.3d 365 (2d Cir. 2014). The Second Circuit concluded that the relevant duty springs from federal law because "looking to idiosyncratic differences in state law"—in that case, the law of the Cayman Islands, which allegedly did not impose a duty on insiders to disclose material information before trading— "would thwart the goal of promoting national uniformity in securities markets."

291 Material information is information "which [is] reasonably certain to have a substantial effect on the market

price of the security if disclosed." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), and *cert. denied*, 404 U.S. 1005 (1971) (citations omitted). Information is considered nonpublic until the relevant markets have had an opportunity to fully digest the information. In a heavily traded issue, this will usually require that the price of the company's shares have stabilized after the initial disclosure of the information.

292 Since insiders owe a duty of loyalty to the corporation, which requires that disclosure of such information be made at the appropriate time and in the best interest of the corporation, it is often said that insiders only have a duty to abstain from trading. *See SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), and *cert. denied*, 404 U.S. 1005 (1971) (citations omitted).

293 *See Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983); *see also SEC v. Falbo*, 14 F. Supp. 2d 508 (S.D.N.Y. 1998) (independent contractor); *SEC v. Softpoint, Inc.*, 958 F. Supp. 846 (S.D.N.Y. 1997), *aff'd without opinion*, 159 F.3d 1348 (2d Cir. 1998) (consultant); *SEC v. Franco*, SEC Litigation Release No. 11206 (D.D.C. Aug. 26, 1986) (public relations advisor).

294 "Information barriers" restricting the dissemination and misuse of material nonpublic information allow a financial institution's trading and investment management departments to trade in securities although the underwriter's corporate finance department has material nonpublic information concerning the issuer of such securities. *See* § 14.07[1][b] for a discussion of the "information barriers" required of broker-dealers; *see also* Rule 10b5-1 under the Exchange Act.

295 *United States v. O'Hagan*, 521 U.S. 642 (1997).

296 *United States v. O'Hagan*, 521 U.S. 642, 653 (1997) (internal quotations omitted).

297 *See United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

298 *See United States v. Carpenter*, 791 F.2d 1024, 1026 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

299 *See SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

300 *See United States v. Newman*, 664 F.2d 12 (2d Cir. 1981).

301 *See United States v. O'Hagan*, 521 U.S. 642 (1997).

302 *See SEC v. Lenfest*, 949 F. Supp. 341 (E.D. Pa. 1996).

303 *See United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990).

304 *SEC v. Barclays Bank PLC*, SEC Litigation Release No. 20132 (May 30, 2007).

305 The *Barclays* case also demonstrated the SEC's apparent willingness to pursue cases even where a bank has entered into non-reliance letters, or so-called "big boy letters," with its trading counterparties. These letters involve an acknowledgment by the counterparty that it is aware that the insider may have material nonpublic information and it still wants to proceed with the transaction. Although these letters may provide some defenses in private civil litigation, *see AES Corp. v. Dow Chemical Co.*, 325 F.3d 174 (3d Cir. 2003); *McCormick v. Fund American Companies, Inc*., 26 F.3d 869 (9th Cir. 1994); *Jensen v. Kimble*, 1 F.3d 1073 (10th Cir. 1993), *Barclays* suggests that the SEC has not adopted the position that a non-reliance letter absolves a trading party of insider trading exposure to government regulators. *See also supra* Note 202.

306 *See* SEC Release No. 33-7881 (Aug. 15, 2000).

307 SEC Release No. 33-7881 (Aug. 15, 2000), 65 Fed. Reg. 51,716, 51,730 (Aug. 24, 2000).

308 SEC Release No. 33-7881 (Aug. 15, 2000), 65 Fed. Reg. 51,716, 51,738 (Aug. 24, 2000).

309 According to the SEC, the only federal appellate court decision on this point— *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992)—took an unduly narrow view of when a duty of confidence arises in the context of family and other personal relationships. *Chestman* held that in the absence of an express agreement of confidentiality or a pre-existing pattern of sharing business confidences, there is not a sufficient basis in such a relationship to establish the duty to support a criminal conviction under the misappropriation theory. SEC Rule 10b5-2 broadens and in effect reverses the result of *Chestman*.

310 *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

311 *SEC v. Cuban*, 634 F. Supp. 2d 713, 724–27 (N.D. Tex. 2009).

312 *SEC v. Cuban*, 634 F. Supp. 2d 713, 727–28 (N.D. Tex. 2009).

313 *See* Rule 10b5-2(b)(1) (creating duty of confidence for purposes of misappropriation theory "[w]henever a person agrees to maintain information in confidence" without requiring that the person also agree to not trade on the information).

314 *SEC v. Cuban*, 634 F. Supp. 2d 713, 728–31 (N.D. Tex. 2009).

315 *SEC v. Cuban*, 620 F.3d 551 (5th Cir. 2010).

316 *SEC v. Cuban*, SEC Litigation Release No. 22855 (Oct. 23, 2013).

317 *SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).

318 *SEC v. Dorozhko*, 574 F.3d 42, 48–51 (2d Cir. 2009).

319 *SEC v. Dorozhko*, 574 F.3d 42, 48 (2d Cir. 2009).

320 *See Dirks v. SEC*, 463 U.S. 646, 663–64 (1983). No liability attaches if the disclosure is made for corporate rather than personal benefit.

321 Until the fall of 2000, the issue of selective disclosure had been exclusively considered under the analysis applicable to securities fraud, particularly insider trading under Rule 10b-5 under the Exchange Act. This approach had focused on whether a corporate insider, by selectively disclosing material nonpublic information to analysts and institutional investors, may be exposed to "tipper" liability for insider trading. The Supreme Court, in *Dirks v. SEC*, 463 U.S. 646 (1983), held that the insider must receive some direct or indirect "personal benefit" from the disclosure in order for liability to attach to the tipper or tippee. The *Dirks* decision was widely construed as providing considerable latitude to insiders who made selective disclosure to analysts, and to the analysts (and their clients) who received selectively disclosed information and acted on it.

The SEC's recognition of the difficulties it faced in proving "personal benefit" under Rule 10b-5 led to its decision to adopt Regulation FD (Fair Disclosure), which became effective in October 2000, and abandon exclusive reliance on Rule 10b-5 to regulate selective disclosure to analysts. *See* SEC Release No. 33-7881 (Aug. 15, 2000). Regulation FD generally requires an issuer that has selectively disclosed material nonpublic information to promptly disclose that information publicly. The requirements of Regulation FD, which do not apply to foreign private issuers, and enforcement activity thereunder, are addressed in more detail in § 4.10[6].

322 *SEC v. Stevens*, No. 91 Civ. 1869 (S.D.N.Y. Mar. 19, 1991) (insider trading proceeding settled by the SEC, involving the CEO's disclosure of information to analysts to enhance his reputation); *see* § 4.10[7] (discussing *Dirks* and *Stevens* in the context of selective disclosure to analysts).

323 *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 311 n.21 (1985) (citing *Dirks v. SEC*, 463 U.S. 646, 663–64 (1983)).

324 The SEC has taken the position that a tipper is liable even if the tippee never actually trades, assuming it was reasonably foreseeable at the time the information was provided that the tippee would trade. It is unclear whether the courts will impose liability under these circumstances, except in the tender offer context, where the "reasonably foreseeable" test is codified in Rule 14e-3 under the Exchange Act. *See* § 11.06[4].

325 A tipper is liable under the misappropriation theory for disclosing nonpublic information even if he or she did not specifically know that the tippee would trade on it, so long as the tipper knew he or she was breaching his or her own duty to maintain the confidentiality of the information. *See United States v. Libera*, 989 F.2d 596 (2d Cir.), *cert. denied*, 510 U.S. 976 (1993).

326 *See United States v. Chestman*, 947 F.2d 551, 567–71 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992) (reversing the conviction of a tippee-defendant where there was an insufficient showing that the tipper owed a duty of confidence to his source, a family member). In *Chestman*, the court held that fiduciary relationships are "marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such

information." Courts have noted that a fiduciary duty cannot be unilaterally imposed by entrusting an individual with confidential information, but an explicit acceptance of a duty of confidentiality must be present in order for misappropriation liability to attach. *See United States v. Cassese*, 273 F. Supp. 2d 481 (S.D.N.Y. 2003) (finding that despite the existence of an unexecuted confidentiality agreement, the relationship between the parties was not a fiduciary one because it was not marked by "*de facto* control" and "dominance" or entailing "discretionary authority and dependency" but was rather an arm's-length relationship that was insufficient to trigger misappropriation liability); *see also United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002) (granting a motion to dismiss and holding that even though confidential information was regularly exchanged between the defendant and a fellow member of a social club and despite the fact that there was a signed confidentiality agreement, no fiduciary relationship was formed).

327 *See Dirks v. SEC*, 463 U.S. 646, 660 (1983).

328 *See Dirks v. SEC*, 463 U.S. 646, 664 (1983). As discussed above, the Supreme Court's position is contrary to that taken in other jurisdictions, such as the United Kingdom, where a duty to abstain arises from mere possession of material nonpublic information.

328.1 *Salman v. United States*, 137 S. Ct. 420, 427–28 (2016) (citing *Dirks*, 463 U.S. at 664 (1983)).

329 *See United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).

329.1 *See United States v. Newman*, 773 F.3d 438, 452 (2d Cir. 2014).

330 *See United States v. Salman*, 792 F.3d 1087 (9th Cir. 2015).

[331] [Reserved.]

331.1 *Salman v. United States*, 137 S. Ct. 420, 424 (2016).

331.2 *Salman v. United States*, 137 S. Ct. 420, 427–28.

331.3 *Salman v. United States*, 137 S. Ct. 420, 427.

331.4 *Salman v. United States*, 137 S. Ct. 420, 429 (2016) (quoting *Dirks v. SEC*, 463 U.S. 646, 664 (1983)).

332 *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).

333 The courts have not offered any definitive rules on this subject since the passage of the Insider Trading Act. *See In re Microstrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 662–63 (E.D. Va. 2000). The *Microstrategy* court summarized the state of the law regarding this question, noting that the decisions from various circuits are not uniform. "[C]ourts … have applied varying definitions of contemporaneity, ranging from requiring that the investor trade on the same date as did the insider, to allowing as much as a month to pass between the trades, with at least one court even holding that ‘the term "contemporaneously" may embrace the entire period while relevant nonpublic information remained undisclosed.’" *In re Microstrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 662–63 (E.D. Va. 2000) (footnote call numbers omitted) (quoting *In re American Business Computers Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶98,839 at 93,055 (S.D.N.Y. Feb. 24, 1994)). However, the trend among some courts has been to "adopt a restrictive reading of the term ‘contemporaneous' at least with respect to shares heavily traded on a national exchange." *In re Microstrategy, Inc. Securities Litigation*, 115 F. Supp. 2d 620, 662–63 (E.D. Va. 2000) (quoting *In re AST Research Securities Litigation*, 887 F. Supp. 231, 233 (C.D. Cal. 1995)). Nor is the prior case law—to which Congress referred in the legislative history—entirely clear. *See, e.g.*, *Wilson v. Comtech Telephone Corp.*, 648 F.2d 88, 94 (2d Cir. 1981) (defendant not liable to the plaintiff who traded a month after the defendant's trading); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 241 (2d Cir. 1974) (defendant liable to those who traded "during the same period" in which the defendant traded); *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800, 803 n.4 (S.D.N.Y. 1983) (defendant liable to the plaintiffs who traded during the week after the defendant's trades, but not to those who traded before him or his tippees).

334 § 20A(b)(4) of the Exchange Act. In *Johnson v. Aljian*, the Ninth Circuit held that a case may proceed under § 20A within the five-year limitations period even if the underlying Rule 10b-5 violation is time-barred—and even if the time-barred Rule 10b-5 violation was the *sole* underlying violation. *Johnson v. Aljian*, 490 F.3d

778 (9th Cir. 2007).

335 *See* § 20A(b)(1) and (2) of the Exchange Act.

336 *See* § 20A(b)(3) of the Exchange Act.

337 *See* Insider Trading Sanctions Act, Pub. L. No. 98-376, 99 Stat. 1264 (1984).

338 *See* § 21(d)(3)(B) of the Exchange Act. This penalty range applied to natural persons; the range for corporate defendants was $50,000 to $500,000. § 21(d)(3)(B) of the Exchange Act; *see also* SEC Release No. 33-7361 (Nov. 1, 1996).

339 *See* § 21A(a)(2) of the Exchange Act.

340 *See* § 21A(f) of the Exchange Act.

341 The definition of control persons under § 21A, like that under § 20A, is narrower than that applicable (under § 20(a)) in determining control person liability with respect to other provisions of the Exchange Act. Among other things, an employer would not be liable under § 21A "solely by reason of employing" the insider trader. *See* § 21A(b)(2) of the Exchange Act.

342 *See* § 21A(a)(3) of the Exchange Act; SEC Release No. No. 33-10104 (June 27, 2016). If the control person is a broker-dealer or an investment adviser and knowingly or recklessly failed to establish, maintain or enforce the "information barriers" required by § 15(f) of the Exchange Act or § 204A of the Advisers Act, *see* §§ 14.07[1][b] and 16.13, he or she is likewise liable for up to $1,525,000 or treble profits. § 21(b)(1)(B) of the Exchange Act. If the controlled person's violation was tipping material nonpublic information and not trading on it, the profits used for the damages calculation are those of the tippee. § 21A(a)(3) of the Exchange Act.

343 *See* § 21A(d)(5) of the Exchange Act.

344 § 9(a) of the Exchange Act.

345 *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977).

346 *See, e.g.*, *Baum v. Phillips, Appel & Walden, Inc.*, 648 F. Supp. 1518, 1530 (S.D.N.Y. 1986), *aff'd*, 867 F.2d 776 (2d Cir.), *cert. denied*, 493 U.S. 835 (1989) (§ 9 actions require proof of *scienter*).

347 *See Baum v. Phillips, Appel & Walden, Inc.*, 648 F. Supp. 1518, 1529–30 (S.D.N.Y. 1986), *aff'd*, 867 F.2d 776 (2d Cir. 1989), *cert. denied*, 493 U.S. 835 (1989) (reading the reliance requirement into a § 9 claim by reference to legislative history, despite the statute's silence on the issue).

348 Defendants are provided an express right of contribution against fellow wrongdoers for civil liability imposed under § 9(e) of the Exchange Act.

349 *See* § 9(e) of the Exchange Act.

350 *See, e.g.*, *United States v. Gilbert*, Fed. Sec. L. Rep. (CCH) ¶98,244 (S.D.N.Y. July 23, 1981), *aff'd*, 668 F.2d 94 (2d Cir. 1981), *cert. denied*, 456 U.S. 946 (1982) (conviction and sentencing of defendant who used multiple accounts with broker-dealers to manipulate the price of stock through "wash" trades and matched orders).

351 *See, e.g.*, *SEC v. Broumas*, SEC Litigation Release No. 12999 (Sept. 27, 1991). *See generally SEC v. Masri*, 523 F. Supp. 2d 361 (S.D.N.Y. 2007) (describing allegations of "marking the close" trades as a mechanism of market manipulation in a case brought pursuant to § 10(b) of the Exchange Act).

352 *See* SEC Release No. 34-13453 (Apr. 19, 1977).

353 *See SEC v. Drexel Burnham Lambert Inc.*, SEC Litigation Release No. 11859 (Sept. 7, 1988) (alleging that Ivan Boesky made large purchases of Wickes common stock at Michael Milken's direction to cause the stock to close within a certain price range so that Wickes, a client of Milken's, could call its outstanding convertible preferred stock for conversion).

354 Many of these same situations could have given rise as well to liability under § 9(a) of the Exchange Act. *See* § 11.05[3][a].

355 *See SEC v. Malenfant*, SEC Litigation Release No. 13339 (Aug. 17, 1992); *SEC v. Sonic Electric Energy*

Corp., SEC Litigation Release No. 13076 (Nov. 4, 1991).

356 *See In re Myron S. Levin*, SEC Release No. 34-31124 (Sept. 1, 1992).

357 *See SEC v. D'Onofrio*, SEC Litigation Release No. 13627 (May 6, 1993); *SEC v. Militano*, SEC Litigation Release No. 12870 (June 4, 1991); *see also SEC v. Militano*, 773 F. Supp. 589 (S.D.N.Y. 1991), *summary judgment granted*, Fed. Sec. L. Rep. (CCH) ¶98,330 (S.D.N.Y. June 23, 1994).

358 *See SEC v. Lorin*, SEC Litigation Release No. 12707 (Nov. 20, 1990); *see also SEC v. Lorin*, 877 F. Supp. 192 (S.D.N.Y 1995), *aff'd in part, vacated in part*, 76 F.3d 458 (2d Cir. 1996); *SEC v. Lorin*, SEC Litigation Release No. 12893 (June 24, 1991); *SEC v. Lorin*, SEC Litigation Release No. 13050 (Oct. 17, 1991).

359 *See SEC v. Steinhardt Management Co.*, SEC Litigation Release No. 14358 (Dec. 16, 1994).

360 *See SEC v. Shull*, SEC Litigation Release No. 14441 (Mar. 15, 1995).

361 Under this theory, broker-dealers have been deemed to represent, among other things, that they: (i) have an "adequate and reasonable basis" for recommending securities to their customers, which necessitates a "reasonable investigation" of the security, (ii) will not recommend securities that they know or should know are not suitable for their customers, (iii) will not sell or purchase securities at prices unrelated to the market price, or with an excessively high mark-up, and (iv) will not churn a customer's account (*i.e.*, trade the customer's securities excessively in order to increase commissions). *See Hanly v. SEC*, 415 F.2d 589, 596–97 (2d Cir. 1969). Broker-dealers have been held liable under the "shingle theory" where they knew their recommendation was false, or disregarded obvious inconsistencies or other negative information of which they were on notice. *See, e.g.*, *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809 (11th Cir. 1989); *Cook v. Avien, Inc.*, 573 F.2d 685 (1st Cir. 1978); *In re Allen R. Asker*, SEC Admin. Proc. File No. 3-7401 (Mar. 14, 1992); *In re Lester Kuznetz*, SEC Release No. 34-23525 (Aug. 12, 1986). *See generally* § 14.07[1][a].

362 *Fezzani v. Bear, Stearns & Co.*, 716 F.3d 18 (2d Cir. 2013) (citing *Janus Capital Group, Inc. v. First Derivatives Traders*, 131 S. Ct. 2296 (2011)).

363 As under old Rule 10b-6, a "distribution" is defined for purposes of Regulation M as any offering of securities that is "distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." *See* Rule 100 of Regulation M under the Exchange Act.

364 *See* SEC Release No. 34-56206 (Aug. 6, 2007).

365 *See* § 3.02[8] for a discussion of violations of Regulation M in the context of public offerings.

366 *See*, *e.g.*, Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 44–46 (1977) (denying Rule 10b-6 standing to a tender offeror seeking to sue a target company for market manipulations that caused it to lose the opportunity to gain control, and suggesting that there might not be any implied right of action under Rule 10b-6 under the Exchange Act).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.06, LIABILITIES CONNECTED WITH TENDER AND EXCHANGE OFFERS

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 § 11.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Exchange Act provides a series of remedies for fraudulent, deceptive or manipulative practices in connection with tender or exchange offers. [367] First, as addressed briefly in § 11.06[1], the broad antifraud provisions of Rule 10b-5 apply to purchases and sales of securities in connection with these offers. In addition, the Williams Act amendments to the Exchange Act, and principally §§ 13(d) and 14(d) and (e) of the Exchange Act, specifically target perceived abuses of the tender offer process by mandating certain types of disclosure and creating causes of action for improper disclosure and other forms of deceit. These provisions are addressed in § 11.06[2]. Finally, as examined in § 11.06[4], Rule 14e-3 under the Exchange Act prohibits insider trading in the context of tender offers, supplementing the general prohibitions on insider trading under Rule 10b-5 discussed in § 11.05[2].

[1] Exchange Act § 10(b) and Rule 10b-5

Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit a wide range of fraudulent, deceptive and manipulative practices in connection with the purchase or sale of securities, including purchases pursuant to tender or exchange offers. As discussed in § 11.04[2][a], a plaintiff bringing a private action under Rule 10b-5 must generally demonstrate that the defendant acted recklessly or with fraudulent intent, [368] that the plaintiff relied on the defendant's conduct in making a purchase or sale of securities, and that the conduct caused injury to the plaintiff in some measurable way. The SEC may also seek injunctive relief or civil penalties for violations of Rule 10b-5 or, in the case of willful conduct, ask the DOJ to bring criminal charges against the alleged violator.

[2] Exchange Act §§ 13(d) and 14(d) and (e)

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The Williams Act, a set of amendments to the Exchange Act enacted in 1968, was intended to increase regulation of, and thereby reduce the incidence of abuses in, the tender offer process. The legislation was aimed at reducing the "undue pressure on shareholders to act hastily and to accept an offer, before management or any other group has an opportunity to present opposing argument or competing offers." [369]

The principal enforcement provisions added by the Williams Act are §§ 13(d) and 14(d) and (e) of the Exchange Act. As discussed in § 6.02[2], § 13(d) generally requires any person (or group acting in concert) who acquires more than 5% of the outstanding voting stock of a publicly held corporation to file a disclosure statement revealing, among other things, the identity of the acquiror, the source and amount of the funds used in making its purchases, the number and percentage of shares it holds, the purpose of the acquisition, including whether it intends to acquire control of the issuer's business and, if so, any plans to liquidate the issuer or effect any similar extraordinary transaction, and the nature of any arrangements the acquiror has with respect to the issuer's securities. [370] Section 14(d) requires similar disclosure by any offeror prior to commencing a tender

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offer. Section 14(e) sets forth a general prohibition against fraudulent, deceptive or manipulative devices, including materially misleading statements or omissions, in the tender offer context.

The courts have generally permitted private actions for injunctive relief (including corrective disclosure) for violations of the reporting requirements of §§ 13(d) and 14(d), but have not extended the private right of action to suits for monetary damages. [371] To obtain an injunction, such as one prohibiting further acquisition of shares by the defendant or voting of shares, the plaintiff must demonstrate that the reporting violation was material [372] and that it was linked to

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plaintiff's injury. [373] If the plaintiff seeks a preliminary injunction, as is often the case in fast-moving tender offers, it must also demonstrate that it would be irreparably harmed without the injunction. In many cases, the court may issue only interim relief pending corrective disclosure by the defendant.

The courts generally have implied a private right of action for violations of § 14(e) by would-be acquirors. [374] Such actions may permit money damages in certain circumstances, as well as injunctive relief. [375] The damage remedy is available to the target company and its shareholders, whether tendering or non tendering, [376] but may not be brought by unsuccessful tender offerors against the successful bidder. [377] The plaintiff in a § 14(e) action must prove that the defendant made material misstatements or omissions, that the defendant acted either intentionally or with reckless disregard for the truth, and that the plaintiff actually relied on the misstatement or omission. [378]

[3] Exchange Act Rule 14d-10

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Although Rule 14d-10 under the Exchange Act, the so-called "best price rule," [379] had been an important basis for tender offer litigation, recent amendments to the rule are likely to substantially reduce the number of lawsuits brought under the implied private right of action created by this provision. [380]

When the SEC adopted Rule 14d-10 in 1986, the stated purpose of the rule was to advance the principle of nondiscrimination in tender offers. Since then, the best price rule had been used increasingly in shareholder litigation in which plaintiffs claimed that amounts paid (by the bidder or by the target) to target executives as retention bonuses or pursuant to golden parachutes, consulting agreements, noncompetition agreements, new equity grants or similar arrangements actually constituted additional payments for the executive's shares. In 2006, the SEC adopted amendments to establish that these arrangements are outside the scope of the best price rule and "clarify that the provisions of the rule apply only with respect to the consideration offered and paid for securities tendered in a tender offer." [381] The SEC noted that such clarification was necessary because conflicting judicial decisions and potentially onerous litigation exposure had substantially chilled tender offer activity. [382]

Prior to the 2006 amendments, Rule 14d-10 provided that "[n]o bidder shall make a tender offer" unless, among other requirements, "[t]he consideration paid to any security holder *pursuant to* the tender offer is the highest consideration paid to any other security holder during such tender offer" (emphasis added). The amended rule focuses on the price paid "for securities tendered in the tender offer," not the price paid "pursuant to the tender offer." Thus, the amended provision reads: "[t]he consideration paid to any security holder *for securities tendered in* the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer" (emphasis added). Also, the amended rule includes an explicit exemption for employment compensation as long as the compensation is for past services and the amount paid is not determined by the number of shares tendered. The amended rule also includes a safe harbor provision for arrangements approved by a properly constituted committee of the involved companies' boards of directors.

[4] Exchange Act Rule 14e-3

Rule 14e-3 under the Exchange Act, promulgated by the SEC under § 14(e) of the Exchange Act, specifically targets insider trading in the tender offer context. It provides that once a bidder has taken a "substantial step or steps to commence, or has commenced, a tender offer," it is unlawful for anyone (other than the bidder or its agents) to trade in the securities sought in the tender offer on the basis of material nonpublic information that such person knows or should know has been obtained directly or indirectly from the bidder or the target. Rule 14e-3 also makes it unlawful for persons connected with the tender offeror or target, such as their officers, directors, employees or advisers—or those who have reason to know the information was misappropriated from such persons—to tip the material nonpublic information to others. The soon-to-be tender offeror does not have a general duty to disclose its intention to make a tender offer and may therefore purchase securities knowing that it plans to make a tender offer before announcing the offer; however, any such purchase may, if sufficiently large, be subject to the reporting requirements of § 13(d) of the Exchange Act and other federal laws. [383]

Like Rule 10b-5, Rule 14e-3 has been interpreted as creating a private right of action. [384] However, within its limited context of tender offers, [385] Rule 14e-3 prohibits a broader range of conduct than does Rule 10b-5. Unlike Rule 10b-5, Rule 14e-3 does not require proof of fraud or breach of fiduciary duty by the defendant. [386] Rule 14e-3 was promulgated in part to respond to the Supreme

Court's decision in *Chiarella v. United States*, [387] which limited insider trading liability to those breaching a fiduciary duty. In *Chiarella*, the court rejected the "parity of information" approach, which deemed trading to be fraudulent whenever the trader possessed material information not generally available to the public. The court instead held that there must be a breach of a fiduciary duty or other relationship of trust and confidence before the law imposes a duty to disclose information or abstain from trading. In *Chiarella*, an employee of a financial printer discovered nonpublic information while printing corporate takeover bids and then used that information to trade at a profit. The court held that the employee did not have a fiduciary duty to disclose his knowledge to the target shareholders. This decision thus created a gap in the coverage afforded by Rule 10b-5, necessitating the enactment of Rule 14e-3.

Rule 14e-3 also prohibits the communication of inside information to others— "tipping"—where it is "reasonably foreseeable" that the tip might result in trading by the tippee, whether or not trading actually occurs. It is unclear whether Rule 10b-5 would be interpreted to extend this broadly. [388]

Rule 14e-3 does contain a defense, or "safe harbor," for financial institutions that conduct both trading and corporate finance activities. These companies may avoid liability by showing both that (i) the person who made the investment decision on behalf of the company was not actually in possession of the material information and (ii) the company had implemented procedures, such as "information barriers," to prevent those persons making investment decisions from obtaining inside information. [389]

Footnotes

367 *See* § 9.05 for a more general discussion of regulation of tender and exchange offers.

368 The "safe harbor" created by the Litigation Reform Act for certain projections and other forward-looking statements made by issuers or underwriters does not apply to statements made in the context of a tender offer or a going-private transaction. *See* § 11.03[5].

369 Senate Committee on Banking and Currency, Hearings Before the Subcommittee on Securities on S. 510, 90th Cong., 1st Sess. 21 (1967).

370 An investor that crosses the 5% threshold is normally required to report on Schedule 13D such holdings within ten days of the purchase that put it over the threshold. *See* Rule 13d-1 under the Exchange Act. However, certain "qualified institutional investors" ("QIIs") may file short-form Schedule 13G within ten days if the securities are not acquired "with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with … any transaction having that purpose or effect," so long as certain other requirements are met. Rule 13d-1(c) under the Exchange Act. Moreover, if the QII acquired no more than 10% of the shares of the company "for investment purposes in the ordinary course of business," and not with the intent of influencing control of the issuer, it may delay filing of short-form Schedule 13G

until 45 days after the end of the calendar year in which it made its purchase (and then only if it continued to own more than 5% at the end of the calendar year). Rule 13d-1(b) under the Exchange Act.

The SEC took a strong stance under § 13(d) of the Exchange Act and Rule 13d-1 thereunder against a merger arbitrage hedge fund that had acquired more than 5% of the voting stock of a company. *See In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009) ("*Perry*"). In *Perry*, the hedge fund was engaged in a strategy known as "merger arbitrage," which consisted of holding long the stock of a suspected target company and holding short the stock of the acquiror. However, when it became apparent that the acquiror's shareholders would vote down the merger, Perry began to purchase stock in the acquiror (without liquidating its short position) in order to use the shares to influence the merger vote, and at the same time entered into a total return swap that effectively eliminated the economic risk of ownership of the shares. When Perry exceeded the 5% threshold of the acquiror's shares, it took the position that it did so in the ordinary course of business and not for the purpose of effecting a change of ownership in the acquiror. Further, because its holdings did not cross the 10% threshold, Perry did not file short-form 13G, intending to wait until 45 days after the end of the calendar year to do so. On these facts, the SEC imposed a fine of $150,000 and entered a cease and desist order. The SEC ruled that whenever a merger arbitrage fund holds stock to affect the outcome of a merger vote, it does not purchase the stock in the ordinary course of business and thus cannot avail itself of the short-form Schedule 13G option. Instead, it must file Schedule 13D within ten days of its purchases exceeding 5% of the acquiring company.

In *Perry*, the SEC adopted a broad reading of § 13(d). It stated that both §§ 13(d) and 13(g) of the Exchange Act are "broad disclosure statutes" that go beyond "mere ‘technical’ reporting provisions." *In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009). Rather, the SEC stated, the provisions are the "pivot" of a regulatory scheme that "may represent the only way that corporations, their shareholders and others can adequately evaluate … the possible effects of a change in substantial shareholdings." *In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009) (citing *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993)). The SEC further explained that § 13(d) served the broad purposes of: "(i) providing adequate disclosure and other protections to stockholders in connection with takeover attempts, such as tender offers, and corporate repurchases, and (ii) providing adequate disclosure to stockholders in connection with any substantial acquisition of securities within a relatively short period of time." *In the Matter of Perry Corp.*, Admin. Proc. File No. 3-13561 (July 21, 2009) (citing Exchange Act Release No. 13291, 42 Fed. Reg. 12,342, 12,343 n.2 (Mar. 3, 1977)); *see also* Chapter 6.

371 *See generally Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 57 (1975) (discussing availability of injunctive relief under § 13(d) of the Exchange Act); *see, e.g.*, *Motient Corp. v. Dondero*, 529 F.3d 532, 536 (5th Cir. 2008) ("We agree with the district court that there is no private cause of action for money damages under Section 13(d)."); *Florida Commercial Banks v. Culverhouse*, 772 F.2d 1513, 1519 (11th Cir. 1985) (holding that there is a private right of action to seek corrective disclosure); *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 714–15 (5th Cir. 1984); *Indiana National Corp. v. Rich*, 712 F.2d 1180, 1184–85 (7th Cir. 1983); *Dan River, Inc. v. Unitex, Ltd.*, 624 F.2d 1216, 1224 (4th Cir. 1980), *cert. denied*, 449 U.S. 1101 (1981); *GAF Corp. v. Milstein*, 453 F.2d 709, 720–21 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972) (private actions under § 13(d)); *E.ON AG v. Acciona, S.A.*, 468 F. Supp. 2d 559, 573 (S.D.N.Y. 2007) (private actions under § 14(d)); *Milstein v. Huck*, 600 F. Supp. 254, 263 (E.D.N.Y. 1984); *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983) (private actions under § 14(d)). *But see Liberty National Insurance Holding Co. v. Charter Co.*, 734 F.2d 545, 570–71 (11th Cir. 1984) (holding that there is no private right of action available under either statute where an issuer seeks injunctive relief requiring the shareholder to divest shares and to refrain from voting its shares, pending divestiture).

372 *See Transcon Lines v. A.G. Becker, Inc.*, 470 F. Supp. 356, 376 (S.D.N.Y. 1979); *see also Treadway Companies v. Care Corp.*, 490 F. Supp. 660, 663–65 (S.D.N.Y.), *aff'd in relev. part, rev'd in part*, 638 F.2d 357, 380 (2d Cir. 1980).

373 *See Stirling v. Chemical Bank*, 382 F. Supp. 1146, 1151–52 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir.

1975); *Washburn v. Madison Square Garden Corp.*, 340 F. Supp. 504, 508 (S.D.N.Y. 1972).

374 The effect of the Sarbanes-Oxley Act on the statute of limitations for private rights of action, including those under § 14(e), is discussed in § 11.07[1][a].

375 *See, e.g.*, *Plaine v. McCabe*, 797 F.2d 713, 717 n.7 (9th Cir. 1986); *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 716 (5th Cir. 1984); *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 370–71 (6th Cir. 1981). *But see Liberty National Insurance Holding Co. v. Charter Co.,* 734 F.2d 545, 570–71 (11th Cir. 1984) (no private right of action for issuers seeking drastic injunctive relief).

376 *See, e.g.*, *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 596 (5th Cir. 1974); *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937, 946 (2d Cir. 1969). Shareholders who decided not to tender due to fraudulent misrepresentations have standing because, unlike § 10(b) of the Exchange Act, § 14(e) contains no language limiting claims to situations involving the actual purchase or sale of securities. *See Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 38–39 (1977).

377 *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 35 (1977). In some cases, unsuccessful offerors have been permitted to bring injunctive actions under § 14(e), on the theory that such actions result in "clear benefit" to the shareholders of the target. *See, e.g.*, *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 371–72 (6th Cir. 1981); *Humana, Inc. v. American Medicorp, Inc.*, 445 F. Supp. 613, 616 (S.D.N.Y. 1977). *But see Astronics Corp. v. Protective Closures Co.*, 561 F. Supp. 329, 332–33 (W.D.N.Y. 1983) (casting doubt about the validity of these cases in light of subsequent legal developments).

378 *See Panter v. Marshall Field & Co.*, 646 F.2d 271, 283–84 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Chris-Craft Industries v. Piper Aircraft Corp.*, 480 F.2d 341, 373 (2d Cir.), *cert. denied*, 414 U.S. 910, and *cert. denied*, 414 U.S. 924 (1973).

379 In addition to the "best price rule," Rule 14d-10 also includes the companion "all holders rule," which provides that any tender offer must be "open to all security holders of the class of securities subject to the tender offer." This provision has not been the subject of private litigation to the same extent as the best price rule.

380 For an example of such a lawsuit, and the court's analysis of the private right of action created under Rule 14d-10, *see Epstein v. MCA, Inc.*, 50 F.3d 644, 652 (9th Cir. 1995), *vacated on other grounds*, 516 U.S. 367 (1996), and *Katt v. Titan Acquisitions, Ltd.*, 133 F. Supp. 2d 632, 640 (M.D. Tenn. 2000) (gathering authority).

381 SEC Release No. 34-54684 (Nov. 1, 2006).

382 Courts had adopted competing interpretations of the best price rule. Some courts followed the "bright line test," holding that a transaction that is entered into with an executive prior to the actual commencement of the tender offer can never be subject to the best price rule. *See, e.g.*, *Gerber v. Computer Associates International, Inc.*, 303 F.3d 126 (2d Cir. 2002); *Lerro v. Quaker Oats Co.*, 84 F.3d 239 (7th Cir. 1996); *Katt v. Titan Acquisitions, Ltd.*, 244 F. Supp. 2d 841 (M.D. Tenn. 2003); *In re Digital Island Securities Litigation*, 223 F. Supp. 2d 546 (D. Del. 2002); *Walker v. Shield Acquisition Corp.*, 145 F. Supp. 2d 1360 (N.D. Ga. 2001). Other courts followed the "integral part test," holding that any transaction integral or closely related to the tender offer can be subject to the best price rule. This test is ambiguous and its application is more difficult to predict. *See, e.g.*, *Epstein v. MCA. Inc.*, 50 F.3d 644 (9th Cir. 1995); *Millionerrors Investment Club v. General Electric Co. PLC*, Fed. Sec. L. Rep (CCH) ¶90,944 (W.D. Pa. Mar. 21, 2000).

383 Filings may be required, for example, under the Hart-Scott-Rodino Antitrust Improvements Act. *See* § 9.06.

384 The Sarbanes-Oxley Act creates a new statute of limitations for private rights of action under Rule 14e-3, which is discussed in § 11.07[1][a].

385 Rule 14e-3 is not applicable to insider trading connected with mergers or consolidations, which must be addressed, along with other types of insider trading, under Rule 10b-5. *See* § 11.05[2].

386 *Cf.* § 11.05[2]. The absence of a "breach of duty" element in Rule 14e-3 sparked challenges to its validity, with litigants contending that the SEC exceeded its rulemaking authority. The Supreme Court has since held, however, that Rule 14e-3 was validly promulgated, and that SEC prohibitions may sweep in

nonfraudulent acts and practices so long as the rule is "reasonably designed" to prevent fraudulent activity. *See United States v. O'Hagan*, 521 U.S. 642 (1997); *see also United States v. Chestman*, 947 F.2d 551, 557 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

387 *See Chiarella v. United States*, 445 U.S. 222 (1980).

388 *See* § 11.05[2][a][ii].

389 Rule 14e-3 under the Exchange Act. *See* § 14.07[1][b] for a discussion of "information barriers."

U.S. Regulation of the International Securities and Derivatives Markets, § 11.07, ENFORCEMENT RELATED PROVISIONS OF THE SARBANES-OXLEY AND DODD-FRANK ACTS

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 § 11.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Sarbanes-Oxley Act contains a number of provisions relevant to civil, administrative and criminal enforcement. Several of these provisions expand on the existing powers of the SEC under the Exchange Act and the Securities Act, while other provisions seek to stiffen penalties and eliminate perceived deficiencies in the previously existing enforcement scheme for corporate and securities fraud in light of the corporate scandals that preceded the passage of the Act.

[1] Civil Enforcement

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[a] Statute of Limitations for Securities Fraud

The Sarbanes-Oxley Act created a new statute of limitations for any private right of action involving a claim for fraud "in contravention of a regulatory requirement" under the securities laws of the earlier of two years from the date of discovery or five years from the date of the violation. [390] Although the Sarbanes-Oxley Act is not explicit about the claims that it intends to cover, the likely interpretation of this provision is that it will provide the applicable limitations period for securities claims only where the securities laws themselves do not expressly set out the limitations period. To determine whether the new statute of limitations applies, courts have noted that, by its terms, the provision only applies to "a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws." [391] Based on this limitation, courts have generally only applied the longer limitations period to claims that require a showing of fraudulent intent as an element of the cause of action. [392] Courts have noted that Congress used language that mirrors § 10(b) of the Exchange Act in § 804, when it could just as easily have made clear that the new limitations period applied to all actions under the securities laws. Thus, the new statute of limitations will likely not apply to causes of action pursuant to §§ 9 and 18 of the Exchange Act or §§ 11 and 12 of the Securities Act, [393] but likely applies to causes of action

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pursuant to § 10(b) of the Exchange Act. [394] The statute of limitations for claims under § 10(b) previously had been the earlier of one year from the date of discovery or three years from the date of violation. [395] Courts, however, have determined that the new statute of limitations does not apply to § 14 of the Exchange Act even though § 14 does not expressly set out the limitations period. [396]

[b] Debts Nondischargeable if Incurred in Violation of Securities Fraud Laws

The Sarbanes-Oxley Act also created an additional exception to the discharge of any individual bankruptcy debtor in a bankruptcy proceeding from any debt relating to any judgment, settlement or order resulting from the violation of the federal or state securities laws or regulations or common law fraud in connection with the purchase or sale of a security. [397]

[c] Whistleblower Protections and Incentives

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[i] *Civil Action to Protect Against Retaliation*

The Sarbanes-Oxley Act created a civil action to protect informants or whistleblowers from possible retaliation for providing assistance or information to federal regulatory or law enforcement agencies, any member or committee of Congress, or any other proceeding concerning alleged violations of any SEC rule, mail fraud, wire fraud, bank fraud, securities fraud or any federal law relating to fraud against shareholders. [398] Initially, the employee is required to show that the whistleblowing conduct was a "contributing factor" in the unfavorable personnel action and must file a claim with the Department of Labor within 90 days of violation. That period was extended to 180 days by the Dodd-Frank Act, and now allows an employee to bring a claim within 180 days of the date in which he or she became aware of the violation. [399]

The Department of Labor administers the employee's complaint, but the employee can bring a claim before a district court if a final decision is not issued by the Department of Labor within 180 days of filing the claim. The Sarbanes-Oxley Act authorizes the following remedies: reinstatement, back pay, interest, attorneys' fees, "any special damages sustained as a result of the discrimination" and "all relief necessary to make the employee whole." [400] It is unclear whether punitive damages are available. The Dodd-Frank Act clarified that a jury trial is available under such claims. [401] These rights may not be waived by any agreement or condition of employment, including by a predispute arbitration agreement. [402]

The Sarbanes-Oxley Act had limited these remedies mainly to employees who work for a publicly traded company or brokerage firm, including the

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employees of their private contractors and subcontractors. [403] The Dodd-Frank Act further expanded coverage to employees of any "nationally recognized statistical rating organization." [404] In addition, the Dodd-Frank Act created a private right of action for *any* employee (not just those of publicly traded companies) that is the subject of discharge, demotion, suspension, harassment, threats or any manner of discrimination in the terms and conditions of employment, for providing information to the SEC or making the disclosures required or protected under the Sarbanes-Oxley Act, the Exchange Act, or any other law or rule subject to the jurisdiction of the SEC. [405] However, in *Liu Meng-Lin v. Siemens AG*, the Second Circuit held that this provision of the Dodd-Frank Act does not apply extraterritorially, and declined to apply the provision where "the whistleblower, his employer, and the other entities involved in the alleged wrongdoing are all foreigners based abroad, and the whistleblowing, the alleged corrupt activity, and the retaliation all occurred abroad." [406]

[ii] *Whistleblower Incentives*

In addition to expanding the protections for whistleblowers as detailed above, the Dodd-Frank Act provided additional incentives in the form of monetary compensation. Section 922(a) of the Act added a new § 21F to the Exchange Act, which establishes the Securities and Exchange Commission Investor Protection Fund (the "SEC Fund"). [407] The SEC must deposit into the SEC Fund all moneys collected in proceedings enforcing the securities laws, to the extent not added to a disgorgement fund under § 308 of the Sarbanes-Oxley Act, [408] and to the extent the balance of the SEC Fund does not exceed $300 million. In addition, the SEC must deposit into the SEC Fund all funds from the

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§ 308 disgorgement funds that are not distributed to victims of securities law violations, unless the SEC Fund's balance exceeds $200 million. [409]

The new § 21F provides that, upon the completion of a successful administrative or judicial action that results in monetary sanctions exceeding $1,000,000, the SEC shall award to any whistleblower who voluntarily provided information not already known to the SEC an amount equal to no less than ten percent and no more than 30% of the total collected as monetary sanction in such enforcement action. [410] The determination of the proper award is left to the discretion of the SEC after consideration of certain guidelines listed in § 21F(c). Whistleblowers are given the opportunity to appeal the SEC's determination of whether or to whom to award any amount under this provision to the appropriate United States Court of Appeals. [411] As of August 2016, the SEC had awarded more than $107 million to 33 whistleblowers under its whistleblower program. [412]

[2] Regulatory Enforcement

[a] Disgorgement of Incentive Compensation Following Restatements

Section 304 of the Sarbanes-Oxley Act requires the chief executive officer and chief financial officer of an issuer to reimburse it for all bonuses and other incentive-based or equity-based compensation received, as well as all profits realized from sales of issuer securities, in the 12-month period following the first public issuance or filing of reported financial statements that are later restated due to material noncompliance with any financial reporting requirement as a result of misconduct. [413] The Ninth Circuit has held that this provision "allows the SEC to seek disgorgement from CEOs and CFOs even if the triggering restatement did not result from misconduct on the part of those officers." [414]

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The Dodd-Frank Act requires the SEC to direct national securities exchanges and associations to modify their listing standards to require new disgorgement policies from listed companies. Specifically, it requires that issuers with listed securities establish a clawback policy in the event of an accounting restatement that would recover incentive-based compensation received during the three-year period *preceding* the date of the restatement due to material noncompliance by the company with any financial reporting requirement under the federal securities laws. [415] The provision is required to apply to any current or former executive officer of the issuer (not just the CEO and CFO) "in excess of what would have been paid to the executive officer under the accounting restatement." [416] A showing of misconduct on the part of either the issuer or the officer is not required. [417]

[b] Restrictions on Persons Serving as Directors and Officers

Section 1105 of the Sarbanes-Oxley Act amended § 21C of the Exchange Act and § 8A of the Securities Act to authorize the SEC, in connection with a cease-and-desist proceeding, to issue an order barring any person who has violated § 10(b) of the Exchange Act or § 17(a)(1) of the Securities Act, as applicable, from acting as a director or officer of any issuer "if the conduct of that person demonstrates unfitness to serve as an officer or director." [418] Prior to these

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amendments to the Exchange Act and Securities Act, the SEC could only seek a bar in court. [419]

Section 305(a) of the Sarbanes-Oxley Act also amended § 21(d)(2) of the Exchange Act and § 20(e) of the Securities Act to provide that a U.S. federal court may, pursuant to a proceeding initiated by the SEC, bar any person who violates § 10(b) of the Exchange Act or § 17(a)(1) of the Securities Act from acting as an officer or director of any issuer, if such person's conduct demonstrates "unfitness" to serve as an officer or director of an issuer. Prior to these amendments, a court could only bar a person whose conduct demonstrated "substantial unfitness" to serve in such capacity.

Notably, the above amendments to the Securities Act and Exchange Act give the SEC and U.S. federal courts the power to determine the eligibility of foreign persons to serve on the boards of directors or as executive officers of foreign issuers that are SEC reporting companies.

[c] Equitable Relief

Section 305(b) of the Sarbanes-Oxley Act created a new § 21(d)(5) of the Exchange Act that states that the SEC may seek, and any federal court may grant, "any equitable relief that may be appropriate or necessary for the benefit of investors." Although both what specific power the Sarbanes-Oxley Act intended to bestow upon the SEC and the scope of those powers are unclear, the SEC has already invoked this provision in an enforcement proceeding to seek disgorgement of all compensation received after allegedly fraudulent conduct had occurred, not just the bonuses or other incentive-based or equity-based compensation that are subject to recapture under § 304. [420]

[d] Disgorgement Funds

Section 308 of the Sarbanes-Oxley Act provides that the SEC may, in any judicial or administrative matter in which the SEC obtains an order or settlement for disgorgement, cause any civil penalties to be paid to the disgorgement fund

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established for the benefit of the violation's victims. [421] The SEC may accept additional contributions to the fund. The Dodd-Frank Act, however, eliminated the requirement that the SEC obtain an order or settlement for disgorgement, and allows it to pay any civil penalties to a disgorgement or other fund established for the benefit of the violation's victims. [422]

[e] SEC Authority to Seek Order Freezing Certain Assets of an Issuer During an Investigation Involving Possible Federal Securities Law Violations

Section 1103 of the Sarbanes-Oxley Act authorizes the SEC to petition a U.S. federal court for a temporary order requiring an issuer of "publicly traded securities" to escrow any "extraordinary payments (whether compensation or otherwise)" that appear likely to the SEC to be made to any director, officer, partner, controlling person, agent or employee of the issuer during an investigation of such issuer or individual involving possible violations of the U.S. federal securities laws. A court may issue such an order after notice and an opportunity for a hearing, unless the court determines this requirement to be impracticable or contrary to the public interest. Section 1103 further provides that a court order would take effect immediately and remain in effect for 45 days, unless set aside or modified by a court. The initial order may also be extended by up to 45 additional days for "good cause shown." If, prior to the expiration of the order, the issuer or individual is charged with a federal securities law violation, § 1103 provides that the order will remain in effect until the conclusion of any related legal proceedings, subject to court approval and the right of the issuer or individual to petition the court. If no charges are brought prior to the order's expiration, the disputed payments (plus accrued interest) must be returned to the issuer or individual.

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Section 1103 raises interpretive issues with respect to scope, including the definition of "publicly traded securities," "extraordinary payments" and "good cause shown" and the duration of an order following the filing of charges relating to an alleged federal securities law violation. [423] Although the SEC sought and the Ninth Circuit Court of Appeals upheld a § 1103 order in *SEC v. Gemstar-TV Guide International, Inc.*, and the then-SEC Chairman signaled that the *Gemstar* decision would prompt increased § 1103 petitions, the SEC has made minimal use of this provision. [424]

[3] Enhanced Criminal Provisions Under the Sarbanes-Oxley Act

[a] Certification of Periodic Reports Containing Financial Statements

Section 906 of the Sarbanes-Oxley Act requires that each "periodic report containing financial statements filed by an issuer with the [SEC]" must be accompanied by a certification by the issuer's chief executive officer and chief financial officer (or equivalent thereof) that the report "fully complies with the requirements of § 13(a) or § 15(d) of the [Exchange Act] and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer." [425] Section 906, which is

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enforceable by the DOJ and not the SEC, imposes criminal liability for inaccurate certifications knowingly or willfully furnished. [426]

[b] Destruction, Alteration or Falsification of Records

The Sarbanes-Oxley Act added § 1519 to Title 18 of the U.S. Code, making it a crime to knowingly destroy, alter or falsify any record, document, or tangible object with the intent to impede, obstruct or influence a federal investigation or bankruptcy or in relation to or contemplation of any such matter, and amended existing § 1512 of Title 18 of the U.S. Code to apply to document destruction or alteration in any federal court or similar proceeding. [427] In each case, the maximum sentence is 20 years imprisonment. In a case concerning the prosecution of a commercial fisherman under this provision for tossing illegally harvested fish into the sea, the Supreme Court recently clarified that § 1519 "cover[s] only objects one can use to record or preserve information, not all objects in the physical world." [428]

[c] Destruction of Corporate Audit Records

The Sarbanes-Oxley Act added § 1520 to Title 18 of the U.S. Code, requiring (i) any accountant conducting an audit of an issuer to maintain work papers for a defined period and (ii) the SEC to promulgate rules regarding the retention

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of work papers and other documents. [429] In response, the SEC amended Regulation S -X to require accountants to retain work papers for seven years following their conclusion of an audit or review of an issuer's financial statements. [430] The maximum sentence for violation of the Sarbanes-Oxley Act's requirement or the SEC's rules thereunder is ten years' imprisonment.

[d] Securities Fraud

The Sarbanes-Oxley Act added § 1348 to Title 18 of the U.S. Code, making it a crime to defraud any person in connection with any security of an issuer. [431] This section does not contain the purchase or sale requirement contained in § 10(b) of the Exchange Act. [432] The maximum sentence is 25 years' imprisonment.

[e] Retaliation Against Informants

The Sarbanes-Oxley Act added § 1513 to Title 18 of the U.S. Code, making it a crime to retaliate against any person for providing information to a law enforcement officer. [433] The maximum sentence is ten years' imprisonment.

[f] Increased Maximum Penalties

The Sarbanes-Oxley Act increased the maximum sentence for mail and wire fraud from five to 20 years' imprisonment. [434] It also increased the maximum criminal penalties under the Exchange Act from $1 million to $5 million for individuals and from $2.5 million to $25 million for entities, and the maximum prison sentence from ten years to 20 years. [435] The Sarbanes-Oxley Act increased the penalties for a willful violation of ERISA's reporting and disclosure provisions to a fine of not more than $100,000 and imprisonment for not more than ten years. [436]

[g] Review by U.S. Sentencing Commission

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The Sarbanes-Oxley Act instructed the U.S. Sentencing Commission, which, as discussed further in § 11.09[3][d], sets the sentencing guidelines used by U.S. federal courts, to review the guidelines for obstruction of justice, criminal fraud and securities and accounting fraud related offenses, and to ensure that the sentencing guidelines reflect the nature of the offenses and penalties set forth in the Act. [437] In 2003, the Commission promulgated permanent amendments to reflect the provisions of the Sarbanes-Oxley Act. [439] These amendments, which became effective November 1, 2003, made permanent the temporary amendments and added several provisions. Together, the amendments increased the penalties and the scope of the current sentencing guidelines for corporate and serious white-collar frauds. Specifically, the amendments:

- significantly increased certain penalty enhancements for offenses affecting more than 50 victims;
- expanded the scope of certain penalty enhancements to cover offenses that substantially endanger (i) the solvency or financial security of an organization that at the time was publicly traded or had 1,000 or more employees, or (ii) the solvency or financial security of 100 or more victims (prior to the amendments, the enhancements applied only if the offense substantially jeopardized the safety and soundness of a financial institution);
- created a new penalty enhancement to cover violations of securities laws by officers or directors of publicly traded companies, registered broker-dealers and investment advisers;
- significantly increased penalties for offenses such as wire fraud and mail fraud;
- significantly increased penalties for offenses in which the loss exceeds $200 million (reduction in value of equity securities or other corporate assets is now a factor in measuring losses); and
- significantly increased penalties for obstruction of justice offenses and create new penalty enhancements to cover alteration or fabrication of substantial

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numbers of documents or objects, destruction of particularly probative documents or objects, or offenses that were extensive in scope, planning or preparation.

Footnotes

390 *See* § 804 of the Sarbanes-Oxley Act.

391 *See* § 804 of the Sarbanes-Oxley Act.

392 *See In re Alstom S.A.*, 406 F. Supp. 2d 402, 412 (S.D.N.Y. 2005) (noting that "Section 804 ‘by its plain text’ does not apply to claims under the securities laws that do not require any showing of fraudulent intent as an element of the cause of action" and holding that the new limitations period does not apply to § 11, § 12 or § 15 claims under the Securities Act or § 18 claims under the Exchange Act, but does apply to § 10(b) claims under the Exchange Act). In *Alstom*, the plaintiff contended that even though a § 11/§ 12 plaintiff need not plead fraud in all cases, the longer limitations should apply when a § 11/§ 12 plaintiff *does* plead fraud. The court rejected this argument in favor of a bright line rule that selects the statutory period based on the elements of the *prima facie* claim instead of the individual circumstances of the plaintiff's factual pleadings. *See also In re Pfizer Inc. Securities Litigation*, 584 F. Supp. 2d 621, 641–43 (S.D.N.Y. 2008) (holding that the extended Sarbanes-Oxley statute of limitations did not apply to § 18 claims because fraudulent intent is not an element of a *prima facie* case under that section).

393 Most courts to consider the issue have determined that the new statute of limitations does not apply to §§

11 and 12 of the Securities Act. *See In re Metropolitan Securities Litigation*, 532 F. Supp. 2d 1260, 1284 (E.D. Wash. 2007); *Cohen v. Northwestern Growth Corp.*, 385 F. Supp. 2d 935 (D.S.D. 2005); *In re Alamosa Holdings, Inc. Securities Litigation*, 382 F. Supp. 2d 832, 863–64 (N.D. Tex. 2005); *Ballard v. Tyco International*, Fed. Sec. L. Rep. (CCH) ¶93,242 (D.N.H. 2005) at 4; *Lawrence E. Jaffe Pension Plan v. Household International, Inc.*, Fed. Sec. L. Rep. (CCH) ¶92,713 (N.D. Ill. Mar. 22, 2004); *In re Merrill Lynch & Co. Research Reports Securities Litigation*, 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003); *In re Global Crossing Ltd. Securities Litigation*, 313 F. Supp. 2d 189, 195–97 (S.D.N.Y. 2003).

394 *See In re Exxon Mobil Corp. Securities Litigation*, 500 F.3d 189, 197 (3d Cir. 2007); *In re Brocade Communication Systems Inc. Derivative Litigation*, 615 F. Supp. 2d 1018, 1035–36 (N.D. Cal. 2009); *GVA Market Neutral Master Ltd. v. Veras Capital Partners Offshore Fund, Ltd.*, 580 F. Supp. 2d 321, 327 (S.D.N.Y. 2008); *In re Alstom S.A. Securities Litigation*, 406 F. Supp. 2d 402, 412 (S.D.N.Y. 2005); *In re AOL Time Warner Securities & "ERISA" Litigation*, Fed. Sec. L. Rep. (CCH) ¶92,812 at 27 (S.D.N.Y. 2004); *In re Merrill Lynch & Co. Research Reports Securities Litigation*, 272 F. Supp. 2d 243, 265 (S.D.N.Y. 2003).

395 *See* Elaine Buckberg *et al.*, National Economic Research Assoc., Inc., *Recent Trends in Securities Class Action Litigation: 2003 Early Update* (2004) (concluding that the Sarbanes-Oxley Act has had a limited impact upon securities litigation, despite the expansion of the statute of limitations). Assuming post-Litigation Reform Act levels, the research indicates that there is no "statistically significant" change in the level of litigation after the enactment of the Sarbanes-Oxley Act. There have been, however, fewer dismissals of cases by district courts. *But see* Price Waterhouse-Coopers LLP, *Securities Litigation Study* (2004) (finding that the Sarbanes-Oxley Act has led to a significant change in the level of litigation by "revealing even more securities violations, financial frauds, accounting irregularities and corporate 'accounting melt-downs,'" while recognizing that in the future the Sarbanes-Oxley Act may work to deter financial frauds).

396 *See In re Exxon Mobil Corp. Securities Litigation*, 500 F.3d 189, 197 (3d Cir. 2007) (holding that the extended statute of limitations did not apply to § 14(a) claims for filing false proxy statements); *In re Maxim Integrated Products, Inc., Derivative Litigation*, 574 F. Supp. 2d 1046, 1072 (N.D. Cal. 2008); *Virginia M. Damon Trust v. North Country Financial Corp.*, 325 F. Supp. 2d 817, 823–25 (W.D. Mich. 2004); *In re Global Crossing Ltd. Securities Litigation*, 313 F. Supp. 2d 189, 195–97 (S.D.N.Y. 2003).

397 *See* § 803 of the Sarbanes-Oxley Act.

398 *See* § 806 of the Sarbanes-Oxley Act, creating new 18 U.S.C. § 1514A; *see also* Robert G. Vaughn, *America's First Comprehensive Statute Protecting Corporate Whistleblowers*, 57 ADMIN. L. REV. 1 (2005); *Carnero v. Boston Scientific Corp.*, Fed. Sec. L. Rep. (CCH) ¶92,910 (D. Mass. Aug. 27, 2004) (noting an absence of Congressional intent for extraterritorial application, the court declined to extend the protection of § 806 to an employee who was a foreign national and who worked exclusively overseas in the Argentinean subsidiary of a U.S. company); § 4.07[7][b] (discussing whistleblowers protection under the Sarbanes-Oxley Act).

399 *See* § 922(c) of the Dodd-Frank Act.

400 18 U.S.C. § 1514A(c)(1); *see, e.g.*, Joseph T. Hallihan, *WaMu Is Ordered to Rehire Staffer*, WALL ST. J., May 13, 2005, at A6 (reporting that the Labor Department ordered Washington Mutual to rehire Theresa Hagman, a former executive who raised questions about the loan granting process in Washington Mutual's construction-loan division, under the whistleblower provisions of the Sarbanes-Oxley Act).

401 *See* § 922(c) of the Dodd-Frank Act.

402 § 922(c) of the Dodd-Frank Act.

403 *See Lawson v. FMR LLC*, 134 S. Ct. 1158 (2014).

404 § 922(b) of the Dodd-Frank Act.

405 *See* § 922(a) of the Dodd-Frank Act. Lower courts have disagreed concerning whether the anti-retaliation protections of the Dodd-Frank Act only protect employees who provide information to the SEC or also extend to employees who only report violations internally. *Compare Asadi v. G.E. Energy (USA), LLC*, 720

F.3d 620 (5th Cir. 2013) ("Based on our examination of the plain language and structure of the whistleblower-protection provision, we conclude that the whistleblower-protection provision unambiguously requires individuals to provide information relating to a violation of the securities laws *to the SEC* to qualify for protection from retaliation.") *with Berman v. Neo@Ogilvy LLC*, 801 F.3d 145, 155 (2d Cir. 2015) (finding the language of the Dodd-Frank Act to be ambiguous and therefore deferring to the SEC's interpretation of the statute as creating a remedy for whistleblowers who report internally).

406 *Liu Meng-Lin v. Siemens AG*, 763 F.3d 175, 179-83 (2d Cir. 2014).

407 *See* § 922(a) of the Dodd-Frank Act.

408 *See* § 11.07[2][d].

409 *See* § 11.07[2][d].

410 *See* § 5.04[6] for a discussion of the whistleblower program implemented under § 21F of the Exchange Act.

411 *See* § 11.07[2][d].

412 *See* Press Release, SEC, SEC Whistleblower Program Surpasses $100 Million in Awards (Aug. 30, 2016).

413 This provision is discussed in greater detail in § 5.05[2].

414 *SEC v. Jensen*, 835 F.3d 1100, 1116 (9th Cir. 2016). Plaintiffs in various circuits have attempted to bring private actions against corporate officers under § 304 of the Sarbanes-Oxley Act. However, no court to date has recognized a private right of action under § 304. *See In re Goodyear Tire & Rubber Co.*, Fed. Sec. L. Rep. (CCH) ¶94,142 (N.D. Ohio Jan. 5, 2007); *In re Digimarc Corp.*, Civil No. 05-1324-HA (LEAD), 2006 WL 2345497, at *2 (D. Or. Aug. 11, 2006) ("That there is no private cause of action explicitly stated in [Sarbanes-Oxley Act § 304] is beyond dispute."), *aff'd in relevant part, In re Digimarc Corp. Derivative Litigation*, 549 F.3d 1223, 1233 (9th Cir. 2008) ("[W]e conclude that section 304 does not create a private right of action"); *In re BISYS Group Inc.*, 396 F. Supp. 2d 463 (S.D.N.Y. 2005) ("[T]he omission in Section 304 [of language explicitly authorizing private actions] appears to have been quite deliberate."); *In re Qwest Communications International, Inc. Securities Litigation*, 387 F. Supp. 2d 1130 (D. Colo. 2005) (holding that a stockholder lacked standing under § 304 and thus not reaching the issue of whether such a claim could be brought by a proper plaintiff).

415 *See* § 954 of the Dodd-Frank Act.

416 *See* § 954 of the Dodd-Frank Act. Although § 954 does not define "executive officer," the SEC has proposed a rule that includes a definition modeled on the definition of "officer" under § 16 of the Exchange Act, which covers "the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer." SEC Release No. 34-75342 (July 1, 2015). The SEC's proposed rule further defines the recoverable amount as "the amount of incentive-based compensation received by the executive officer or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement," calculated on a pre-tax basis. SEC Release No. 34-75342 (July 1, 2015).

417 *See* § 954 of the Dodd-Frank Act.

418 *See, e.g.*, *SEC v. Symbol Technologies*, SEC Litigation Release No. 19086 (Feb. 17, 2005) (relating to consent of former Chief Accounting Officer and Senior Vice President of Worldwide Operations to permanent injunctive relief and officer-and-director bar); *see also* § 5.04[4] (discussing further orders barring persons from serving as directors and officers).

419 The Charity Aid, Recovery and Empowerment Act of 2003 (the "CARE Act"), which was passed by the Senate but never reached a vote in the House of Representatives, would have further expanded the SEC's power to act without court authority, including the ability to impose fines in administrative proceedings. S. 476, 108th Cong. (2003). The relevant provision of the CARE Act was previously introduced in the Senate as the SEC Civil Enforcement Act and incorporated in whole in the CARE Act. S. 183, 108th Cong. (2003).

420 *See SEC v. Kozlowski*, SEC Litigation Release No. 17722 (Sept. 12, 2002); § 5.04[3].

421 This provision was applied by the SEC in its $300 million settlement against Time Warner and its $500 million settlement against WorldCom. *See SEC v. Time Warner Inc.*, SEC Litigation Release No. 19147 (Mar. 21, 2005); *SEC v. WorldCom Inc.*, SEC Litigation Release No. 18147 (May 19, 2003). The former Chairman of the SEC also indicated he intended that the federal regulators' portion of the penalties in connection with the global settlement regarding analyst conflicts of interest be contributed under this provision to the distribution funds created by the settlement. *See* Global Research Analyst Settlement: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs, 108th Cong. (May 7, 2003) (statement of William H. Donaldson, former Chairman, SEC). On June 5, 2003, the SEC announced the $22 million payment it will receive from its settlement with six senior executives of Xerox Corporation alleged to have participated in securities fraud will be paid into a court account pursuant to this provision. *See SEC v. Allaire*, SEC Litigation Release No. 18174 (June 5, 2003).

422 *See* § 929B of the Dodd-Frank Act.

423 Pursuant to § 1103 of the Sarbanes-Oxley Act, a California district court ordered Gemstar-TV Guide International, Inc. ("Gemstar") to freeze for 45 days the $37.64 million it agreed to pay its former Chief Executive Officer and Chief Financial Officer, whose accounting and disclosure practices during their tenure at Gemstar were being investigated by the SEC. *See SEC v. Yuen*, SEC Litigation Release No. 18135 (May 13, 2003). The Ninth Circuit, en banc, upheld the decision and declared that when determining the scope of an extraordinary payment, courts should be free to determine the proper context in which to evaluate such evidence as the size, purpose and circumstances of payments. The court held that Sarbanes-Oxley "does not compel any specific method of making the determination but allows for the consideration of a variety of factors." *SEC v. Gemstar-TV Guide International, Inc.*, 401 F.3d 1031 (9th Cir. 2005) (*en banc*), *cert. denied sub nom.*, *Yuen v. SEC*, 546 U.S. 933 (2005); *see also SEC v. Gemstar-TV Guide International, Inc.*, SEC Litigation Release No. 18760 (June 23, 2004).

HealthSouth Corp. also consented to an escrow of certain extraordinary payments to its executive officers and directors. *See SEC v. HealthSouth Corp.*, SEC Litigation Release No. 18044 (Mar. 20, 2003); *SEC v. HealthSouth Corp.*, 261 F. Supp. 2d 1298 (N.D. Ala. 2003).

424 *See SEC v. Gemstar-TV Guide International, Inc.*, 401 F.3d 1031 (9th Cir. 2005) (*en banc*), *cert. denied sub nom.*, *Yuen v. SEC*, 546 U.S. 933 (2005); *Testimony Before The House Committee On Financial Services Concerning The Impact Of The Sarbanes-Oxley Act*, by Former Chairman William H. Donaldson (Apr. 21, 2005).

425 The periodic reports for which this certification is required, the location of the certification and the other certification requirements of the Sarbanes-Oxley Act are discussed in further detail in § 5.03[7]. *See also supra* Note 194 (discussing whether certifications may be used to demonstrate *scienter* in civil litigation actions brought under § 10(b) of the Exchange Act and Rule 10b-5 thereunder).

426 The penalties include up to 20 years' imprisonment for anyone who "willfully" certifies such statements, or up to ten years' imprisonment for anyone who otherwise certifies such statements knowing that the report does not comport with all the relevant requirements. One peculiar aspect of the statute is that the penalties apply to non-compliance with the terms of the certification, but the statute does not explicitly provide that a failure to certify triggers liability.

427 *See* §§ 802 and 1102 of the Sarbanes-Oxley Act. Prior to the Sarbanes-Oxley Act, the general obstruction statute, 18 U.S.C. § 1503, prohibited a person from corruptly endeavoring to influence, obstruct or impede the due administration of justice, and the general tampering statute, 18 U.S.C. § 1512, prohibited one person from corruptly persuading another to destroy a document to prevent its use in an official proceeding. In 2002, Arthur Andersen was convicted under the then-existing 18 U.S.C. § 1512. The Supreme Court reversed the conviction in 2005 due to flawed jury instructions and remanded the case for further proceedings. *See Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005). The Sarbanes-Oxley Act amendments likely reflect Congressional concerns that the existing statutes were inadequate: § 1503 captured individuals acting alone, but required a pending proceeding, and § 1512 did not require a pending

proceeding, but failed to capture individuals acting alone. Both the amended § 1512 and the new § 1519 capture individuals acting alone and neither requires a pending proceeding. Amended § 1512 also applies beyond document destruction to include any conduct that corruptly "otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so." § 1102 of the Sarbanes-Oxley Act.

428 *See Yates v. United States*, 135 S. Ct. 1074 (2015).

429 *See* § 802 of the Sarbanes-Oxley Act.

430 *See* Rule 2-06 of Regulation S -X.

431 *See* § 807 of the Sarbanes-Oxley Act.

432 *See* § 11.04[2].

433 *See* § 1107 of the Sarbanes-Oxley Act.

434 *See* § 903 of the Sarbanes-Oxley Act.

435 *See* § 1106 of the Sarbanes-Oxley Act.

436 *See* § 904 of the Sarbanes-Oxley Act.

437 *See* §§ 805, 905, and 1104 of the Sarbanes-Oxley Act.

[438] [Reserved.]

439 *See* U.S. Sentencing Commission, GUIDELINES MANUAL, App. C (2003).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.08, ENFORCEMENT OF THE FOREIGN CORRUPT PRACTICES ACT

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 § 11.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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As discussed in § 4.08, the Foreign Corrupt Practices Act of 1977, [440] as amended by the Foreign Corrupt Practices Act Amendments of 1988 [441] and the International Anti-Bribery and Fair Competition Act of 1998 [442] (collectively, the "FCPA"), [443] comprises two sets of provisions that impose certain prohibitions and requirements on companies, referred to in the FCPA as "issuers," that have registered securities under the Exchange Act or are required to file reports under § 15(d) of the Exchange Act. One set prohibits the bribery [444] of foreign officials. [445] The other requires issuers to (i) maintain books, records and accounts

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which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer and (ii) devise and maintain an adequate system of internal accounting controls. [446] Enforcement of the two types of prohibitions is frequently in tandem because, as U.S. authorities explain, bribes are "often concealed under the guise of legitimate payments, such as commissions or consulting fees," and the "payment of bribes often occurs in companies that have weak internal control environments." [447] As discussed at § 11.08[5], the SEC and the DOJ have aggressively expanded FCPA enforcement over the last decade.

[1] Penalties for Violations of the FCPA

Both the antibribery and record keeping portions of the FCPA provide for criminal and civil penalties for violations of the Act. Settlement agreements

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resolving FCPA enforcement actions now often require defendants to appoint independent compliance monitors with broad authority to review corporate compliance with anticorruption laws.

[a] Antibribery Provisions

The FCPA's antibribery provisions provide for severe criminal penalties. Convicted individuals face imprisonment of up to five years and a fine of up to $250,000. [448] Convicted issuers are subject to fines of $2,000,000. [449] A court can also impose a fine equal to double the amount of gross gain or loss from the violation. [450]

In addition, the SEC may bring civil actions against issuers and individuals, which can result in a $19,787 fine for each violation. [451] When such criminal or civil fines are imposed on an officer, director, employee or agent of an issuer, the issuer may not pay the fine on behalf of the individual. [452]

[b] Accounting Provisions

An issuer that willfully violates the FCPA's accounting provisions is subject to a fine of up to $25 million. [453] An individual who willfully violates the accounting provisions can be fined up to $5 million and imprisoned up to 20 years. [454] The SEC can also impose disgorgement of profits and fines in civil actions under the FCPA accounting provisions, without regard to intent or negligence. [455]

[2] Injunctions

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The Exchange Act authorizes the SEC to issue a cease-and-desist order or to bring an action to obtain an injunction against any person, including an issuer, who has engaged or is about to engage in acts or practices that violate any part of the Exchange Act, including the FCPA. [456]

[3] Enforcement by the DOJ and the SEC

The SEC is responsible for civil enforcement of the FCPA with respect to issuers. The DOJ brings all criminal enforcement actions against issuers, as well as civil enforcement actions against non-issuers. Enforcement actions under the FCPA are not limited to domestic issuers. Foreign issuers are also subject to the reach of the FCPA, as seen in the recent SEC and DOJ actions brought against foreign issuer VimpelCom Limited, an Amsterdam-based company, for allegedly conspiring to pay more than $114 million in bribes to a government official in Uzbekistan to allow VimpelCom to operate in the Uzbek telecommunications market. [457] Similarly, the DOJ and SEC may bring enforcement actions against foreign subsidiaries of U.S. issuers in reliance on the jurisdictional provision of 15 U.S.C. § 78dd-3, which allows FCPA charges to be brought against any

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person that engages in any act in furtherance of a bribery scheme "while in the territory of the United States." [458]

The courts have held that there is no private cause of action for a violation of the FCPA. [459] However, a violation of the FCPA's antibribery provisions may be one basis for civil or criminal actions brought under RICO. [460] Also, some plaintiffs have attempted to frame § 10(b) claims around FCPA charges and investigations, alleging that the defendants failed to disclose the extent or nature of their potential FCPA violations. There has been a steady stream of securities and derivative shareholder lawsuits based on alleged FCPA violations in recent years. [461] Although many courts have rejected these claims, some have survived a defendant's motion to dismiss. In one recent case, a federal court in Texas refused to dismiss a class action alleging violations of the securities laws based on the company's failure to disclose the allegedly corrupt nature of its oil business in Angola, activity for which it was later investigated by the SEC and DOJ for potential FCPA violations. The court held that the plaintiffs adequately alleged that the company misrepresented its knowledge of the connection between its business partner and senior government officials in Angola. [462]

[4] Department of Justice Opinion Procedure

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Issuers and other parties subject to the FCPA may request opinions from the DOJ as to whether their prospective conduct would violate the antibribery provisions of the FCPA. [463] If such an opinion approves specified conduct, a rebuttable presumption exists in any action brought under the FCPA that the approved conduct does not violate the FCPA. [464] Documents and other materials submitted in connection with such requests are exempt from public disclosure. [465] This practice is infrequently used because (i) it may require a time-consuming submission, (ii) the transaction at issue, as well as any prior or future transactions between the parties, may come under greater government scrutiny, (iii) the DOJ's public release may identify the requesting party and the transaction or the media may identify the parties given the details in the opinion release, and (iv) the requesting party can often obtain similar comfort from outside counsel while maintaining the confidentiality of the parties and the transaction. [466] The DOJ has issued 12 opinions since 2008 and none since 2014. [467]

[5] Increased SEC and DOJ Enforcement of the FCPA

The last decade has seen a dramatic increase in enforcement actions under the FCPA, as well as an increase in fines and penalties levied for violations of the Act. In a keynote address in 2015, the Director of Enforcement at the SEC

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noted that 2015 had been "especially active" for the SEC, with 14 actions filed against entities and individuals for FCPA violations, resulting in $215 million of financial remedies. [468] In 2007, Baker Hughes paid $44 million to settle FCPA charges, which was, at the time, by far the largest FCPA sanction ever recorded. But subsequent FCPA penalties have soared into the hundreds of millions of dollars. [469] In the largest FCPA penalty ever imposed, in 2008 Siemens AG, a German company, and several of its subsidiaries were charged with fraudulent bookkeeping to mask bribes paid to government officials to secure lucrative contracts, throughout the course of many years and in dozens of different countries. The companies agreed to pay criminal fines totaling more than $450 million, and more than $350 million in disgorgement to the SEC. The case marked the first time the DOJ brought criminal charges for violation of the FCPA's internal controls provision. [470]

The prosecutions arising out of the Nigerian gas line case are illustrative of both the potential magnitude of FCPA cases and expanded FCPA jurisdiction. Starting in 1990, Technip S.A., a French company, Halliburton subsidiary Kellogg Brown & Root LLC ("KBR"), Snamprogetti Netherlands, a Dutch entity, and Japan Gas Corporation ("JGC") formed a joint venture to bid on contracts to construct natural gas lines on Bonny Island in Nigeria. They then hired a U.K. solicitor and a Gibraltar entity as "consultants" to pay bribes to Nigerian government officials. Over $180 million in bribes were paid, and the joint venture was awarded contracts worth over $6 billion. In February of 2009 in a settlement that eclipsed most of the previous fines imposed under the FCPA, KBR pled guilty to a five-count criminal information charging it with violations of the FCPA for payment of these bribes. The plea agreement required KBR to pay a

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$402 million fine. [471] KBR also settled civil FCPA charges with the SEC, agreeing to pay $177 million in disgorgement and to the imposition of a three-year independent monitor for FCPA compliance. [472]

In June of 2010, the SEC and DOJ charged Technip and another of its joint venture partners with violations of the FCPA antibribery, books and records and internal controls provisions. Technip agreed to pay $98 million to the SEC in disgorgement of profits, and a $240 million penalty to the DOJ under a two-year deferred prosecution agreement that required Technip to retain an independent compliance monitor for two years. [473]

And in July of 2010, the SEC and DOJ charged another of the joint venture partners, Snamprogetti and its Italian parent company (Eni S.p.A.) with violations of the FCPA in connection with the Nigerian officials bribe scheme. [474] The case is notable, in part, because the SEC charged Snamprogetti "as an agent of an issuer" for allegedly falsifying the issuer's (Eni's) books. This theory effectively permits the SEC to charge not just issuers, but also their subsidiaries in connection with the FCPA's books and records provisions. As part of its settlement with the SEC, Snamprogetti agreed to $125 million in disgorgement. [475] It also entered into a two-year deferred prosecution agreement with the DOJ that required it to pay a $240 million criminal penalty. [476]

The KBR-related cases also illustrate the DOJ's aggressive approach in expanding the reach of the FCPA's jurisdiction. In each of these prosecutions, the correspondent bank connection was one basis for jurisdiction. Specifically, the bribe funds were transferred from banks accounts in Amsterdam to the agents' account in Japan, Morocco or Switzerland. The DOJ did not allege that any relevant bank account was located in the United States, but rather simply that because the transactions were made in U.S. dollars they were transferred "via a correspondent bank account in New York, New York." [477] Effectively, this "correspondent bank account" theory of liability allows the U.S. government to reach most U.S. dollar transactions. This theory has not yet been challenged by a defendant in court.

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As the *Siemens*, *Technip* and *Snamprogetti* cases suggest, FCPA enforcement is not limited to U.S. companies. In fact, as of February 2016, eight of the top ten FCPA enforcement settlements were against foreign companies. [478] Moreover, the DOJ and SEC have been actively seeking cooperation of foreign government entities in enforcement of the FCPA. The Director of the SEC Enforcement Division has publicly attributed the

SEC's success in recent FCPA cases in part to its effective coordination with international regulators, noting the "tremendous increase in cooperation from other governments and better access to evidence in foreign countries." [479] The Assistant Attorney General of the DOJ Criminal Division has made similar remarks, stating that the DOJ "increasingly find[s itself] shoulder-to-shoulder with law enforcement and regulatory authorities in other countries," and affirming that "this international approach has dramatically advanced [its] efforts to uncover, punish and deter foreign corruption." [480]

While the DOJ routinely brings FCPA cases against non-issuers, in November 2010, the SEC for the first time brought FCPA charges against an entity that is neither a U.S. issuer nor affiliated with one, on the theory that it was "an agent of its issuer customers" in violating the FCPA. [481]

In addition, individual defendants have not been immune from this increased FCPA enforcement, with some of the actions leading to substantial fines and prison terms. The DOJ has increasingly touted the importance of individual accountability, describing it as a matter of "basic fairness" to a company's employees and shareholders, and noting that "nothing discourages corporate criminal activity like the prospect of people going to prison." [482] In the fall of 2015, the DOJ initiated an official policy to facilitate its ability to identify and pursue individuals involved in corporate misconduct, including by predicating *any* cooperation credit granted to a company on the company's provision of "all relevant facts about individuals involved in corporate misconduct." [483]

The DOJ has sought harsh sentences for those individuals charged. For example, in 2010, an individual was sentenced to 87 months in prison after

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pleading guilty to violating the FCPA by paying bribes to Panamanian government officials to secure maritime contracts and making a false statement to the FBI regarding how the bribe money was paid. This remains the longest prison sentence ever imposed on an individual for violating the FCPA, reflecting the DOJ's effort to deter foreign bribery through individual culpability. In announcing the sentence, prosecutors stated that the "sentence makes clear that this is a serious crime that the U.S. government is intent on enforcing." [484]

In 2012 and 2013, the DOJ brought FCPA charges against individuals associated with a broker-dealer in connection with a scheme to bribe a senior official of Venezuela's state economic development bank in exchange for bond trading work. The individuals pled guilty to conspiracy to violate the FCPA and admitted to paying over $5 million in bribes to the Venezuelan official and generating more than $60 million in commissions from the resulting trading business. The individuals were sentenced to prison terms from two to four years, and forfeitures ranging from $2.7 million to $11.9 million. [485] Notably, the Venezuelan official was also arrested in 2013 upon entering the United States and charged with money laundering and violations of the Travel Act (since the FCPA does not criminalize the recipient of bribe payments), to which she pled guilty and was sentenced to time served. [486]

In 2009, the SEC charged a parent corporation with violating the FCPA's antibribery, books and records, and internal control provisions in connection with bribes paid by its Brazilian subsidiary to Brazilian customs brokers. [487] Notably, the SEC also charged two of the company's executives as "control persons" within the meaning of § 20 of the Exchange Act, the first time the control person provision of the Exchange Act had been used against individuals in the FCPA

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context. The SEC did not allege that the executives participated in or knew of the violations, but instead based its control person liability charges on a "failure to supervise" theory. Each executive was required to pay a fine of $25,000.

Moreover, while the DOJ has long used deferred prosecution agreements as an enforcement tool under the FCPA, in May of 2011, the SEC announced its first-ever deferred prosecution pact under the FCPA, involving global steel pipe manufacturer Tenaris. [488] Under the agreement, the company would pay over $5 million in disgorgement and prejudgment interest, in an approach the SEC hopes will encourage cooperation by individuals and companies in the future. [489]

In 2012, the DOJ and SEC collaboratively published ("the FCPA GUIDE"), a comprehensive manual that provides guidance on a broad range of topics regarding the enforcement of and compliance with the FCPA. In addition to setting forth detailed information on the FCPA statutory requirements, THE FCPA GUIDE provides useful insight into the enforcement approaches and priorities of the DOJ and SEC.

On April 5, 2016, the DOJ announced a three-step "enhanced FCPA enforcement strategy," which stated that the DOJ was "committed to enhancing its efforts to detect and prosecute both individuals and companies" for violations of the FCPA. [490] In what it described as the "first and most important step in combatting FCPA violations," the DOJ announced it was increasing the number of

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staff for its FCPA unit by 50%, adding 10 new prosecutors and creating three new squads of FBI special agents dedicated to FCPA investigation and enforcement. For the second step of the new program, the DOJ announced that it was strengthening its coordination with foreign law enforcement officials in corruption cases, including by sharing leads and striving to share more effectively documents and witnesses. The third step of the strategy was the launch of a pilot program aimed at inducing more companies to self-report FCPA problems. To satisfy the pilot program's criteria, a company must:

- Make a voluntary self-disclosure, including by disclosing the matter before "an imminent threat" that the government will learn of the matter, making the disclosure "reasonably prompt[ly]" after the company discovers the matter, and disclosing all relevant facts known to the company, including concerning individual malfeasance.
- Provide "full cooperation," including by making timely disclosure of all facts relevant to the alleged wrongdoing, updating that disclosure in a timely manner, proactively offering information, preserving and providing relevant documents, translating relevant documents, making individuals available for interviews, detailing the sources of information, and "de-conflict[ing]" internal investigations.
- Make "timely and appropriate remediation," including by implementing a compliance program that is periodically reviewed and modified if necessary, establishing a culture of compliance, providing sufficient resources for the compliance function, which must be independent, retaining qualified and experienced compliance personnel, conducting risk assessments and tailoring the compliance program to meet those risks, auditing the compliance program, and implementing an appropriate reporting structure for compliance personnel.

If the company meets these requirements and disgorges any profits earned from the bribery scheme, the DOJ "may" (1) grant a 50% reduction from the bottom end of the sentencing guidelines fine range, (2) "generally" not require a monitor if the company has implemented an effective compliance program, and (3) "consider" a declination of prosecution based on a consideration of "countervailing interests," including whether the company has a history of misconduct or the incident involved large sums of money or senior management. On the other hand, companies that fully cooperate and conduct timely and appropriate remediation but fail voluntarily to disclose misconduct will receive "markedly less" credit than those that self-report, including at best a reduction of no more than 25% off the bottom of the Sentencing Guidelines fine range.

Footnotes

440 *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977).

441 *See* Foreign Corrupt Practices Act Amendments of 1988, Pub. L. No. 100-418, Title V, Subtitle A, Part I, 102 Stat. 1107, 1415 (1988).

442 *See* International Anti-Bribery and Fair Competition Act of 1998, Pub. L. No. 105-366, 112 Stat. 3302 (1998) (the "1998 Amendments").

443 The FCPA is incorporated into the Exchange Act as §§ 13(b), 30A and 32(c) (penalties).

444 *See United States v. Kay*, 359 F.3d 738, 743 (5th Cir. 2004) (holding that invocation of the antibribery portion of the FCPA requires payments "that are intended to (1) influence a foreign official to act or make a decision in his official capacity, or (2) induce such an official to perform or refrain from performing some act in violation of his duty, or (3) secure some wrongful advantage to the payor" and that "[t]he FCPA … criminalizes these kinds of payments only if the result they are intended to produce—their *quid pro quo*—will assist (or is intended to assist) the payor in efforts to get or keep some *business*") (second emphasis added); *see also United States v. Kozeny*, 493 F. Supp. 2d 693, 705 (S.D.N.Y. 2007) (agreeing with *Kay* that "the FCPA's business nexus element was intended to be construed broadly").

Under the antibribery provisions, bribe payments must be made "corruptly," 15 U.S.C. § 78dd-1(a), § 78dd-2(a), § 78dd-3(a), which, according to the DOJ and the SEC, means made with an "an intent or desire to wrongfully influence the recipient," The Criminal Division of the DOJ and the Enforcement Division of the SEC, "A Resource Guide to the U.S. Foreign Corrupt Practices Act" 14 (Nov. 14, 2012) ("*FCPA Guide*").

445 The FCPA's antibribery provisions apply to issuers if the bribe occurs in connection with U.S. interstate commerce. 15 U.S.C. § 78dd-1(a). These provisions also apply to "domestic concerns," which are U.S. citizens, nationals and residents, and all companies that have their principal place of business in the United States or are organized under U.S. law. 15 U.S.C. § 78dd-2(h)(1). The antibribery provisions apply to domestic concerns regardless of whether the activity related to the bribe involves U.S. interstate commerce or has any other connection to the United States. 15 U.S.C. § 78dd-2(i). Finally, for persons or entities who are not issuers or domestic concerns, the antibribery provisions apply if they, or any person acting on their behalf, perform any part of the acts of bribery in connection with U.S. interstate commerce while in the territory of the United States. 15 U.S.C. § 78dd-3(a).

The FCPA defines the term "foreign official" as an "officer or employee of a foreign government or any department, agency, or instrumentality thereof," but does not define "instrumentality," "department" or "agency." *See* 15 U.S.C. § 78dd-2(h)(2). A decision by the Tenth Circuit found that the term "foreign officials" includes employees of state-owned companies. *See United States v. Esquenazi*, 752 F.3d 912 (11th Cir. 2014) (holding state-owned telecommunications company as an "instrumentality" of government and defining "instrumentality" as "an entity controlled by the government of a foreign country that performs a function the controlling government treats as its own"). Some DOJ prosecutions under the FCPA, such as the KBR-related actions described below, *see infra* Notes 478, 484, raise the specter that the DOJ views even certain minority ownership by a foreign government of a private entity to suffice to make that entity an "instrumentality" of a foreign government, and thus subject payments to employees of such entity to FCPA enforcement. *See also United States v. Alcatel-Lucent*, No. 10-cr-20907 (S.D. Fla. Dec. 27, 2010). Moreover, in September 2010, the DOJ issued an opinion procedure release that expanded the scope of who the DOJ would consider to qualify as a "foreign official" for FCPA purposes to include, in certain instances, otherwise private individuals or organizations who act on behalf of a foreign government, such as a "consultant" and its employees. *See* DOJ, Opinion Procedure Release No. 10-03 (Sept. 1, 2010).

446 § 13(b)(2) of the Exchange Act. The SEC has opined that the "reasonableness" standards contained in § 13(b)(2)–(7) of the Exchange Act should be "based not on a ‘materiality’ analysis but on the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs." SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999), Fed. Sec. L. Rep. (CCH) ¶75,563. In determining whether a misstatement has resulted in a violation of § 13(b)(2), registrants should consider (i) the significance of the misstatement, (ii) how the misstatement arose, (iii) the cost of correcting the misstatement, and (iv) the clarity of authoritative accounting guidance with respect to the misstatement. These factors should be considered along with the ten other factors that should be assessed when making a determination of materiality. *See* § 11.04[2].

Under § 404 of the Sarbanes-Oxley Act, management is required to report on the adequacy of internal controls and auditors of those companies are required to provide an attestation on internal controls. *See* § 5.03[7][a][ii].

447 FCPA Guide at 39-40. *See, e.g.*, *In re Key Energy Services, Inc.*, SEC Release No. 78558 (Aug. 11, 2016) (employees made payments to a Pemex employee to induce him to provide advice, assistance and inside information, all in violation of the books and records and internal controls provisions).

448 *See* § 32(c)(2)(A) of the Exchange Act.

449 *See* § 32(c)(1)(A) of the Exchange Act.

450 *See* 18 U.S.C. § 3571.

451 *See* §§ 32(c)(1)(B) and 32(c)(2)(C) of the Exchange Act; SEC Release No. 33-10104 (June 27, 2016).

452 *See* § 32(c)(3) of the Exchange Act.

453 *See* § 32(a) of the Exchange Act. As with violations of the antibribery provisions, if a defendant derives a gain or causes a loss to another person by violating the accounting provisions, the defendant may be fined up to twice the amount of the gross gain or loss. *See* 18 U.S.C. § 3571(d).

454 *See* § 32(a) of the Exchange Act, which is discussed in § 11.07[3][f]. A defendant cannot, however, be imprisoned if he or she had no knowledge of the rule or regulation he or she is convicted of violating. § 32(a) of the Exchange Act.

455 These penalties may not exceed the higher of (i) the amount the defendant gained from the violation or (ii) an amount based upon the egregiousness of the violation, ranging from $8,156 to $178,156 for a natural person and from $81,559 to $890,780 for an issuer. *See* § 21(d)(3) of the Exchange Act; SEC Release No. 33-10104 (June 27, 2016).

456 *See* §§ 21C and 21(d)(1) of the Exchange Act.

457 The Dutch defendant, VimpelCom, was at the time of the regulatory action the sixth-largest telecommunications company in the world, and an issuer of publicly traded securities in the United States. To enter into and operate in the Uzbek telecommunications market, VimpelCom and its Uzbek subsidiary, Unitel, allegedly paid bribes to an Uzbek government official who had influence over the governmental body that regulated the telecom industry in Uzbekistan. Over a six-year period, VimpelCom and Unitel executives and employees allegedly funnelled bribe payments through a shell company beneficially owned by the Uzbek official. The DOJ charged VimpelCom with conspiracy to violate the antibribery and books and records provisions of the FCPA, and a separate count of violating the internal controls provisions of the FCPA. VimpelCom entered into a deferred prosecution agreement with the DOJ pursuant to which it agreed to pay a criminal penalty of $230 million, implement rigorous internal controls and retain an independent compliance monitor for three years. In related proceedings, VimpelCom settled with the SEC and the Public Prosecution Service of the Netherlands, agreeing to pay a total of $375 million in disgorgement of profits and prejudgment interest to be apportioned between the SEC and the Dutch prosecutors, with additional criminal penalties paid to the Dutch prosecutors. In total, VimpelCom paid over $795 million in criminal and regulatory penalties to the U.S. and Dutch authorities, making it one of the largest foreign bribery matters to date. The DOJ subsequently filed two civil complaints seeking a total of $850 million in forfeiture comprising the illegal bribes paid and property involved in the laundering of those bribe payments. *See* Press Release, DOJ, VimpelCom Limited and Unitel LLC Enter into Global Foreign Bribery Resolution of More Than $795 Million; United States Seeks $850 Million Forfeiture in Corrupt Proceeds of Bribery Scheme (Feb. 18, 2016).

458 *See, e.g.*, *United States v. Universal Leaf Tabacos Ltda.*, No. 3:10-cr-00225 (E.D. Va. 2010) (charging a wholly owned Brazilian subsidiary of a U.S. issuer with FCPA criminal violations on the jurisdictional basis of 15 U.S.C. § 78dd-3 for kickback payments facilitated in the territory of the United States to the Government of Thailand to secure the improper sale of leaf tobacco).

459 *See, e.g.*, *Lamb v. Phillip Morris, Inc.*, 915 F.2d 1024, 1027–30 (6th Cir. 1990), *cert. denied*, 498 U.S. 1086 (1991) (antibribery provisions); *Shields ex rel. Sundstrand Corp. v. Erickson*, 710 F. Supp. 686, 688 (N.D. Ill. 1989) (recordkeeping provisions).

460 *See* 18 U.S.C. §§ 1962–1968; *Environmental Tectonics v. W.S. Kirkpatrick, Inc.*, 847 F.2d 1052, 1063–64 (3d. Cir. 1988), *aff'd*, 493 U.S. 400 (1990); *see also, e.g.*, *Aluminum Bahrain B.S.C. v. Alcoa, Inc.*, No. 08-

cv-299 (W.D. Pa 2008) (aluminum production company, which pled guilty to violations of the FCPA for bribing government officials in Bahrain in order to induce the government-controlled metals company to overpay for raw materials, was thereafter sued by the government-controlled entity on allegations of common law fraud and RICO violations for subjecting the entity to fraud, bribery and overcharging). For a further discussion, *see* § 11.09[1][b].

461 *See, e.g.*, *City of Pontiac Gen. Emps.' Ret. Sys. v. Walmart Stores Inc. et al.*, No. 12-05162 (W.D. Ark. 2012) (putative securities fraud class action alleging company intentionally concealed the extent of possible bribery of Mexican officials and prior internal investigation in its regulatory filing on the subject); *City of Brockton Ret. Sys. v. Avon Prods. Inc. et al.*, 1:11-cv-04665 (S.D.N.Y. 2011) (putative derivative class action alleging company intended to mislead shareholders regarding bribes given to Chinese government officials to obtain licenses for direct sales operations).

462 *In re Cobalt Int'l Energy, Inc. Sec. Litig.*, 14-CV-3428 (NFA) (S.D. Tex. Jan. 19, 2016). *But see Glazer Capital Mgmt. v. Magistri*, 549 F.3d 736 (9th Cir. 2008) (dismissing a purported shareholder class action alleging misstatements in the company's merger agreement related to potential FCPA violations, on the basis that the complaint failed to meet the heightened pleading standard of the Litigation Reform Act for *scienter*).

463 *See* § 30A(e)(1) of the Exchange Act. The DOJ has issued regulations governing the opinion procedure at 28 C.F.R. §§ 80.1–80.16.

464 *See* § 30A(e)(1) of the Exchange Act.

465 *See* § 30A(e)(2) of the Exchange Act.

466 *See* Don Zarin, *Doing Business Under the Foreign Corrupt Practices Act*, C ORPORATE L AW & P RACTICE H ANDBOOK at 943 (Practicing Law Institute, 2006).

467 In one such release, a public U.S. multinational consumer products company planned to acquire a foreign company and its wholly-owned foreign subsidiary. During the pre-acquisition due diligence process, the U.S. company identified numerous likely improper payments by the target to foreign government officials and substantial weaknesses in internal controls and recordkeeping. For jurisdictional reasons, the payments did not appear to violate the FCPA. The DOJ opined that it would not bring an enforcement action for the pre-close conduct because the bribes did not appear to be FCPA violations when they were made. Foreign Corrupt Practices Act Review, Release No. 2014-02 (Nov. 7, 2014). *See* Foreign Corrupt Practices Act Review, Release No. 2012-02 (Oct. 18, 2012) ((U.S. non-profit adoption agencies propose to host foreign officials during visits to the United States, including officials with direct responsibilities relating to adoptions, to allow officials to learn more about the non-profit's work and see how adopted children from the foreign country have adjusted to life in the United States; the DOJ permits the reasonable and *bona fide* payments associated with trips); Foreign Corrupt Practices Act Review, Release No. 10-03 (Sept. 1, 2010) (DOJ takes no action against a company that hired a consultant to represent it before a foreign government with whom the consultant had extensive ties, given certain procedures put in place to ensure that the consultant was not conflicted and effectively acting as a "foreign official.").

468 Andrew Ceresney, Director of Enforcement Div., SEC, Keynote Address at American Conference Institute's 32nd International Conference on the Foreign Corrupt Practices Act (Nov. 17, 2015). In public remarks, the DOJ continually emphasizes its "commitment to the fight against foreign bribery" reflected in its "robust enforcement record" of more than 50 individual criminal convictions and 50 resolutions with companies in FCPA and FCPA-related cases between 2009 and 2014, with penalties and forfeitures approximating $3 billion. Leslie R. Caldwell, Asst. Att'y Gen., DOJ, Remarks at American Conference Institute's 31st International Conference on the Foreign Corrupt Practices Act (Nov. 19, 2014).

469 *See, e.g.*, Press Release, DOJ, Alstom Pleads Guilty and Agrees to Pay $772 Million Criminal Penalty to Resolve Foreign Bribery Charges (Dec. 22, 2014); Press Release, DOJ, Alcoa World Alumina Agrees to Plead Guilty to Foreign Bribery and Pay $223 Million in Fines and Forfeiture (Jan. 9, 2014); Press Release, DOJ, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines; Coordinated Enforcement Actions by DOJ, SEC

and German Authorities Result in Penalties of $1.6 Billion (Dec. 15, 2008); Press Release, DOJ, Kellogg Brown & Root LLC Pleads Guilty to Foreign Bribery Charges and Agrees to Pay $402 Million Criminal Fine (Feb. 11, 2009).

470 *See* Press Release, DOJ, Siemens AG and Three Subsidiaries Plead Guilty to Foreign Corrupt Practices Act Violations and Agree to Pay $450 Million in Combined Criminal Fines (Dec. 15, 2008); *SEC v. Siemens Aktiengesellchaft*, SEC Litigation Release No. 20829 (Dec. 15, 2008).

471 *See* Press Release, DOJ, Kellogg Brown & Root LLC Pleads Guilty to Foreign Bribery Charges and Agrees to Pay $402 Million Criminal Fine (Feb. 11, 2009).

472 *See SEC v. Halliburton Co.*, SEC Litigation Release No. 20897A (Feb. 11, 2009).

473 *See* Press Release, DOJ, Technip S.A. Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay $240 Million Criminal Penalty (June 28, 2010); *SEC v. Technip*, Litigation Release No. 21578 (June 28, 2010).

474 *See SEC v. ENI, S.p.A. and Snamprogetti Netherlands B.V.*, SEC Litigation Release No. 21588 (July 7, 2010).

475 *See SEC v. ENI, S.p.A. and Snamprogetti Netherlands B.V.*, SEC Litigation Release No. 21588 (July 7, 2010).

476 *See* Press Release, DOJ, Snamprogetti Netherlands B.V. Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay $240 Million Criminal Penalty (July 7, 2010).

477 *See United States v. Kellogg Brown & Root LLC*, No. 4:09-cr-071 (S.D. Tex. Feb. 11, 2009).

478 *See* FCPA Blog, Here's our new Top Ten list, with VimpelCom landing sixth (Feb. 19, 2016).

479 Andrew Ceresney, Director of Enforcement Division, SEC, Keynote Address at American Conference Institute's 32nd International Conference on the Foreign Corrupt Practices Act (Nov. 17, 2015).

480 Leslie R. Caldwell, Asst. Att'y Gen., DOJ, Remarks at American Conference Institute's 31st International Conference on the Foreign Corrupt Practices Act (Nov. 19, 2014).

481 *See SEC v. Panalpina, Inc.*, SEC Litigation Release No. 21727 (Nov. 4, 2010).

482 Deputy Att'y Gen. Sally Quillian Yates, DOJ, Remarks at New York University School of Law Announcing New Policy on Individual Liability in Matters of Corporate Wrongdoing (Sept. 10 2015).

483 Deputy Att'y Gen. Sally Quillian Yates, DOJ, *Individual Accountability for Corporate Wrongdoing* (Sept. 2015).

484 *See* Press Release, DOJ, Virginia Resident Sentenced to 87 Months in Prison for Bribing Foreign Government Officials (Apr. 19, 2010). The co-conspirator was sentenced to more than three years in prison. *See* Press Release, DOJ, Virginia Resident Sentenced to 37 Months in Prison (June 25, 2010).

485 Press Release, DOJ, CEO and Managing Director of U.S. Broker-Dealer Sentenced for International Bribery Scheme (Mar. 27, 2015). For other representative examples of enforcement actions brought against individuals by the SEC and the DOJ, see Press Release, SEC, SEC Charges Former Software Executive With FCPA Violations 2015-165 (Aug. 12, 2015) (regional director of technology company charged with bribing Panamanian officials to secure government technology contracts consented to cease-and-desist order and disgorgement of over $90,000); *United States v. Garcia*, No. 3:15-cr-00366 (N.D. Cal. 2015) (sentenced to 22 months imprisonment in parallel DOJ criminal proceeding), and Garth Peterson, *SEC v. Peterson*, SEC Litigation Release No. 22346 (real estate investment adviser charged with acquiring real estate assets for himself and an influential Chinese government official ordered to disgorge $3.8 million); *United States v. Peterson*, No. 12-cr-224 (E.D.N.Y. 2012) (sentenced to nine months imprisonment in parallel DOJ criminal proceeding).

486 Press Release, DOJ, High Ranking Banking Official at Venezuelan State Development Bank Pleads Guilty in Manhattan Federal Court to Participating in Bribery Scheme (Nov. 18, 2013).

487 *See SEC v. Nature's Sunshine Products, Inc.*, SEC Litigation Release No. 21162 (July 31, 2009).

488 Under a deferred prosecution agreement such as that entered into with Tenaris, the SEC "agrees to forego

an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution." *See* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010). The use of a deferred prosecution agreement in this case was possible under the SEC's Cooperation Initiative, announced in January of 2010, with which the agency sought to establish incentives for individuals and companies to cooperate with investigations by streamlining the manner in which it will evaluate whether to credit cooperation and by expanding the set of enforcement tools available to the staff of the enforcement division to include cooperation agreements, deferred prosecution agreements and non-prosecution agreements. *See* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010).

489 *See* Press Release, SEC, Tenaris to Pay $5.4 Million in SEC's First-Ever Deferred Prosecution Agreement (May 17, 2011). In 2013, the SEC entered into its first ever non-prosecution agreement in an FCPA matter involving Ralph Lauren Corporation as part of its 2010 Cooperation Initiative to incentivize cooperation in SEC investigations. *See* Press Release, SEC, SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct (Apr. 22, 2013). In the years following, the SEC has announced a number of deferred and non-prosecution agreements in FCPA matters where the companies self-reported misconduct promptly and cooperated extensively with the ensuing investigations. *See, e.g.*, Press Release, SEC, SEC Announces Two Non-Prosecution Agreements in FCPA Cases (June 7, 2016) (announcing NPAs with two unrelated U.S. companies whose foreign subsidiaries made bribe payments to Chinese officials).

490 *See* Andrew Weissmann, Chief, Fraud Section, Criminal Division, DOJ, The Fraud Section's Foreign Corrupt Practices Act Enforcement Plan and Guidance (Apr. 5, 2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.09, ENFORCEMENT SCENARIOS

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 § 11.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The previous sections have examined the principal sources of liability under the U.S. federal and state securities laws. This section highlights a number of common enforcement scenarios. In § 11.09[1], we address two common vehicles for civil enforcement: actions brought on behalf of a wide class of plaintiffs ("class actions") and private actions under the RICO statute. Issues concerning administrative enforcement are addressed in § 11.09[2], including general SEC powers to investigate and prosecute offenses and to seek a variety of forms of relief, such as injunctions and civil monetary penalties, as well as a recent series of actions against market professionals that were initially spearheaded by the states' attorneys general rather than the SEC. Finally, § 11.09[3] examines several different mechanisms available for criminal enforcement of the securities laws and briefly examines the provisions of federal law that relate to penalties for crimes committed by or on behalf of organizations.

[1] Civil Enforcement

[a] Class Actions

Class actions are civil suits brought by an individual plaintiff or a group of plaintiffs who seek to represent the interests of a much broader group of similarly situated parties (the "class"). The would-be class representative must demonstrate that questions of law or fact are common to the class (commonality), that those common claims of the class predominate over individual questions (predominance), that the claims asserted by the named plaintiffs are typical of the class (typicality), that the members of the class are so numerous that it would be impracticable to join each plaintiff in the suit (numerosity), that the class representative will adequately represent the interests of the class (adequacy), and that a class action is superior to other means of pursuing the claims (superiority). [491]

Class actions are prevalent in the United States, including in securities litigation (involving both domestic issuers and foreign issuers listed on U.S. exchanges), [492] and are often brought in situations where an individual plaintiff's claimed damages do not justify the substantial costs of litigating the claim, but where the total damages alleged to have been sustained by the class are

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extremely large, thereby making the suit worthwhile. [493] A typical example would be a class action on behalf of shareholders who purchased stock on the basis of allegedly misleading information published by the issuer in its annual report. Since in these cases there is no need to establish that each plaintiff relied on a particular statement (or, in a fraud-on-the-market case, that each plaintiff was even aware of the statement), [494] the elements of the claim are typically common to all members of the plaintiff class and appropriate for resolution in a class action suit. Because an adverse judgment before a single court binds the defendant with respect to all members of the class [495]—as opposed to a series of individual actions where the decisions of one court usually do not bind the others—class actions can pose a risk of substantial damages for defendants.

Most class litigation is brought pursuant to Fed. R. Civ. P. 23(b)(3), which requires a plaintiff to demonstrate that the criteria set forth above have been met, including numerosity, typicality, commonality, predominance, and adequacy. [496] A decision from the Second Circuit Court of Appeals in 2006 clarified the scope of inquiry and held that a court considering a motion for class certification must resolve any factual disputes relevant to each Rule 23 requirement, including an analysis of the evidence presented by all of the parties—an analysis that may necessarily reach the merits of the litigation. [497] This decision significantly

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increased the plaintiff's burden at the class certification stage of the litigation by rejecting earlier decisions that had suggested that the plaintiff was only required to make "some showing" that it could satisfy the requirements of Rule 23. [498]

A key issue in class certification motions filed in actions asserting claims under Rule 10b-5 is predominance and, in particular, whether plaintiffs are entitled to the presumption of reliance of *Basic v. Levinson*. [499] In the absence of such a presumption, individualized questions of reliance will predominate over common questions, making class certification inappropriate. In a recent line of decisions, the Supreme Court has held that plaintiffs do not bear the burden of directly proving loss causation, materiality, or price impact at the class certification stage in order to trigger the *Basic* presumption. [500] In *Erica P. John Fund, Inc. v. Halliburton Co.*, [501] the Supreme Court held that a securities class action plaintiff need not prove loss causation at the class certification stage because "[t]he fact that a subsequent loss may have been caused by factors other than the revelation of a mispresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory." Nonetheless, the Court left open the question whether a loss causation inquiry may be appropriate at the class certification stage to defeat another element of the Rule 23 showing, such as to demonstrate that the lead plaintiff's claims are not typical of those of the entire class, [502] or to rebut the *Basic* presumption of reliance by establishing that the alleged misrepresentation or omission had no impact on the price of the stock. [503]

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In *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, the Supreme Court likewise held that securities class action plaintiffs need not prove materiality in order to obtain class certification. [504] Although the Supreme Court acknowledged that materiality is an essential predicate of the "fraud-on-the-market" theory underlying the *Basic* presumption of reliance, it concluded that the question of materiality is common to the class and that proof of materiality was therefore not needed to ensure that questions of law or fact common to the class would predominate over individual questions, as required by Rule 23(b)(3). And, in *Halliburton Co. v. Erica P. John Fund, Inc.*, the Supreme Court held that plaintiffs need not prove price impact directly at the class certification stage in order to invoke the fraud-on-the-market presumption because such a rule "would radically alter the required showing for the reliance element of the Rule 10b-5 cause of action." [505] However, as noted above, the Court nonetheless held that a defendant may introduce price impact evidence at the class certification stage either to counter a plaintiff's showing of market efficiency or to directly rebut the presumption. [506]

In several recent decisions arising outside the securities context, the Supreme Court has otherwise increased the burden on putative class plaintiffs to obtain class certification. In *Wal-Mart Stores, Inc. v. Dukes*, which involved a putative class action concerning employment discrimination, the Supreme Court held that a party seeking class certification must affirmatively demonstrate compliance with Rule 23 and that the trial court must conduct a rigorous analysis to determine if Rule 23(a)'s prerequisites have been satisfied. [507] The *Wal-Mart* Court observed that this inquiry could entail some overlap with the merits of the plaintiff's underlying claim, but stated "[t]hat cannot be helped." The Court further noted that the commonality requirement of Rule 23(a)(2) requires the claims of the class to depend upon a "common contention," which must be of such a nature as to be "capable of classwide resolution."

The Supreme Court expanded on its *Wal-Mart* decision in *Comcast Corp. v. Behrend*, which involved a putative class action alleging violations of the federal antitrust laws. [508] In *Comcast*, the putative class plaintiff originally alleged four theories of antitrust liability, but the district court subsequently rejected all

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but one of those theories. Nonetheless, the plaintiffs' damages model assumed that all four of the original theories were valid and did not attribute damages to any one particular theory. Under this circumstance, the Supreme Court held that the plaintiffs had failed to satisfy the predominance requirement of Rule 23(b)(3) because they did not establish "that damages are capable of measurement on a classwide basis."

Applying this precedent, the Fifth Circuit recently affirmed the denial of class certification in the securities litigation arising out of the explosion of BP's Deepwater Horizon drilling rig in the Gulf of Mexico. [509] The plaintiffs in that case (as is typical in securities class actions) alleged that the defendants made a number of misstatements and omissions. The plaintiffs also indicated that they would calculate class members' damages by use of an event study (as is also common in securities class actions). However, the plaintiffs did not offer a specific event study in connection with their class certification motion that was capable of isolating losses attributable to each of the individual misstatements and omissions alleged in the complaint. The Fifth Circuit therefore held that the plaintiffs had failed to satisfy their burden of "providing an adequate measure of class-wide damages under *Comcast*" because their damages model could not "be applied uniformly across the class."

With the passage of the Litigation Reform Act in 1995, Congress sought to reduce certain perceived abuses of the class action mechanism in securities lawsuits, particularly the common practice in which the class representative was merely a nominal party, or "professional plaintiff," selected and controlled by plaintiffs' counsel who filed the suit with little real financial stake in its outcome. [510] Specifically, the Litigation Reform Act mandates, for all class actions brought under the Securities Act or the Exchange Act, the appointment by the court of the "lead plaintiff," who will not necessarily be the original named plaintiff in the lawsuit and who, among other things, selects the plaintiffs' counsel. [511] The lead plaintiff will be the person deemed by the court

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most capable of adequately representing the interests of the class, and generally may not have served in this role in more than five class actions in any three-year period. A group may act as lead plaintiff, and claims may be aggregated in most circumstances in order for a group to be appointed lead plaintiff. [512] The statute includes a rebuttable presumption that the class member with the largest financial interest in the litigation should be designated as the lead plaintiff. [513] Congress intended to facilitate appointment of institutional investors as lead plaintiffs. [514] Although there was little change initially, [515]

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institutional investors increasingly are having a greater impact in securities class actions as the lead plaintiff. [516]

Shortly after the enactment of the Litigation Reform Act, many plaintiff's attorneys sought to avoid the Act's tougher pleading requirements and mandatory stays of discovery pending a defendant's motion to dismiss by filing securities class actions in state rather than federal court. Concerned that the state courts were now being used to frustrate the objectives of the Litigation Reform Act, in 1998, Congress passed SLUSA, which requires most class action securities fraud cases to be brought exclusively in federal court under federal law. [517] SLUSA prohibits a private party from bringing a covered class action in state or federal court based upon the statutory or common law of any state if the party alleges (i) an untrue statement or omission of material fact in connection with the purchase or sale of a covered security or (ii) that the defendant used a manipulative or deceptive device in connection with the purchase or sale of a covered security. [518] Any such action that is brought in state court can be removed

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to federal court and dismissed, and a federal court is required to dismiss any such action filed with it. Once a court decides that SLUSA does not authorize removal of an action to federal court, the case must be remanded; because this decision is jurisdictional, the remand may not be reviewed by the federal appellate courts. [519]

In *Merrill, Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, [520] the Supreme Court held that SLUSA authorized the removal and dismissal not only of claims for which federal law provides a remedy (*i.e.*, viable Rule 10b-5 claims), but also claims brought on behalf of holders of securities, which are not actionable under Rule 10b-5. [521] The Court held that this broad reading of the "in connection with the purchase or sale" requirement of SLUSA was consistent with the policies articulated in *Blue Chip Stamps*, by preventing plaintiffs from circumventing the federal prohibition on "holder" claims by filing their claims in state court. [522] In a recent decision arising out of the Allen Stanford Ponzi scheme, however, the Supreme Court held that the "covered security" requirement is not satisfied by the purchase or sale of uncovered securities that were falsely claimed to be backed by covered securities. [523] Instead, citing SLUSA's focus upon transactions in covered securities, the Supreme Court concluded that SLUSA preemption requires a fraudulent misrepresentation or omission that "is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a 'covered security.'" In a case arising out of the Bernie Madoff Ponzi scheme, which alleged that certain feeder funds violated state law by making misrepresentations about their investments with Bernie Madoff and breached various

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duties owed to investors by failing to detect the Ponzi scheme, the Second Circuit has further held that SLUSA preclusion only applies when the state law claim is predicated on conduct by the defendant (rather than a third party), and that in circumstances where some but not all of the claims in an action are precluded by SLUSA courts may only dismiss the specific claims that are precluded by SLUSA and not the entire action. [524]

In a similar strategy to evade the heightened rigors of the Litigation Reform Act, plaintiffs have filed Securities Act class actions in state courts, arguing that claims based entirely on the Securities Act, without any state law claims, are not removable. Although courts have split on the question of whether a claim must be precluded by § 26(b) of SLUSA in order to be removable under § 26(c) of SLUSA, [525] several district courts have ruled that SLUSA eliminated state court jurisdiction over "covered class actions" brought under the Securities Act. [526] Under these rulings, the disagreement among the courts as to the scope of the *removal* provision of the Securities Act is irrelevant because defendants

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do not need to invoke the removal provision of the Securities Act to effect the removal of actions over which state courts lack jurisdiction. However, several courts have recently disagreed that state courts lack jurisdiction over class actions asserting Securities Act claims, including many district courts within the Ninth Circuit. [527]

As discussed below in § 11.10[4][a], SLUSA also prevents parties from obtaining discovery in parallel state court proceedings while discovery in the federal action is stayed. Section 101 of the Act empowers a federal court to stay discovery in private state court actions when it is "necessary in aid of [the court's] jurisdiction, or to protect or effectuate its judgments."

Furthermore, in 2005, Congress enacted the Class Action Fairness Act ("CAFA"), [528] which significantly alters federal court jurisdiction in class action cases and provides a powerful new tool to defendants. Federal courts under CAFA have original jurisdiction over class actions that seek more than $5 million in damages where any one defendant is a citizen of a state different from any one plaintiff. Thus, under CAFA, defendants may remove large interstate class actions from state to federal court that they could not have removed pursuant to the stricter requirements of federal diversity jurisdiction. [529] Additionally, even if class certification is later denied, CAFA allows the federal court to maintain jurisdiction over the suit.

There are some limitations, however, to this jurisdictional grant: CAFA does not apply to class actions where the primary defendants are states or state officials or where the number of proposed class members is less than 100. In

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addition, federal courts are required to remand class actions to state courts in certain cases when more than two-thirds of the class members are citizens of the forum state. Courts have also reached differing conclusions on whether CAFA permits the removal of Securities Act class actions, notwithstanding that § 22(a) of the

Securities Act otherwise prohibits the removal of actions filed in state court asserting Securities Act claims. [530]

Finally, the mortgage-backed securities ("MBS") litigation has generated a number of decisions regarding the scope of claims that can be asserted by putative class plaintiffs as a matter of constitutional and statutory standing. In these cases, many courts have held that class action plaintiffs can only bring claims related to the offerings or securities in which they personally invested. [531] In *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, [532] however, the Second Circuit held that a putative class plaintiff who invested in one offering may possess "class standing" to bring claims related to other offerings if both claims raise the same set of concerns. In *NECA-IBEW*, the court thus concluded that a putative class plaintiff who invested in securities from one MBS offering could represent a class containing investors in other securities from that offering, as well as investors in other MBS offerings, so long as all of the securities were backed by mortgages from the same originators. The Second Circuit further observed that purchasers of corporate debt securities from one offering likewise may have "class standing" to assert claims on behalf of investors in other debt securities from the same corporation if the offering documents all contained identical misrepresentations.

[b] RICO

Prior to 1995, one of the most common vehicles for civil enforcement of the securities laws stemmed from RICO. The Litigation Reform Act eliminated RICO liability for "conduct that would have been actionable as fraud in the purchase or sale of securities," unless the defendant actually has been criminally convicted in connection with the fraud. [533] This provision explicitly eliminated

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securities fraud (absent a conviction) as a predicate act for RICO liability. According to the Conference Committee report, it was also intended to preclude use of the RICO statute to impose liability under any other theories (such as wire or mail fraud) if the conduct relied upon would constitute securities fraud. The effect of the Litigation Reform Act provision is to remove the significant threat of RICO treble damages suits for what essentially are federal securities fraud claims.

[2] Regulatory Enforcement

In addition to the private enforcement mechanisms addressed above and elsewhere in this chapter, the SEC has wide powers to pursue and punish violations of the securities laws. The various weapons in its enforcement arsenal, which was enhanced by the Sarbanes-Oxley Act and the Dodd-Frank Act, are discussed below. The SEC has employed these weapons to attempt to achieve "real time" enforcement by initiating proceedings immediately upon discovery of violations. [534]

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In recent years, the SEC has also developed a number of computerized tools intended to detect early warning signs of suspicious activities. [535]

[a] Investigation and Prosecution

The SEC has broad powers to investigate past, existing or imminent violations of the securities laws. [536] This investigatory power includes the right to administer oaths, compel sworn testimony and require the production of documents by subpoena. [537]

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SEC administrative proceedings and civil actions commenced by the SEC are generally preceded by an investigation conducted by staff attorneys and other professionals in the SEC's Division of Enforcement. The SEC staff often requests that persons with information pertinent to a matter under investigation provide documents and testimony on a wholly voluntary basis. If such cooperation is not forthcoming, the staff requests the SEC to authorize a formal investigation. In a formal investigation, the staff is authorized to issue and enforce subpoenas.

Upon conclusion of the investigation, the Division of Enforcement recommends whether further action should be taken. If the Division plans to recommend that the SEC authorize commencement of proceedings, the Division will issue a notification, or Wells Notice, to individuals and companies to provide them an opportunity to explain their alleged wrongdoing and assure the SEC of attempts to rectify the violations. The SEC then decides whether to authorize the commencement of administrative or judicial proceedings. [538] SEC staff attorneys conduct administrative proceedings before a quasi-judicial administrative law judge employed by the SEC. [539] The administrative law judge conducts a hearing and then issues a decision. [540] The decision of the administrative law judge can be appealed to the SEC, and any final order of the SEC can be appealed to a federal appellate court. [541]

In recent years, the SEC has faced criticism for its increased reliance on internal administrative law judges, who have been perceived as providing a more favorable forum for the SEC than the federal courts. [542] Several defendants have

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challenged the constitutionality of the SEC's in-house judges in the proceedings pending against them, arguing that the judges were appointed in violation of the Appointments Clause or that the use of administrative proceedings violates their due process rights, and certain district courts have expressed the view that certain aspects of the in-house courts are "likely unconstitutional." [543] However, several circuit courts have dismissed similar challenges on jurisdictional grounds, ruling that defendants must complete the administrative process within the SEC before appealing to federal court, [544] and others have issued conflicting opinions on whether the SEC's administrative law judges' appointments are constitutional. [545] In response to this criticism, the SEC has provided additional guidance on when it considers bringing cases before its in-house courts, has increased the protections provided to defendants in its in-house proceedings, and has reduced its usage of in-house courts. [546]

Alternatively, the SEC can agree to settlements with the targets of its investigation before filing administrative or judicial proceedings. The SEC reached

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such settlements with many financial institutions concerning alleged securities law violations arising out of the 2008 financial crisis. [547] These settlement agreements generally require judicial approval, and have been the subject of increased judicial scrutiny. Most notably, in 2011, Judge Jed S. Rakoff of the Southern District of New York rejected a settlement agreement between the SEC and Citigroup, in which Citigroup agreed to disgorge $160 million in profits, plus $30 million in interest, and pay a civil penalty of $95 million. [548] For several reasons, Judge Rakoff concluded that the proposed settlement was "neither fair, nor reasonable, nor adequate, nor in the public interest." Most fundamentally, Judge Rakoff criticized the SEC's "long-standing policy—hallowed by history, but not by reason—of allowing defendants to enter into Consent Judgments without admitting or denying the underlying allegations." Judge Rakoff stated that such settlements fail to "provide the Court with a sufficient evidentiary basis to know whether the requested relief is justified." Judge Rakoff further pointed to the "overriding public interest in knowing the truth," and rebuked the SEC for failing to fulfill its "duty, inherent in its statutory mission, to see that the truth emerges." Judge Rakoff also characterized the settlement at issue as imposing "only very modest penalties," which could be viewed "as a cost of doing business imposed by having to maintain a working relationship with a regulatory agency, rather than as any indication of where the real truth lies."

Although the Second Circuit Court of Appeals subsequently held that Judge Rakoff committed an abuse of discretion in rejecting the settlement, after concluding that "there is no basis in the law for the district court to require an admission of liability as a condition for approving a settlement between the parties" and that the SEC is not required to "establish the 'truth' of the allegations against a settling party as a condition for approving" a settlement, [549] the SEC

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nonetheless announced a new policy in 2013, under which it will require admissions of wrongdoing in certain cases. [550] Pursuant to this policy, the SEC requires companies to admit wrongdoing in certain settlements. [551]

[b] Injunctive Relief

The SEC has authority to enforce the securities laws by bringing suit in federal district court for injunctive relief. [552] The injunction—a court order compelling or prohibiting specified conduct of the defendant—is among the SEC's strongest weapons for enforcing compliance with the securities laws. [553] Generally, for injunctive relief to be ordered, the SEC must show there is a reasonable

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likelihood of a future violation. [554] The court will look at such factors as the nature of the violation (*e.g.*, whether a minor technical violation or a flagrant one) and defendant's past conduct to determine whether such a likelihood exists. [555]

The SEC also has the authority to request a federal court to enjoin any person who violated the antifraud provisions of § 17(a)(1) of the Securities Act or § 10(b) of the Exchange Act from acting as an officer or director of a public company. [556] The Sarbanes-Oxley Act, as discussed in § 11.07[2][b], makes it easier for the SEC to obtain such a court injunction.

[c] “Cease-and-Desist” Proceedings and Stop Orders

The SEC also has the authority to institute administrative proceedings to order a person to "cease and desist" committing or causing a present or future violation of the major U.S. securities laws. [557] The SEC may also, in connection with this cease-and-desist proceeding, issue an order barring any person who has violated § 10(b) of the Exchange Act or § 17(a)(1) of the Securities Act from acting as a director or officer of a public company.

Unlike the SEC's power to seek injunctive relief, these orders can be issued by the SEC in an administrative proceeding without seeking court action and do not require a showing of likelihood of future violation.

If the SEC determines that the alleged violation is likely to result in significant harm to investors or the public interest, it can enter a temporary order pending completion of the proceedings. [558] A temporary cease-and-desist order can only be entered against a "broker, dealer, investment adviser, investment company, municipal securities dealer, government securities broker, government securities dealer, or transfer agent" or any of their associated persons. The order,

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effective upon service, can be entered without giving the affected party notice and opportunity to be heard if the SEC determines that "notice and hearing prior to entry would be impracticable or contrary to the public interest." [559] Such orders are subject to judicial review within ten days. [560]

The SEC may also issue, after notice and hearing, an order, known as a "stop order," denying effectiveness to a registration statement if it appears inaccurate or incomplete in any material respect, or suspending the effectiveness of a registration statement if it contains a material misstatement or omission. [561]

[d] Civil Monetary Penalties and Disgorgement

The SEC has authority to bring an action in federal court to impose civil penalties for violations of any of the federal securities laws or any cease-and-desist order. [562] The SEC's penalty authority was limited prior to 1984, mainly consisting of a $100 per day assessment against issuers for reporting requirement violations. However, through the 1984 Insider Trading Sanctions Act, the 1988 Insider Trading and Securities Fraud Act, the Sarbanes-Oxley Act, and the Dodd-Frank Act, this power has gradually expanded. [563] The largest civil penalties are imposed for violations that involve "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement" and where the violation "directly or indirectly resulted in substantial losses or created significant risk of substantial losses to other persons"; penalties for such violations are the greater of (i) $178,156 for individuals or $890,780 for corporations and (ii) the gross amount of the pecuniary gain to the defendant resulting from such violation. [564]

The SEC considers three core issues in the assessment of a monetary penalty: first, the type of violation, and notably the presence of a fraud element;

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second, the degree of harm or loss to investors (for a regulated entity, there is a greater degree of harm because of the danger of a public loss of confidence in the markets); and third, the extent of a violator's cooperation. [565] Additional

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considerations, such as recidivism, the relative sophistication or seniority of the party, evidence of personal enrichment, the violation's duration and the size of the entity or the net worth of the individual, are all important in computing the final monetary penalty. [566]

When considering the appropriateness of monetary sanctions against corporate defendants, the SEC staff has identified two primary considerations: (i) "[t]he presence or absence of a direct benefit to the corporation as a result of the violation" and (ii) the degree to which the penalty will recompense or further harm the injured shareholders; as well as several secondary considerations, including:

- the need to deter the particular type of offense;
- the extent of the injury to innocent parties;
- whether complicity in the violation is widespread throughout the corporation;
- the level of intent on the part of the perpetrators;
- the degree of difficulty in detecting the particular type of offense;
- presence or lack of remedial steps by the corporation; and
- extent of cooperation with the SEC and other law enforcement. [567]

Certain provisions authorizing the SEC to assess civil penalties contain explicit statutes of limitations, which fix the time in which the SEC must file actions seeking such penalties. For example, actions assessing civil penalties for insider trading must be brought within "5 years after the date of the purchase or sale." [568] Civil penalty provisions that do not contain specific statutes of limitations are subject to the default five-year statute of limitations contained in 28 U.S.C. § 2462, which begins to run on the date that the claim "first accrued." In *Gabelli v. SEC*, a unanimous Supreme Court rejected the SEC's argument that this default statute of limitations should not begin to run on claims that sound in fraud until the agency discovered or should have discovered the alleged wrongdoing, holding that the default statute of limitations for civil penalties begins to run on the date of the alleged wrongdoing and is not subject to the discovery rule. [569]

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The SEC also may seek the "disgorgement," or forfeiture, of profits arising from the defendant's violations. [570] Disgorgement is an equitable remedy within the discretion of the court, but is generally a powerful tool. [571] Courts have held, for example, that defendants in disgorgement actions may not plead defenses based on laches or the statute of limitations, because the SEC acts in the public interest. [572] Moreover, the government may seek disgorgement in addition to criminal sanctions for the same wrongful conduct: disgorgement orders do not constitute "punishment" for purposes of the Double Jeopardy Clause of the U.S. Constitution, provided that the amount ordered to be disgorged bears a rational relationship to the actual damages and costs caused by the defendant. [573] Under the Sarbanes-Oxley Act, the SEC has the authority to add any civil penalties obtained in connection with such disgorgement to the disgorgement fund. [574]

The SEC also has limited authority to impose civil penalties in certain administrative proceedings against persons who have willfully violated provisions of the securities laws if the penalty is "in the public interest." [575] Prior to the enactment of the Dodd-Frank Act, the SEC could only impose penalties in administrative proceedings against certain regulated entities, including broker-dealers and investment advisers. Section 929P of the Dodd-Frank Act, however, expanded the SEC's ability to impose civil penalties in administrative proceedings to encompass any person or company.

In the aftermath of the 2008 financial crisis, the DOJ has also pursued civil penalties against various banks, their executives, and the credit rating agencies

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under the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"), which imposes civil penalties for violations of various criminal statutes, including the federal mail and wire fraud statutes, that "affect[] a federally insured financial institution." [576] Although the statute, which was enacted following the savings and loan crisis of the 1980s, was arguably intended to protect financial institutions from fraud committed by others that affected them, a number of district courts have permitted the government to pursue FIRREA claims against financial institutions themselves based on so-called "self-affecting" misconduct. [577] One of those cases subsequently proceeded to trial, which resulted in a verdict in favor of the government and the imposition of a $1.27 billion civil penalty, although the verdict was subsequently reversed on appeal based on the government's failure to prove fraudulent intent. [578] Prior to that reversal, however, a number of financial institutions agreed to multi-billion dollar settlements of similar FIRREA claims with the DOJ for alleged wrongdoing in connection with mortgages and mortgage-related securities in the years before the financial crisis. [579]

[e] Publication of Findings

The SEC has power under § 15(c)(4) of the Exchange Act to publish a report of the findings of administrative proceedings in connection with noncompliance with the registration, reporting or proxy requirements of the Exchange Act by issuers that are reporting companies under the Exchange Act. [580] It can also issue orders under § 15(c)(4) to bring conduct of the particular issuer into

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compliance with the securities laws. [581] In addition, the SEC has the power under § 21(a)(1) of the Exchange Act to publish reports concerning securities law violations it has investigated. The SEC primarily uses these so-called § 21(a) reports to publicize its view on matters for which enforcement proceedings have not been pursued or with respect to "novel or unique matters." [582]

[f] Enforcement Activities Against Market Professionals

By the fall of 2002, the SEC, the NASD (now known as FINRA), the NYSE and state attorneys general began cooperatively investigating the practices of financial institutions. These investigations resulted in several settlements related to analyst conflicts of interest issues and allocation practices in initial public offerings, such as "spinning," in which shares of an initial public offering that are expected to trade in the aftermarket at a premium are allocated to company executive officers and directors in order to induce those individuals to steer investment banking business to the underwriter.

Notably, in January 2002, Credit Suisse First Boston settled for $100 million with the NASD and the SEC to resolve a federal investigation of IPO allocation practices. [583] After more than six months of investigation by the Attorney General of the State of New York (the "NYAG"), a similar settlement agreement for a $100 million payment was reached between Merrill Lynch, Pierce, Fenner & Smith Incorporated and the NYAG in May 2001, regarding allegations that

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Merrill Lynch analysts issued misleading research related to the technology and Internet sectors, and that their research was influenced by investment banking relationships. [584]

Around the same time, the SEC, the NASD, the North American Securities Administrators Association ("NASAA"), the NYSE and attorneys general from a number of states, including New York, undertook a broader investigation of 12 prominent Wall Street banking firms with regard to research and IPO allocation practices, such as "spinning" in initial public offerings. During the course of these investigations, [585] damaging evidence was made public suggesting that the public recommendations of Wall Street analysts often did not reflect their firms' internal assessments of a company and that the independence of analysts was compromised by their firms' investment banking relationships with the same companies they were analyzing. In October 2002, the SEC, the NASD, the NASAA, the NYSE, the NYAG and various state securities regulators officially agreed to coordinate investigation and enforcement efforts, [586] and a global settlement between each of these regulators and ten of the financial institutions under investigation was announced on April 28, 2003 and was entered by the court on

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October 31, 2003. [587] A later settlement with the remaining two firms was announced on August 26, 2004. [588]

Under the terms of the settlements, the 12 firms were required to pay disgorgement and civil penalties totaling approximately $1.5 billion, which included Merrill Lynch's prior payment of $100 million in connection with its initial settlement with the NYAG. [589] Some of the money was used to create funds for investors, to pay for independent research and for investor education. [590] The settling firms also agreed to structural reforms to separate research and investment banking and to improve disclosure as to possible conflicts of interest. The 12 firms also entered into a voluntary agreement to restrict spinning in initial public offerings. A variety of different statutory provisions were invoked against the settling firms:

- Firms issuing fraudulent research reports were charged with violating § 15(c) of the Exchange Act.
- Firms issuing research reports that were not based upon principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, and/or contained opinions for which there were not reasonable bases were charged with violating NYSE Rules 401, 472 and 476(a)(6) and then—NASD Rules 2110 and 2210 and states' ethics statutes.
- Firms receiving payments for research without disclosing such payments were charged with violating § 17(b) of the Securities Act as well as NYSE Rules 476(a)(6), 401 and 472, then—NASD Rules 2210 and 2110 and state statutes.
- Firms engaging in spinning of initial public offerings were charged with violating NYSE and NASD rules requiring adherence to high business standards and the recordkeeping provisions of § 17(a) of the Exchange Act, NYSE Rule 440 and NASD Rule 3110.
- All firms were alleged to have failed to maintain appropriate supervision over their research and investment banking operations in violation of NASD Rule 3010 and NYSE Rule 342.

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Two individual analysts were fined and agreed to an injunction against future securities laws violations and a bar on associating with a broker, dealer or investment adviser. [591] The settlements did not foreclose further actions against the 12 firms (or other firms or individuals) by regulatory or individual investors, and civil plaintiffs filed hundreds of class action complaints related to IPO allocation practices, which were settled in 2009 for $586 million. [592]

The SEC also has pursued actions against certain securities exchanges. In 2013, the SEC charged NASDAQ with securities law violations relating to the initial public offering of Facebook, during which a computer error caused more than 30,000 orders to remain stuck in the exchange's system for several hours without being executed or cancelled. [593] In its order against NASDAQ, the SEC charged that, despite widespread anticipation that the Facebook IPO would be among the largest in history, NASDAQ failed to correct the computer error and thereby violated its rule governing the price/time priority for executing trade orders. The SEC order further asserted that NASDAQ violated its rules by utilizing an unauthorized error account. NASDAQ agreed to settle the charges by paying a $10 million penalty.

[3] Criminal Enforcement

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Violations of the U.S. securities laws can also give rise to criminal prosecution by the DOJ [594] and, upon conviction, to sentences ranging from substantial fines to imprisonment. As in civil enforcement, there are multiple statutory provisions under which criminal charges may be brought. This section discusses several provisions within the securities laws themselves, as well as several general criminal statutes that are frequently applied in securities cases. It also discusses the federal guidelines applicable for sentencing corporations and other entities.

[a] Securities Law Provisions

The principal U.S. securities laws each authorize the commencement of criminal proceedings against persons who willfully violate certain provisions of these statutes. [595] The Securities Act, the Investment Company Act and the Advisers Act each provide for fines of up to $10,000, [596] and the Exchange Act provides for fines of up to $5 million for natural persons or $25 million for others. [597] Alternatively, fines may be fixed at twice the profit gained by the defendant or the loss inflicted on the victim, if this amount is greater than the statute would otherwise provide. [598] The DOJ may also seek imprisonment of up to five years for violations of the Securities Act, the Investment Company Act

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and the Advisers Act [599] or up to 20 years for violations of the Exchange Act. [600] Certain defenses to imprisonment are available for nonwillful, technical violations of rules and regulations under the Act if the defendant can prove that he or she had no actual knowledge of the rule or regulation at issue. [601]

Following significant economic downturns coupled with revelations of misconduct, prosecutors have reacted by vigorously prosecuting violations of the securities laws. In the late 1980s, prosecutors brought highly publicized and successful prosecutions of insider trading, market manipulation and other securities violations. [602] In the wake of Enron and the Sarbanes-Oxley Act, prosecutors aggressively investigated and prosecuted alleged misconduct related to accounting and disclosure issues, related-party transactions and insider trading. [603]

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Another wave of securities-related prosecutions targeted the back-dating of stock options. In the second half of 2006, over 100 companies acknowledged either internal or governmental investigations into potential backdating, a practice by which the exercise price of executives' stock options is set prior to the board meetings at which the options were awarded and at a lower price than the stock was trading on the day of the grant. [604] More recently, prosecutors have pursued a number of criminal prosecutions arising from the 2008 financial crisis, including actions concerning mortgage-related assets, Ponzi schemes, and insider trading. [605]

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These actions represent a further intensification of the prosecutions from the 1980s in terms of both the number of actions brought and the aggressiveness of prosecutors. [606]

It is not uncommon for separate civil and criminal proceedings brought by the government against the same defendant to proceed simultaneously. Although the SEC and the DOJ are separate and distinct governmental entities, they often cooperate to exert greater pressure on a defendant. In *United States v. Kordel*, the Supreme Court held that federal prosecutors may use evidence obtained in a civil action in prosecuting a related criminal proceeding, provided the civil action was not brought in "bad faith." [607] Moreover, in recent years, the DOJ and the SEC have also cooperated with other regulators at the state, federal, and international levels to investigate several recent securities-related scandals and negotiate large global settlements. [608] Further, the DOJ has itself pursued a number of civil actions alleging securities fraud in the years leading up to the 2008 financial crisis, including several actions relating to the marketing and sale of mortgage-backed securities. [609]

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And, more recently, several banks agreed to plead guilty to criminal charges concerning alleged rate manipulation. [610]

Some observers, however, sharply criticized the government for failing to prosecute more high-level executives for alleged wrongdoing in connection with the financial crisis. [611] In response to this criticism, on September 9, 2015, the Department of Justice issued new guidelines aimed at prioritizing its focus on individual responsibility in cases of both civil and criminal corporate wrongdoing. [612] The guidelines, which are set out in a memorandum from Deputy Attorney General Sally Quillian Yates, describe steps that the DOJ was taking to "strengthen" its "pursuit of individual corporate wrongdoing," including providing that:

- In order to qualify for any cooperation credit, corporations must provide to the DOJ all relevant facts relating to the individuals responsible for misconduct.
- Criminal and civil corporate investigations should focus on individuals from the inception of the investigation.
- Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.
- Absent extraordinary circumstances or approved departmental policy, the DOJ will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation.

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- DOJ attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should memorialize any declinations as to individuals in such cases.
- Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.

A growing number of companies have entered into deferred prosecution agreements with the DOJ. In exchange for a deferral of prosecution, these companies often agree to the payment of large penalties, institute extensive internal corporate reforms and cooperate fully with federal ongoing or subsequent investigations. [613] Since the 1995 agreement with Prudential Securities Inc. over the fraudulent marketing of limited partnerships, [614] the DOJ has entered into deferred prosecution agreements with a significant number of companies—including Lloyds Banking Group, Credit Suisse, ABN AMRO, Bristol-Myers, Monsanto, Time Warner, InVision, American International Group Inc., Computer Associates, Canadian Imperial Bank of Commerce, Merrill Lynch, PNC Financial Services Corporation, Banco Popular De Puerto Rico, Barclays, UBS, HSBC, The Royal Bank of Scotland, JPMorgan, and Deustche Bank. [615] The DOJ

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reiterated its commitment to deferred prosecutions in December 2006, when Deputy Attorney General Paul J. McNulty issued a memorandum setting forth the factors that the Department would consider when determining whether to indict a corporation or offer a deferred prosecution agreement. [616] These factors largely echoed the factors set forth three years earlier in the Thompson Memo. [617] Moreover, a memorandum issued by Deputy Attorney General Mark R. Filip in 2008 explained that deferred prosecutions would be particularly useful tools in situations where a corporate conviction would result in significant collateral consequences on innocent third parties. [618]

[b] Mail and Wire Fraud

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The same conduct that violates provisions of the securities laws may also be recharacterized by prosecutors as violations of various other criminal statutes. Two general antifraud statutes, commonly known as the mail and wire fraud statutes, are used with particular frequency. [619] The former provides for criminal penalties for use of the U.S. postal system, [620] and the latter for use of interstate or foreign wire, radio or television communications, [621] in furtherance of a scheme to defraud. The allegedly fraudulent information need not have been placed in the mail or transmitted over the wires (such as facsimile or telephone) to be actionable under the mail and wire fraud statutes; use of the mails or interstate wires is simply the jurisdictional means necessary to invoke the federal laws. [622] Therefore, almost any conduct that could be characterized as fraud under the common law will violate the mail and wire fraud statutes, although unlike the common law action alleging fraudulent conduct, it is not necessary that the fraud be successful [623] or that the intended victims of the scheme have relied to their detriment on the alleged fraud. [624]

The mail and wire fraud statutes are intended to protect individual property rights, [625] including intangible property rights such as the "intangible right of honest services." [626] In *Carpenter v. United States*, the Supreme Court affirmed the conviction of R. Foster Winans, a columnist at *The Wall Street Journal*, who had schemed with brokers to trade in the securities of companies that were to be the subject of upcoming "Heard on the Street" columns. The Court held that *The Wall Street Journal* had an intangible "property right in keeping confidential and making exclusive use, prior to publication, of the schedule and contents of the ‘Heard’ columns" and that this property had been fraudulently misappropriated since Winans owed a fiduciary duty not to exploit confidential information obtained during his employment. [627]

The U.S. Supreme Court upheld the constitutionality of the "honest services law" while narrowing its scope to cases that involve bribery or kickback schemes. In *Skilling v. United States* [628] the Court held that a broader interpretation of the law, to include undisclosed self-dealing by a public official or private employee, would be unconstitutionally vague because the statute had been infrequently applied to such conflict-of-interest cases and because the term "honest services" was itself ambiguous. The Court also invoked the rule of lenity to construe the statute in favor of Skilling, the former CEO of Enron, given the perceived ambiguity in the law. The government had charged Skilling with conspiring to defraud its shareholders by lying about the company's financial health, and profiting by receiving salary and bonuses and selling Enron stock at an inflated price. Because the government did not "allege that Skilling solicited or accepted side payments from a third party in exchange for making these misrepresentations," the Court held that the "honest services law" could not serve as a basis for prosecuting Skilling. [629]

A defendant may be charged simultaneously with violating the mail or wire fraud statutes and with violating an antifraud provision under the U.S. securities laws; there is no requirement that prosecutors select one or the other criminal statute on which to base their case. [630] In order to be convicted under the mail or wire fraud statutes, the defendant must have acted intentionally or with reckless indifference to the truth. [631] Good faith is a defense to a charge of scheming to defraud if the defendant reasonably and actually believed in the sound basis of the representations made or the scheme proposed. [632] A mail or wire fraud conviction can result in fines of up to $250,000 for an individual, $500,000 for an

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organization, or twice the profit gained or loss avoided by the violation, [633] as well as up to 20 years' imprisonment. [634]

The Sarbanes-Oxley Act created a new securities fraud crime, the elements of which are similar to the existing mail and wire fraud crimes and which may be brought as an additional charge in fraud cases relating to securities. [635]

[c] Other Criminal Statutes

There are numerous other federal criminal statutes that may be applied to illegal activities in the securities marketplace. As discussed in § 11.09[1][b], the broad RICO statute allows for criminal and, in limited circumstances, civil enforcement of "fraud in the sale of the securities," so long as a "pattern" of such fraudulent acts can be shown. [636] It is also a crime in the United States to: (i) make false statements "in any matter within the jurisdiction of any department or agency of the United States," including the SEC, [637] (ii) engage in financial transactions with the proceeds of unlawful activities, with the intention of promoting those activities or concealing the nature or source of the proceeds ("money laundering"), [638] or (iii) structure financial transactions to avoid triggering certain cash reporting requirements of financial institutions. [639]

[d] Entity Sentencing Guidelines

As discussed previously, U.S. law sets forth a range of possible fines that can be imposed on corporations or others convicted of violating criminal statutes. While some of these laws provide for stiff penalties on their face, [640] others that originally contained lighter penalties have been superseded by a general penalty provision, enacted in 1984, which increased the possible fine for corporate

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defendants to the greater of $500,000 or twice the benefit gained by the defendant or the loss inflicted on the victim. [641] Even where the pecuniary benefit or loss is minimal, however, fines can nonetheless far exceed the $500,000 alternative amount because a single episode of criminal misconduct often entails the commission of multiple criminal acts, each of which can support the imposition of a separate penalty. [642]

In 1991, the U.S. Sentencing Commission, created by Congress in 1984 to devise guidelines to limit the discretion of judges in determining sentences, issued sentencing guidelines for criminal activities of corporations and other entities. [643] While these guidelines do not by themselves modify the maximum fines that the federal courts are authorized by statute to impose, they do furnish ranges within an existing fine authorization from which the court is recommended to select the appropriate sentence. [644] Importantly, they also provide significant incentives for corporations doing business in the United States, including non-U.S. corporations or U.S. subsidiaries of non-U.S. corporations, to adopt compliance and ethics programs to prevent and detect violations of federal criminal law by employees, by significantly reducing the applicable fines for corporations that have implemented such programs.

The operation of the sentencing guidelines is complex, involving the determination of a "base fine" amount based on various specified "offense levels," and the subsequent application of multipliers based on the particular characteristics of the organization, determined by its so-called "culpability score." This score may be increased (resulting in larger fines) for corporations with large numbers of employees, corporations where senior managers "participated in, condoned, or [were] willfully ignorant of the offense," corporations with prior histories of related criminal or civil violations, or corporations that attempted to obstruct justice while the misconduct at issue was being investigated. The culpability score may be decreased (resulting in lower fines) if the organization had in place "an effective compliance and ethics program," or if the organization is highly cooperative with prosecuting authorities, for example by voluntarily

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bringing the matter to the government's attention or promptly accepting responsibility for the criminal conduct. [645]

The sentencing guidelines for corporations set out various general criteria that a compliance and ethics program must satisfy to qualify as an "effective" one for purposes of reducing the organization's culpability score. These criteria include:

- the development, implementation and enforcement of standards and procedures "generally effective in preventing and detecting criminal conduct" and effective communication of these standards to all employees;
- knowledge by an organization's governing authority about the content and operation of the compliance and ethics program and the exercise of reasonable oversight with respect to the implementation and effectiveness of such a program;
- the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law;
- the designation of specific high-level personnel to oversee compliance and the delegation of day-to-day operational responsibility for the compliance and ethics program to specific individuals;
- the development of specific procedures to monitor compliance and report violations;
- the periodic evaluation of the effectiveness of the compliance and ethics program;
- the establishment and publication of a system whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation; and
- the promotion and consistent enforcement of the organization's compliance and ethics program through appropriate incentives to perform in accordance with the program and appropriate disciplinary measures for engaging in criminal conduct and/or for failing to take reasonable steps to prevent or detect criminal conduct. [646]

Footnotes

491 *See* FED. R. CIV. P. 23(a) and (b).

492 *See* PricewaterhouseCoopers LLP, 2015 Securities Litigation Study (Apr. 2016) (noting that 43 foreign-filers listed on U.S. exchanges were sued in U.S. private securities class actions in 2015, out of the total of 195 private securities class actions during the year). The report highlighted that the majority of actions against foreign filers were related to China and Canada-based entities, and that a disproportionate percentage of those cases involved accounting-related allegations.

493 Many corporate scandals have produced civil class actions. *See, e.g.*, *In re WorldCom, Inc. Securities Litigation*, 219 F.R.D. 267 (S.D.N.Y. 2003) (certifying putative class of "tens of thousands of investors" who asserted, among other claims, claims under §§ 11 and 12 of the Securities Act and § 10(b) of the Exchange Act arising out of the WorldCom accounting scandal); *In re Initial Public Offering Securities Litigation*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003) (consolidated action involving 1,000 class action lawsuits against more than 300 issuers, more than 50 underwriters and various individuals alleging violations of § 10(b) of the Exchange Act and § 11 of the Securities Act in connection with undisclosed compensation in exchange for allocations in initial public offerings, "tie-ins" or laddering agreements (in which banks allocate IPO shares to investors based upon their commitment to purchase additional shares at fixed prices once public trading begins to inflate newly issued shares' values) with banks in order to receive allocations, and research analysts conflicts of interest); *In re Credit Suisse First Boston Corp. Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶90,306 (S.D.N.Y. Oct. 19, 1998) (class action alleging violations of § 10(b) of the Exchange Act in connection with false research reports).

494 *See* §§ 11.03[2] and 11.04[2]. *But see In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006) (holding that fraud-on-the-market theory would not apply to claims based on alleged misstatements in connection with an initial public offering where there was no developed or efficient market for the stock).

495 The sole exception is for members of the class who choose to "opt out" of the class action proceedings,

preserving their right to sue separately but at the same time waiving their right to participate in the class action or share in the proceeds of its settlement or judgment. *See* FED. R. CIV. P. 23(c)(2).

496 *See* FED. R. CIV. P. 23.

497 *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006). The court noted that the ultimate fact-finder would not be bound by the factual determinations made during the class certification proceedings.

498 *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2d Cir. 2006) (quoting *Caridad v. Metro-North Commuter Railroad*, 191 F.3d 283 (2d Cir. 1999)).

499 *See* § 11.04[2][b].

500 *See* § 11.04[2][b].

501 *Erica P. John Fund, Inc. v. Halliburton Co.*, 132 S. Ct. 2179 (2011).

502 *See, e.g.*, *In re Flag Telecom Holdings, Ltd. Securities Litigation*, 574 F.3d 29, 39–41 (2d Cir. 2009) (holding that it was proper to deny certification of a class that included putative members who had sold the securities at issue before the truth regarding the alleged misstatements was revealed to the public because the plaintiffs "failed to demonstrate that any of the information that 'leaked' into the market prior to [the date plaintiffs sold their stock], revealed the truth with respect to the specific misrepresentations alleged" and thus their claims were not typical of those of the class members plaintiffs sought to represent).

503 In *Halliburton*, the issuer also defended the lower court's decision by arguing that the court's reliance on the evidence of lack of loss causation to uphold the denial of class certification was really a proxy for a determination that the alleged misrepresentations had no impact on the price of the securities at issue. *See Erica P. John Fund, Inc. v. Halliburton Co.*, 132 S. Ct. 2179, 2186–87 (2011). The Supreme Court refused to credit this interpretation of the lower court's decision, finding that the Fifth Circuit unequivocally rested on the lack of loss causation to uphold the denial of class certification. Nevertheless, as the Court explained in *Halliburton*, under *Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. 336 (2005), a showing that the alleged misrepresentation did not cause a change in the price of the security defeats the *Basic* presumption of reliance. The Court also cited favorably the *In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474 (2d Cir. 2008), decision, where the Second Circuit reiterated that a defendant could defeat the *Basic* presumption by establishing lack of price impact of the alleged misrepresentation or omission. Thus, after *Halliburton*, defendants may still use the lack of loss causation at the class-certification stage as one factor that may lead a court to conclude that an alleged misrepresentation had no impact on the price of the security at issue, thus defeating the *Basic* presumption of reliance.

504 *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2013).

505 *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398 (2014).

506 *See* § 11.04[2][a].

507 *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

508 *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013).

509 *Ludlow v. BP, P.L.C.*, 800 F.3d 674 (5th Cir. 2015).

510 *See, e.g., Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing and Securitization, LLC*, 616 F. Supp. 2d 461, 463 (S.D.N.Y. 2009) (discussing the legislative history and purposes of the Litigation Reform Act as indicating clear intent to curtail "the vice of 'lawyer-driven' litigation"); *In re Nice Systems Securities Litigation*, 188 F.R.D. 206, 214–15 (D.N.J. 1999) (discussing the legislative history and purpose of the Litigation Reform Act). The Litigation Reform Act also mandates imposition of sanctions, presumed to be attorneys' fees and costs, against any parties or counsel found to have filed frivolous or abusive suits, and in the case of private class actions under the Exchange Act, specifically authorizes courts to require parties or their counsel to post bonds at the outset to cover any such fees or costs that may be imposed. *See* §§ 21D(c)(3) and 21D(a)(8) of the Exchange Act, respectively; §§ 27(c)(3) and 27(a)(8) of the Securities Act, respectively.

511 The lead plaintiff's choice of counsel, however, is subject to the court's approval. § 21D(a)(3)(B)(v) of the

Exchange Act. Equipped with this veto power, some courts now require lead counsel to be selected through a competitive bidding process . *See, e.g.*, *Sherleigh Associates LLC v. Windmere-Durable Holdings, Inc.*, 186 F.R.D. 669 (S.D. Fla. 1999); *In re Cendant Corp. Litigation*, 182 F.R.D. 144 (D.N.J. 1998). The Third Circuit Court of Appeals disagreed with the district court's use of a competitive bidding process in *Cendant*, however, but held that the use of the process was harmless error. *In re Cendant Corp. Litigation*, 264 F.3d 201 (3d Cir. 2001).

512 *See Burke v. Ruttenberg*, 102 F. Supp. 2d 1280 (N.D. Ala. 2000); *In re Cephalon Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶99,313 (E.D. Pa. Aug. 27, 1996). In *Weltz v. Lee*, 199 F.R.D. 129, 132 (S.D.N.Y. 2001), the court appointed an aggregate group of seven investors as lead plaintiff. However, the court also noted that there is an "outer limit to the number of plaintiffs allowed to proceed as lead plaintiff," citing cases in which groups of 137, 141 and 250 plaintiffs were deemed too large. Some courts have rejected aggregation altogether. *See, e.g.*, *Goldberger v. FXRE Group Ltd.*, Nos. 06-CV-3410 (KMK), 06-CV-3440 (GBD), 06-CV-3544 (KMK), 06-CV-4638 (KMK), 2007 WL 980417, at *4–5 (S.D.N.Y. Mar. 30, 2007). *See generally In re UBS Auction Rate Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶94,791 (S.D.N.Y. July 16, 2008) (permitting aggregation of seven class members and discussing split of authority on aggregation issue).

513 § 21D(a)(3)(B)(iii)(I)(bb) of the Exchange Act and § 27(a)(3)(B)(iii)(I)(bb) of the Securities Act. Although courts have been willing to apply this rebuttable presumption, they have also closely scrutinized aggregating plaintiff groups, questioning whether they are "simply an artifice cobbled together by cooperating counsel for the obvious purpose of creating a large enough grouping of investors to qualify as 'lead plaintiff,' which can then select the equally artificial grouping of counsel as 'lead counsel.'" *In re Razorfish, Inc. Securities Litigation*, 143 F. Supp. 2d 304, 308 (S.D.N.Y. 2001). *In Klugmann v. American Capital Ltd.*, Fed. Sec. L. Rep. (CCH) ¶95,318 (D. Md. Aug. 13, 2009), the court noted in *dicta* that aggregation of wholly unrelated plaintiffs solely for the purpose of totaling the largest losses was inappropriate, but accepted aggregation of three plaintiffs who each had, individually, larger losses than the other proposed lead plaintiff. In the Third Circuit, before appointing a lead plaintiff, the court must determine whether "the way in which a group seeking to become lead plaintiff was formed or the manner in which it is constituted would preclude it from fulfilling the tasks assigned to a lead plaintiff." *In re Cendant Corp. Litigation*, 264 F.3d 201, 266 (3d Cir. 2001). "If the court concludes that the group was created by counsel rather than class members, then 'the court should disqualify that movant on the grounds that it will not fairly and adequately represent the interests of the class.'" *In re Able Laboratories Securities Litigation*, 425 F. Supp. 2d 562, 567–68 (D.N.J. 2006) (quoting *In re Cendant Corp. Litigation*, 264 F.3d 201, 266 (3d Cir. 2001)).

514 *See* Max Berger, et al., *Institutional Investors as Lead Plaintiffs: Is There a New and Changing Landscape?*, 75 ST. JOHN'S L. REV. 31, 31 (2001) (citing H.R. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730).

515 In a 1997 report to the President and Congress, the SEC indicated that institutional investors had not become more active in securities class actions in the year following enactment of the Litigation Reform Act, and that such actions continued to be controlled by plaintiffs'law firms frequently representing smaller investors. The SEC suggested that "there are substantial disincentives for institutional investors considering intervention" in securities class actions, including the added costs of managing the litigation, the potential exposure of key personnel to discovery not only from defendants but also from other potential lead plaintiffs and the possibility of added liability in suits brought by other plaintiffs based on the lead plaintiff's class action litigation decisions. Some institutional investors have apparently concluded that they can obtain a better recovery and reduce exposure by opting out of the securities class and proceeding separately. As the SEC concluded, "[w]hether or not institutions will look beyond these disincentives remains to be seen." SEC, *Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995*, at 2, 51–52 (Apr. 1997), *reprinted in* 3 SECURITIES REFORM ACT LITIG. RPTR. 27, 56 (May 1998).

516 *See* Karen Donovan, *Legal Reform Turns a Steward Into an Activist*, N.Y. TIMES, Apr. 16, 2005 (noting

increased role of institutional investors, including public pension funds, under the Litigation Reform Act, and highlighting the role of then-New York state comptroller Alan Hevesi as representative of the lead plaintiff in the *WorldCom* class action); Richard B. Schmitt, *Accounting for Enron: Pension Funds, Not Lawyers, Drive Holder Suits*, WALL ST. J., Jan. 24, 2002; Max Berger, *et al.*, *Institutional Investors as Lead Plaintiffs: Is There a New and Changing Landscape?*, 75 ST. JOHN'S L. REV. 31 (2001). Several studies have found that class action settlements are higher when institutional plaintiffs are lead plaintiffs. James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter?: An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 100 COLUM. L. REV.101 (2006); Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Lawsuits: Settlements Reported Through December 2003* (Cornerstone Research, 2004).

517 SLUSA does not prohibit: (i) actions that are based on the statutory or common law of the state in which the issuer is incorporated and that involve (a) any communication with respect to the sale of the securities of the issuer that is made by or on behalf of the issuer to its equity holders and concerns decisions of those holders with respect to voting their securities, acting in response to a tender or exchange offer or exercising dissenters'or appraisal rights or (b) the purchase or sale of securities by the issuer exclusively from or to holders of equity securities of the issuer, (ii) actions involving a covered security brought by a state, its political subdivisions or a state pension plan, and (iii) actions seeking to enforce contractual agreements between an issuer and an indenture trustee.

518 § 101 of SLUSA, as incorporated into § 16 of the Securities Act. "Covered class action" is defined in § 16(f)(2) of the Securities Act as "any single lawsuit in which damages are sought on behalf of more than 50 persons," in which certain questions of law and fact predominate "without reference to issues of individualized reliance on an alleged misstatement or omission." This definition also applies to groups of lawsuits consolidated, joined or otherwise filed as a single action. Representative class actions are also covered by the definition. Section 16(f)(2)(B) of the Securities Act provides an exception for derivative actions. The term "covered security" is defined in § 16(f)(3) of the Securities Act by reference to § 18(b)(1) and (2) of the Securities Act, which defines "covered securities" as those "listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed or authorized for listing on the National Market System of the Nasdaq Stock Market," or "on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards" of those exchanges. "A security of the same issuer that is equal in seniority or one that is a senior security to a security" described above, is also a "covered security." § 18(b)(1)(C) of the Securities Act.

519 *Kircher v. Putnam Funds Trust*, 547 U.S. 633 (2006).

520 *Merrill*, *Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006).

521 *See supra* Note 219 and accompanying text (discussing the judicially imposed limitations on standing in private litigation under § 10(b) of the Exchange Act and Rule 10b-5 thereunder, which require that a claim be brought by purchasers or sellers of securities and not by holders of securities).

522 *Merrill*, *Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006).

523 *Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058 (2014).

524 *In re Kingate Management Limited Litigation*, 784 F.3d 128 (2d Cir. 2015).

525 *Compare Purowitz v. Dreamworks Animation SKG, Inc.*, C.A. No. CV 05-6090 MRP (VBKx), at 3–4 (C.D. Cal. Nov. 15, 2005), *Brody v. Homestore, Inc.*, 240 F. Supp. 2d 1122, 1124 (C.D. Cal. 2003), *and Alkow v. TXU Corp.*, Fed. Sec. L. Rep. (CCH) ¶92,495 (N.D. Tex. May 8, 2003) (all denying motions to remand), *with In re Tyco International, Ltd. Multidistrict Litigation*, 322 F. Supp. 2d 116, 118 (D.N.H. 2004), *Nauheim v. Interpublic Group of Cos.*, 2003 U.S. Dist. LEXIS 6266, at *1 (N.D. Ill. Apr. 15, 2003), *and In re Waste Management Inc. Securities Litigation*, 194 F. Supp. 2d 590 (S.D. Tex. 2002).

526 *Rovner v. Vonage Holdings Corp.*, Civil Action No. 07-178 (FLW), 2007 WL 446658, at *5 (D.N.J. Feb. 7, 2007) ("The Court agrees with those district courts which have found an interpretation of [§ 77v(a)] to require removal of only those securities class action cases raising state law claims to be irreconcilable with the congressional findings. Instead, I find that the plain language of the statute, coupled with the legislative

history and a healthy dose of common sense compel the conclusion that this class action, which alleges only federal Securities Act claims, was removable."); *see also Knox v. Agria Corp.*, 613 F. Supp. 2d 419 (S.D.N.Y. 2009) ("The narrow reading [of SLUSA] granting remand [over covered class actions that raise only Securities Act claims] creates a jurisdictional anomaly because it has the effect of prohibiting state securities fraud claims in state court, while allowing federal securities fraud class actions to be litigated there. It also does not make sense. SLUSA was intended to curtail the proliferation in state courts of securities fraud class actions (federal or state) beyond the reach of the [Litigation Reform Act]'s heightened pleading standards. Instead, the constricted approach threatens to spawn federal securities fraud class actions in state courts where they could proceed under the radar. That bizarre result would shift the center of gravity of federal securities fraud class actions under the 1933 Act from federal to state courts."); *In re Fannie Mae 2008 Securities Litigation*, Fed. Sec. L. Rep. (CCH) ¶95,531 (S.D.N.Y. Nov. 24, 2009) (agreeing with *Knox in dicta* because the court found that it had jurisdiction under a different statutory provision as well); *Rubin v. Pixelplus Co., Ltd.*, No. 06-CV-2964 (ERK), 2007 WL 778485, at *5 (E.D.N.Y. Mar. 13, 2007) ("[B]y enacting SLUSA Congress eliminated concurrent jurisdiction for covered class actions, which made federal court the sole venue for securities fraud class actions and effectively abolished state law causes of action for the types of cases at issue here.").

527 *See, e.g.*, *City of Warren Police and Fire Retirement System v. Revance Therapeutics, Inc.*, 125 F. Supp. 3d 917 (N.D. Cal. 2015) (stating that "[t]he Northern District of California has soundly rejected Defendants' position [that state courts lack jurisdiction over Securities Act class actions] in recent years" and the contrary position "appears to be emerging as the dominant view around the country and has almost uniformly been upheld by district courts since 2012"); *see also Niitsoo v. Alpha Natural Resources, Inc.*, 902 F. Supp. 2d 797 (S.D. W. Va. 2012); *Luther v. Countrywide Financial Corporation*, 125 Cal. Rptr. 3d 716 (Cal Ct. App. 2011).

528 Class Action Fairness Act, Pub. L. No. 109-2, 2119 Stat. 9 (2005) (codified at 28 U.S.C. § 1332(d)).

529 Diversity jurisdiction under 28 U.S.C. § 1332 requires that each plaintiff individually satisfy the $75,000 minimum amount in controversy requirement (meaning that a class action in which each plaintiff has an identical claim for $60,000 will not meet the requirement, even if there are 20 plaintiffs with an aggregate amount in controversy of $1,200,000). Also, diversity jurisdiction requires "complete diversity," meaning that none of the plaintiffs may be from the same state as any of the defendants (in the case of class actions, the court will look at the residence or domicile of the class representatives, not all class members). *See* 28 U.S.C. § 1332(a).

CAFA changes both of these rules. Instead of the individual $75,000 amount in controversy requirement, CAFA requires an aggregate amount of $5 million. Instead of "complete diversity," CAFA requires only that one class member be diverse from at least one defendant. CAFA only applies to class actions with greater than 100 class members. *See* 28 U.S.C. § 1332(d)(2)–(7).

530 *Compare Luther v. Countrywide Home Loans Servicing LP*, 533 F.3d 1031 (9th Cir. 2008) (holding that "CAFA's general grant of the right of removal of high-dollar class actions does not trump § 22(a)'s specific bar to removal of cases arising under the Securities Act of 1933") *with Katz v. Gerardi*, 552 F.3d 558 (7th Cir. 2009) ("disagree[ing] with *Luther* and hold[ing] that securities class actions covered by [CAFA] are removable").

531 *See, e.g.*, *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Corp.*, 632 F.3d 762 (1st Cir. 2011); *In re Countrywide Financial Corporation Mortgage-Backed Securities Litigation*, 860 F. Supp. 2d 1062 (C.D. Cal. 2012); *Genesee County Employees' Retirement System v. Thornburg Mortgage Securities Trust 2006-3*, 825 F. Supp. 2d 1082 (D.N.M. 2011).

532 *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 1624 (2013).

533 18 U.S.C. § 1964.

534 The SEC's real time enforcement initiative began at the end of 2001 alongside the Enron bankruptcy. As described by then-SEC Chairman Pitt, "[t]his policy aims to improve our protection of investors by moving

faster, or in real time, to bring enforcement actions. We seek to learn of violations quickly and, where investor interests are being disserved or abused, take immediate action to undo or halt the effects of misconduct." Remarks by SEC Chairman Harvey L. Pitt at the Directors' Education Institute, Duke University (Oct. 22, 2002). In one matter, the SEC brought a fraud action against an Internet investment scheme, operating under the name of Invest Better 2001, before it was able to identify the individual behind it. *See* Stephen M. Cutler, Recent SEC Enforcement Cases, 1344 PLI/Corp 991, 1009 (Nov. 2002). In another action against an oil and gas investment scam, the SEC brought an action and obtained an order within four days of learning of the scheme. *See* Press Release, SEC, SEC Halts $3.9 Million Oil & Gas Scheme; "Real-Time" Enforcement Initiative Cited (Dec. 3, 2001). In WorldCom, the SEC filed charges within 24 hours of WorldCom's initial restatement of its financial statements. *See* Seth Schiesel, *WorldCom Seems Close to Deal to Settle S.E.C.'s Fraud Case*, N.Y. TIMES, Nov. 5, 2002.

The SEC also has indicated that its enforcement will be influenced by the cooperation or lack of cooperation of a company it is investigating. *See* Harvey L. Pitt, Chairman, SEC, Remarks before the U.S. DOJ Corporate Fraud Conference (Sept. 26, 2002); *see also* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010); *infra* Note 565. As further discussed below, the DOJ has also indicated that cooperation is an important factor in charging and sanctioning decisions. *See infra* Note 565.

In 2010, the SEC announced a "Cooperation Initiative," which included, *inter alia*, an expansion of the enforcement tools available to its staff to include cooperation agreements, deferred prosecution agreements and non-prosecution agreements. Under cooperation agreements, the enforcement division staff will normally agree to recommend to the SEC that a cooperator receive credit for his or her assistance to investigations or enforcement actions, if the cooperator provides "substantial assistance." Under a deferred prosecution agreement, the SEC "agrees to forego an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and to comply with express prohibitions and undertakings during a period of deferred prosecution." *See supra* Note 488. Finally, under a non-prosecution agreement, which the SEC has indicated is appropriate under "limited and appropriate circumstances," the SEC "agrees not to pursue an enforcement action against a cooperator if the individual or company agrees, among other things, to cooperate fully and truthfully and comply with express undertakings." *See* Press Release, SEC, SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations (Jan. 13, 2010). The SEC entered into its first-ever deferred prosecution agreement under the initiative in May 2011 in connection with an FCPA investigation. *See supra* Note 488. In December of 2010, the SEC entered into its first-ever non-prosecution agreement with Carters Inc., a clothing marketer, in connection with the financial fraud and insider trading of one of its top executives. The SEC indicated that it entered into the non-prosecution agreement given "the relatively isolated nature of the unlawful conduct, Carters' prompt and complete self-reporting of the misconduct to the SEC, its exemplary and extensive cooperation in the investigation, including undertaking a thorough and comprehensive internal investigation, and Carter's extensive and substantial remedial actions." Under the terms of the agreement, the company agreed to cooperate fully in any further investigation conducted by the SEC. The SEC filed civil enforcement proceedings against the officer. *See* Press Release, SEC, SEC Charges Former Carter's Executive With Fraud and Insider Trading (Dec. 20, 2010). The non-prosecution agreement can be found at http://www.sec.gov/litigation/cooperation/2010/carters1210.pdf.

535 *See, e.g.*, Press Release, SEC, SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis (July 2, 2013) (discussing launch of several initiatives, including the Financial Reporting and Audit Task Force and the Center for Risk and Quantitative Analytics, in order to "increase the potential for uncovering financial statement and microcap fraud early" through the use of "analytical techniques and computing capacity with special expertise in data mining"); Jean Eaglesham, *Accounting Fraud Targeted*, WALL ST. J., May 27, 2013 (discussing several technological developments at the SEC, including fraud detection software that analyzes public filings and financial disclosures for "warning signs of earnings manipulation").

536 *See* § 20(a) of the Securities Act; §§ 21(a), 21(b) and 21(c) of the Exchange Act; §§ 42(a), 42(b) and 42(c)

of the Investment Company Act; §§ 209(a), 209(b) and 209(c) of the Advisers Act. The SEC invoked the investigative powers of § 21(a) of the Exchange Act as the basis for its June 2002 order requiring sworn statements by senior officers of 945 companies as to the accuracy of reports previously filed with the SEC. *See SEC Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Exchange Act*, File No. 4-460 (June 27, 2002). Shortly after the SEC announced this June 2002 order, the Chair and Vice Chair of the American Bar Association's Committee on Securities Regulation wrote a letter to the SEC stating their concerns with the use of this section, noting it was unclear whether § 21(a) sworn statements could be required outside the context of investigations of specific possible violations of securities laws and as such they were forming a task force to consider the scope of the SEC's § 21(a) authority. Letter from Stanley Keller & Dixie Lynn Johnson to Harvey Pitt, Chairman, SEC (July 15, 2002).

537 The SEC may invoke the power of the courts to compel such testimony and production of documents. *See* § 19(b) of the Securities Act; § 21(c) of the Exchange Act; § 42(c) of the Investment Company Act; § 209(c) of the Advisers Act.

538 Under § 929U of the Dodd-Frank Act, the SEC must either file such an action, or provide notice of its intent to not file such an action, within 180 days of issuing the Wells Notice, except for "certain complex actions," in which the SEC may receive one or more extensions of the 180-day period.

539 In 2003, the SEC amended its Rules of Practice to improve the timeliness of its administrative proceedings by imposing maximum time periods for administrative proceedings and appellate review. *See* SEC Release No. 33-8240 (June 11, 2003).

540 The administrative law judge is required to issue an initial decision, unless the SEC directs otherwise, in which case the administrative law judge recommends a decision and certifies the record to the SEC for a decision. *See* 5 U.S.C. § 557(b); 17 U.S.C. § 201.360.

541 *See* § 9(a) of the Securities Act; § 25(a)(1) of the Exchange Act; § 43(a) of the Investment Company Act; § 213(a) of the Advisers Act.

542 *See, e.g.*, Jean Eaglesham, *SEC Wins With In-House Judges*, WALL ST. J., May 6, 2015 (stating that the SEC enjoys "a home-court advantage … when it sends cases to its own judges rather than federal courts," which "is a practice the agency increasingly follows," and that the SEC has a "high success rate in appeals of its administrative law judges' rulings—the appeals its own commissioners hear"); Jean Eaglesham, *SEC Is Steering More Trials to Judge It Appoints*, WALL ST. J., Oct. 21, 2014 (describing "a marked shift at the [SEC] toward trying cases that are more complex before its administrative law judges," stating "[t]he agency's win rate in recent years is considerably higher in front of its administrative law judges than it is in jury trials" including because its administrative judges "found in its favor in every verdict for the [prior] 12 months," and observing that "[t]he move is creating a backlash among lawyers and defendants, who say in federal court they have more extensive rights to take witness testimony and collect evidence ahead of trial").

543 *See, e.g.*, *Duka v. SEC*, 124 F. Supp. 3d 287, 289 (S.D.N.Y. 2015) (holding that SEC administrative law judges' appointments are "likely unconstitutional in violation of the Appointments Clause" because they are "inferior officers" but were not appointed "by the President, courts of law, or department heads" as required by the Constitution); *Hill v. SEC*, 114 F. Supp. 3d 1297, 1319 (N.D. Ga. 2015) (concluding that the administrative law judge's "appointment is likely unconstitutional in violation of the Appointments Clause" because he "was not appointed by the President, a department head, or the Judiciary").

544 *See, e.g., Hill v. SEC*, 825 F.3d 1236, (11th Cir. 2016); *Tilton v. SEC*, 824 F.3d 276 (2d Cir. 2016); *Jarkesy v. SEC*, 803 F.3d 9 (D.C. Cir. 2015); *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).

545 *Compare Raymond J. Lucia Companies, Inc. v. SEC*, No 15-1345, 2016 WL 4191191, at *3-7 (D.C. Cir. Aug. 9, 2016) (holding that the appointment of SEC administrative law judges does not violate the Appointments Clause because such judges do not "issue final decisions of the Commission"), *with Bandimere v. SEC*, No. 15-9586, 2016 WL 7439007 at *9 (10th Cir. 2016) (holding that "SEC ALJs are inferior officers who must be appointed in conformity with the Appointments Clause").

546 *See, e.g.*, SEC Release No. 34-78319 (July 13, 2016) (adopting amendments to Rules of Practice

applicable to in-house courts that provide defendants with more time to prepare for trial and permit additional depositions); Jean Eaglesham, *SEC Trims Use of In-House Judges*, WALL ST. J., Oct. 11, 2015 (stating that the SEC "has quietly pulled back on its use of in-house judges" and during the full fiscal year ended September 30, 2015, "the SEC used its internal tribunal for 28% of its contested cases, compared with 43% for the previous 12 months"); Jean Eaglesham, *SEC Gives Ground on Judges*, WALL ST. J., Sept. 24, 2015 (describing the "new rules, approved by a vote of the five commissioners who run the SEC, [that] would give defendants in cases sent by the agency to its own judges more of the legal protections offered in federal court," including easing deadlines and allowing defendants to get sworn testimony from witnesses before trial); Aruna Viswanatha, *SEC Issues Guidance on Venues for Cases*, WALL ST. J., May 8, 2015 (describing new SEC guidance that it considers bringing cases before its in-house courts based on factors including if the "matter involves old conduct or a continuing issue," and if the "case is likely to raise unsettled or complex legal issues about the federal securities laws").

547 *See, e.g.*, Press Release, SEC, SEC Charges Merrill Lynch With Misleading Investors in CDOs (Dec. 12, 2013) (announcing that Merrill Lynch agreed to pay $131.8 million to settle the SEC's charges); Press Release, SEC, SEC Charges Royal Bank of Scotland Subsidiary with Misleading Investors in Subprime RMBS Offering (Nov. 7, 2013) (announcing $150 million settlement); Press Release, SEC, UBS to Pay $50 Million to Settle SEC Charges of Misleading CDO Investors (Aug. 6, 2013) (announcing $50 million settlement); Press Release, SEC, SEC Charges J.P. Morgan and Credit Suisse With Misleading Investors in RMBS Offerings (Nov. 16, 2012) (announcing settlements totaling more than $400 million); Press Release, SEC, SEC Charges Mizuho Securities USA with Misleading Investors by Obtaining False Credit Ratings for CDO (July 18, 2012) (announcing $127.5 million settlement); Press Release, SEC, J.P. Morgan to Pay $153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market (June 21, 2011) (announcing $153.6 million settlement); Press Release, SEC, SEC Charges Citigroup and Two Executives for Misleading Investors About Exposure to Subprime Mortgage Assets (July 29, 2010) (announcing $75 million penalty).

548 *See SEC v. Citigroup Global Markets, Inc.*, 827 F. Supp. 2d 328 (S.D.N.Y. 2011).

549 *See SEC v. Citigroup Global Markets, Inc.*, 752 F.3d 285 (2d Cir. 2014).

550 *See, e.g.*, James B. Stewart, *S.E.C. Has a Message for Firms Not Used to Admitting Guilt*, N.Y. TIMES, June 21, 2013 (describing new policy as providing that there might be cases that "justify requiring the defendant's admission of allegations in our complaint or other acknowledgement of the alleged misconduct as part of any settlement" in order to increase deterrence).

551 *See, e.g.*, Press Release, SEC, JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013) (announcing settlement of charges against JPMorgan concerning its attempt to hide losses from investments made by the so-called "London Whale" in its chief investment office, which included an admission of "the facts underlying the SEC's charges" as well as JPMorgan "publicly acknowledging that it violated the federal securities laws").

552 *See* § 20(b) of the Securities Act; § 21(d)(1) of the Exchange Act; § 42(d) of the Investment Company Act (including, in a proceeding in connection with transactions by an unregistered investment company, seeking equitable relief from the court to "take exclusive jurisdiction and possession" of the investment company); § 209(d) of the Advisers Act. The Sarbanes-Oxley Act amended § 21(d) of the Exchange Act to further clarify the right of the SEC to seek only equitable relief. *See* § 21(d) of the Exchange Act; *see, e.g.*, *SEC v. Goldman Sachs & Co.*, SEC Litigation Release No. 19051 (Jan. 25, 2005) (describing an injunction against certain IPO share allocation methodologies); *SEC v. Morgan Stanley & Co.*, SEC Litigation Release No. 19050 (Jan. 25, 2005); *SEC v. Bristol-Myers Squibb Co.*, SEC Litigation Release No. 18822 (Aug. 6, 2004) (describing an injunction against "channel-stuffing," a $100 million civil penalty and a $50 million shareholder fund).

553 The influence of the Sarbanes-Oxley Act and its emphasis on corporate governance is evidenced in several SEC civil injunctive actions. In *SEC v. Hollinger International, Inc.*, for example, the SEC filed a civil injunctive action alleging Hollinger's SEC filings contained misstatements regarding transfers of corporate

assets. Hollinger agreed to corporate governance reforms that included maintaining a special committee to investigate the alleged misconduct and to continue efforts to recover and maintain corporate assets. *SEC v. Causey*, SEC Litigation Release No. 18551 (Jan. 21, 2004). Another example of a financial reporting case in which the SEC imposed corporate governance reforms on an issuer through settlement is the settlement between the SEC and the Italian company Parmalat Finanziaria. The SEC, which had jurisdiction over Parmalat because it offered and sold debt (albeit privately) in the United States, imposed a settlement that incorporated elements of the Sarbanes-Oxley Act despite the fact that Parmalat had not made any public offerings in the United States, was not listed in the United States and was not even a foreign private issuer filing annual reports with the SEC on Form 20-F. The settlement provisions included corporate governance changes, adoption of by-laws providing for a shareholder-elected board that was independent with pre-set term limits, and the establishment of an internal Code of Conduct and Ethics. *See SEC v. Parmalat Finanziaria S.p.A*, SEC Litigation Release No. 18803 (July 28, 2004) (summarizing the allegations that Parmalat sold over $1 billion in bonds through private placements exempt from SEC registration, while systematically defrauding investors).

554 *See SEC v. Calvo*, 378 F.3d 1211, 1216 (11th Cir. 2004); *SEC v. Parklane Hosiery Co.*, *Inc.*, 558 F.2d 1083 (2d Cir. 1977).

555 *See SEC v. Steadman*, 967 F.2d 636, 647–48 (D.C. Cir. 1992); *SEC v. Lipson*, 129 F. Supp. 2d 1148 (N.D. Ill. 2001), *aff'd*, 278 F.3d 656 (7th Cir. 2002).

556 *See* § 20(e) of the Securities Act and § 21(d)(2) of the Exchange Act; *see, e.g.*, *SEC v. Computer Associates International, Inc.*, SEC Litigation Release No. 18891 (Sept. 22, 2004).

557 § 8A of the Securities Act; § 21C of the Exchange Act; § 9(f) of the Investment Company Act; § 203(k) of the Advisers Act.

558 *See* § 8A(c)(1) of the Securities Act.

559 *See* § 8A(c)(1) of the Securities Act.

560 *See* § 8A(d)(2) of the Securities Act.

561 §§ 8(b) and (d) of the Securities Act; *see* § 11.03[3].

562 *See* § 20(d) of the Securities Act; § 21(d)(3) of the Exchange Act; § 42(e) of the Investment Company Act; § 209(e) of the Advisers Act. *See*, *e.g.*, SEC v. Aragon Capital Management, SEC Litigation Release No. 19995A (Feb. 8, 2007); *SEC v. Royal Dutch Petroleum Co.*, SEC Litigation Release No. 18844 (Aug. 24, 2004). According to the SEC's order and complaint, Shell overstated proved reserves reported in its 2002 Form 20-F by 4.47 billion barrels of oil equivalent and overstated its future cash flows by approximately $6.6 billion.

563 *See* Stephen M. Cutler, Director, SEC Division of Enforcement, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004) (noting that under the current regulatory regime, both entities and individuals can be assessed significant monetary penalties aimed at achieving both general deterrence and accountability).

564 *See* § 20(d)(2)(C) of the Securities Act; SEC Release No. 33-10104 (June 27, 2016).

565 *See* Stephen M. Cutler, Director, SEC Division of Enforcement, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004); *see also* Ken Belson, *Lucent Fined $25 Million by SEC in Fraud Case*, N.Y. TIMES, May 18, 2004. In 2004, the SEC levied a $25 million fine against Lucent Technologies for failure to cooperate with a fraud investigation, the largest penalty ever imposed against a corporation for failure to cooperate. The noncooperation penalty was levied in part because after reaching a settlement agreement in connection with the fraud investigation, Lucent expanded the scope of employees that could be indemnified against the SEC enforcement action. The SEC stated that such conduct is contrary to the public interest. *SEC v. Lucent Technologies Inc.*, SEC Litigation Release No. 18715 (May 17, 2004). In contrast to the Lucent case, the SEC demonstrated the potential benefits of cooperation by settling financial fraud charges brought against Delphi Corporation without imposing a financial penalty. *SEC v. Delphi Corp.*, SEC Litigation Release No. 19891 (Oct. 30, 2006); *see also Report of Investigation*

Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, SEC Accounting and Auditing Enforcement Release No. 1470 (Oct. 23, 2001). The report explains the SEC's decision not to sue Seaboard Corp. for financial reporting problems. It details the steps that Seaboard took when an internal investigation uncovered financial irregularities and sets forth a variety of criteria that the SEC will consider when deciding whether to sue issuers in the context of financial reporting irregularities.

On January 13, 2010, the SEC's Office of Chief Counsel in the Enforcement Division issued a revised ENFORCEMENT MANUAL in which it discussed cooperation issues. *See* SEC Division of Enforcement, ENFORCEMENT MANUAL (Jan. 13, 2010) (*rev.* Feb. 8, 2011) ("ENFORCEMENT MANUAL"). The ENFORCEMENT MANUAL contains the SEC's new policy statement on cooperation by individuals in its investigations, *see* ENFORCEMENT MANUAL at 121–25, which became effective on January 19, 2010. *See* 17 C.F.R. § 202.12. Under 17 C.F.R. § 202.12, the SEC will determine "whether, how much, and in what manner to credit cooperation by individuals by evaluating four considerations." These considerations are: (i) the value and nature of the individual's assistance, (ii) the importance of the underlying matter, which includes consideration of the character of the investigation and the dangers to investors presented by such investigation, (iii) society's interest in holding the cooperating individual accountable, which includes consideration of the individual's culpability, and (iv) the appropriateness of cooperation credit given the individual's personal history or profile. 17 C.F.R. § 202.12. However, the ENFORCEMENT MANUAL clarifies that the policy statement and factors listed in 17 C.F.R. § 202.12 "are not listed in order of importance nor are … they intended to be all-inclusive or to require a specific determination in any particular case." ENFORCEMENT MANUAL at 125. Instead, the SEC vows to consider the unique facts and circumstances of every case and to accord appropriate weight to the principles set forth in 17 C.F.R. § 202.12 depending on such facts and circumstances.

The defendant company's cooperation with investigators is also an important factor in the context of federal prosecutions. Determining what a company must do to qualify for "cooperation" credit has been the subject of debate. In a 2003 Memorandum, Deputy Attorney General Larry D. Thompson outlined the principles of federal prosecution of business organizations, with the main focus of the memo being "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation." Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003) ("Thompson Memo") (the memorandum was, in large measure, a reaffirmation of positions first outlined in a 1999 memorandum by then-Deputy Attorney General Eric Holder). The Thompson Memo (like the Holder memo) noted that one indicator of a company's cooperation is its willingness to waive the attorney-client privilege. Companies argued that this policy forced a difficult choice between waiving the privilege and being considered uncooperative.

In late 2006, the DOJ backtracked from the Thompson Memo; Deputy Attorney General Paul H. McNulty issued new guidance to prosecutors, directing that they consider a company's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate" but restricting the prosecutors' discretion in seeking waivers of the attorney-client or attorney work product protections. Such waivers should only be sought upon a "legitimate need," and waiver "is not a prerequisite to a finding that a company has cooperated." Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006) ("McNulty Memo").

This position is consistent with other developments, such as the September 2006 hearings on Attorney-Client Privilege and Corporate Waivers before the Senate Judiciary Committee. The then-Chairman of the committee, Senator Arlen Specter, later introduced a bill called "The Attorney-Client Privilege Protection Act of 2007," which would go further than the McNulty Memo by prohibiting prosecutors from demanding or requesting privileged materials from companies under investigation. S. 186, 110th Cong., 1st Session (Jan. 4, 2007). In 2007, the American Bar Association submitted a letter in support of the bill to Senator Patrick J. Leahy, the chairman of the Senate Judiciary Committee. *See* Letter from Karen J. Mathis, American Bar Association, to Patrick J. Leahy, Chairman, Senate Judiciary Committee (June 4, 2007). A similar bill passed the House on November 12, 2007, *see* H.R. 3013, 110th Cong., 1st Session (Nov. 13, 2007), and was reintroduced to the Senate Judiciary Committee by Senator Specter on June 2008, but the bill did not leave the Committee. *See* S. 3217, 110th Cong., 2d Session (June 26, 2008); *see also* S. 445, 111th Cong., 1st Session (Feb. 13, 2009).

In 2008, the DOJ retreated still further, and, in a memorandum by Deputy Attorney General Filip, expressly prohibited prosecutors from requesting privilege waivers as a consideration of cooperation. Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008) ("Filip Memo"). The Filip Memo noted that businesses and commentators had decried a culture of waivers.

After the DOJ issued the McNulty Memo, SEC Deputy Enforcement Director Peter Bresnan said that the SEC was "not contemplating any changes" to the guidelines set forth in the Seaboard policy. *See Federal News: SEC Enforcement*, 39 Sec. REG. AND LAW REPORTER (BNA) 122 (Jan. 29, 2007). However, the ENFORCEMENT MANUAL indicates the measures of a company's cooperation set forth in the Seaboard report serve as general principles but are not intended to limit the SEC's "broad discretion to evaluate every case individually, on its own unique facts and circumstances." ENFORCEMENT MANUAL at 126.

566 *See* Stephen M. Cutler, Director, SEC Division of Enforcement, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004).

567 Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006). The consequences of a company's failure to cooperate with the SEC was illustrated in the 2006 settlement with Morgan Stanley, in which the firm paid $15 million for failing to produce e-mail in the course of an investigation lasting from 2000 through 2005. The SEC alleged that Morgan Stanley had failed to produce documents requested by the staff because the firm failed to undertake diligent searches, overwrote back-up tapes and made misstatements about the documents it had preserved, the documents it had reviewed and the documents it had produced. *See SEC v. Morgan Stanley & Co.*, SEC Litigation Release No. 19693 (May 10, 2006). The settlement in this action was wholly independent of any sanction or settlement related to the facts underlying the SEC investigation that prompted the requests for e-mail productions.

568 *See* § 21A(d)(5) of the Exchange Act.

569 *See Gabelli v. SEC*, 133 S. Ct. 1216 (2013).

570 Although disgorgement is generally intended to force a defendant to give up the amount by which *he* was enriched by his wrongdoing, the Second Circuit Court of Appeals recently held that a defendant who commits insider trading, which resulted in a benefit to a third party, can be forced to disgorge the gains that accrued to that third party. *See SEC v. Contorinis*, 743 F.3d 296 (2d Cir. 2014) (affirming disgorgement award that required an individual to disgorge the profits that his employer earned from his insider trading).

571 *See, e.g.*, *SEC v. Tome*, 833 F.2d 1086, 1096 (2d Cir. 1987), *cert. denied*, 486 U.S. 1014 (1988). Recently, the SEC has sought disgorgement under § 21(d)(3) of the Exchange Act against two accounting firms for their respective roles in the Adelphia and Xerox accounting frauds. *See SEC v. KPMG LLP*, SEC Litigation Release No. 19191 (Apr. 19, 2005); *SEC v. Deloitte & Touche LLP*, SEC Litigation Release No. 19202 (Apr. 26, 2005).

572 *See SEC v. Toomey*, 866 F. Supp. 719, 724–25 (S.D.N.Y. 1992).

573 *See Hudson v. United States*, 522 U.S. 93 (1997); *United States v. Gartner*, 93 F.3d 633, 635 (9th Cir.), *cert. denied*, 519 U.S. 1047 (1996).

574 *See* § 308 of the Sarbanes-Oxley Act; § 11.07[2][d].

575 *See* § 21B of the Exchange Act; § 9(d) of the Investment Company Act; § 203(i) of the Advisers Act. As in judicial actions, the largest civil penalties are imposed for violations that involve fraud and cause substantial losses. Penalties are the greater of (i) $163,118 for individuals or $788,401 for corporations and (ii) the gross amount of the pecuniary gain to the defendant resulting from such violation. *See* SEC Release No. 33-10104 (June 27, 2016).

576 12 U.S.C. § 1833a.

577 *See, e.g., United States v. Wells Fargo Bank, N.A.*, 972 F. Supp. 2d 593 (S.D.N.Y. 2013); *United States v. Countrywide Financial Corporation*, 961 F. Supp. 2d 598 (S.D.N.Y. 2013); *United States v. Bank of New York Mellon*, 941 F. Supp. 2d 438 (S.D.N.Y. 2013).

578 *United States ex rel. O'Donnell v. Countrywide Home Loans, Inc.*, 822 F.3d 650 (2d Cir. 2016).

579 *See, e.g.*, Press Release, DOJ, Bank of America to Pay $16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014) (announcing Bank of America "agreed to pay a $5 billion penalty" under FIRREA, which was "the largest FIRREA penalty ever"); Press Release, DOJ, Justice Department, Federal and State Partners Secure Record $7 Billion Global Settlement with Citigroup for Misleading Investors About Securities Containing Toxic Mortgages (July 14, 2014) (announcing settlement of claims concerning residential mortgage-backed securities, including "a $4 billion civil penalty—the largest penalty to date under [FIRREA]"); Press Release, DOJ, Justice Department, Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (Nov. 19, 2013) (announcing settlement including a $2 billion civil penalty for claims under FIRREA).

580 *See* § 4.02 for a discussion of issuers subject to Exchange Act registration and reporting.

581 However, § 15(c)(4) of the Exchange Act does not allow the SEC to impose orders of general future compliance with the securities laws. *See In re George C. Kern, Jr.*, SEC Release No. 34-29356 (June 21, 1991).

582 *See, e.g.*, *Report of Investigation re: Netflix, Inc., and Reed Hastings*, SEC Release No. 34-69279 (Apr. 2, 2013) (discussing the application of Regulation FD and Section 13(a) of the Exchange Act to the Netflix CEO's use of his personal Facebook page to announce company metrics where the company had not previously informed shareholders that it would use that Facebook page to disclose information); *Report of Investigation re: The Titan Corporation*, SEC Release No. 34-51283 (Mar. 1, 2005) (discussing the potential liability under §§ 10(b) and 14(a) of the Exchange Act for a military and intelligence subcontractor arising out of the company's disclosures contained in a merger agreement; the disclosure represented that the company had not violated the FCPA, and the SEC's § 21(a) report examined the company's duty to update disclosures made in merger agreements upon learning of contradictory material facts); *see also* Ralph C. Ferrara & Philip S. Khinda, *SEC Enforcement Proceedings: Strategic Considerations for When the Agency Comes Calling*, 51 ADMIN. L. REV. 1143, 1193 n.198 (1999) (citing, *inter alia, In re W.R. Grace & Co.*, SEC Release No. 34-39157 (Sept. 30, 1997); *Report of Investigation in the Matter of The Cooper Companies, Inc. as it Relates to the Conduct of Cooper's Board of Directors*, SEC Release No. 34-35082 (Dec. 12, 1994)).

583 *See SEC v. Credit Suisse First Boston Corp.*, SEC Litigation Release No. 17327 (Jan. 22, 2002).

584 The agreement, which resulted after the NYAG commenced an action in New York state court under the Martin Act, provided a $48 million payment to New York state and a $52 million payment to the other affected states, in addition to changes of Merrill Lynch's policies and organization to address analyst conflicts of interest. Unlike many states, New York has not adopted the Uniform Securities Act and retains its original "blue sky" statute, the Martin Act or General Business Law Article 23-A, which dates from 1921. *See* N.Y. GEN. BUS. LAW § 352 (McKinney's 1996 & Supp. 2010). Among the unique features of the Martin Act is that it grants the NYAG unusually broad investigatory powers and it does not require a showing of reliance or intent. There is no private right of action under the Martin Act. *See* Nicholas Thompson, *The Sword of Spitzer*, LEGAL AFFAIRS, May/June 2004 (discussing the history of the Martin Act and Spitzer's use of it in the mutual fund and other financial scandals); Carey S. Dunne, *Role of the States Attorneys General in Policing the Securities Markets*, in 34 TH Annual INSTITUTE OF SECURITIES REGULATION at 1081 (Practicing Law Institute, 2002).

585 During this time period, the SEC, the NYSE and the NASD were actively engaged in a series of rulemakings directed at analyst conflicts of interest. The SEC approved rules adopted by the NYSE and the NASD to address analyst conflicts of interest on May 8, 2002, and the NYSE and NASD proposed additional rules to the SEC at the end of May 2002. *See* § 14.07[5][a]. In some respects, these rules appear

to conflict with the terms of the Merrill Lynch settlement. *See* SEC Release No. 34-45908 (May 10, 2002) (order approving proposed rule changes); SEC Release No. 34-47110 (Dec. 31, 2002) (proposed rule changes). In addition, § 15D of the Sarbanes-Oxley Act invites additional rulemaking by the SEC largely along the lines of the rules previously adopted by the NYSE and the NASD. *See* § 14.07[5][b]. Simultaneously with the passage of the Sarbanes-Oxley Act, the SEC proposed Regulation AC, the final version of which was promulgated in February 2003. *See* SEC Release No. 33-8119 (Aug. 2, 2002) (solicitation of public comment); SEC Release No. 33-8193 (Feb. 20, 2003) (final rule). *See generally* § 14.07[5][c].

586 *See* Press Release, SEC, SEC, NY Attorney General, NYSE, NASD, NASAA Reach Agreement on Reforming Wall Street Practices (Oct. 23, 2002).

587 *See* Press Release, SEC, SEC Fact Sheet on Global Analyst Research Settlements (Apr. 28, 2003); § 14.07[5][b].

588 *See* Press Release, SEC, Deutsche Bank Securities Inc. and Thomas Weisel Partners LLC Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Aug. 26, 2004).

589 Press Release, SEC, SEC Fact Sheet on Global Analyst Research Settlements (Apr. 28, 2003).

590 *See generally* § 14.07[5] for a more detailed discussion of analyst conflicts of interest issues.

591 The NYAG concluded its involvement in the spinning investigation in July 2006 after reaching a $4.4 million settlement with a former executive who allegedly steered his company's investment banking business to Salomon Smith Barney in exchange for IPO allocations. This was the fifth settlement reached between an individual defendant and the NYAG; the total value of the settlements in these cases was over $10 million. *See* Press Release, NYAG, Telecom Exec Settles Final IPO Spinning Case (July 31, 2006). The NASD brought spinning-related charges against former Credit Suisse First Boston banker Frank P. Quattrone and imposed against him a lifetime ban from the securities industry. After several years of litigation, the Second Circuit Court of Appeals overturned Quattrone's conviction for obstruction of justice, the SEC revoked the lifetime ban and the NASD decided not to pursue the case against Quattrone. *See* Randall Smith & Paul Davies, *Quattrone Deal Drops All Charges, Allows His Return To Wall Street*, WALL ST. J., Aug. 23, 2006; Randall Smith, *IPO "Spinning" Is Under Fire; Securities Firms Are Charged*, WALL ST. J., Apr. 29, 2003.

The SEC in 2004 proposed amendments to Regulation M that could result in the adoption of a new Rule 106, which would expressly prohibit conditioning the award of allocations of offered securities on the receipt of consideration in addition to the stated offering price. SEC Release No. 33-8511 (Dec. 9, 2004) (solicitation of public comment). The comment period for the proposed amendments closed, and no action has been taken with respect to the proposed amendments.

592 *See In re Initial Public Offering Securities Litigation*, 671 F. Supp. 2d 467 (S.D.N.Y. 2009).

593 *See* Press Release, SEC Charges NASDAQ for Failures During Facebook IPO (May 29, 2013).

594 The SEC does not have authority to bring criminal proceedings, but may refer violations to the DOJ.

595 *See* § 24 of the Securities Act (any provision, including willful material misstatements or omissions in a registration statement); § 32 of the Exchange Act (willful or knowing material misstatements in any document required to be filed or any provision that states that a violation is unlawful); § 49 of the Investment Company Act (any provision, including willful material misstatements or omissions in a registration statement or document); § 217 of the Advisers Act (any provision); 18 U.S.C. § 1348 (any fraudulent act related to a public company's securities).

596 *See* § 24 of the Securities Act; § 49 of the Investment Company Act; § 217 of the Advisers Act. As a practical matter, prosecutors may actually seek fines of up to $500,000 per violation for corporate defendants under a separate statutory provision applicable to essentially all existing federal crimes. *See* 18 U.S.C. § 3571(c)(3).

597 *See* § 32(a) of the Exchange Act, which is discussed in § 11.07[3][f]. In contrast to criminal procedures in many other countries, which limit criminal prosecutions to individuals, corporations as well as their

employees are subject to indictment, conviction and criminal punishment in the United States. Misconduct by corporate employees is attributed to the corporation itself, regardless of the employee's managerial status or lack of it within the corporation, if the employee's conduct occurred within his "scope of employment" and if his conduct was intended to confer some benefit to the corporation, whether or not that benefit was the principal motivating factor for the employee or whether it actually accrues to the corporation.

598 *See* 18 U.S.C. § 3571(d).

599 *See* § 24 of the Securities Act; § 49 of the Investment Company Act; § 217 of the Advisers Act.

600 *See* § 32 of the Exchange Act, which is discussed in § 11.07[3][f].

601 *See* § 49 of the Investment Company Act; § 32(a) of the Exchange Act. *But see United States v. Sloan*, 399 F. Supp. 982, 985 (S.D.N.Y. 1975) ("The 'no knowledge' proviso was not intended to permit one who knowingly conspires to violate the general standard of conduct set forth in [the securities laws] to claim protection on the ground that he [or she] did not have knowledge of some specific rule or requirement promulgated thereunder.").

602 *See, e.g.*, Laurie Cohen, *Public Confession: Milken Pleads Guilty to Six Felony Counts and Issues an Apology*, WALL ST. J., Apr. 25, 1990; Laurie Cohen *, Lewis Pleads Guilty to Three Felony Counts*, WALL ST. J., Aug. 31, 1989; James Stewart, *Boesky is Slated to Plead Guilty to Felony Today*, WALL ST. J., Apr. 23, 1987; James Stewart, *The Drexel Settlement—Biting the Bullet: Drexel Agrees to Plead Guilty and Pay Out a Record $650 Million*, WALL ST. J., Dec. 12, 1988; James Stewart, *Levine Pleads Guilty, Agrees to Cooperate*, WALL ST. J., June 6, 1986.

603 Since Enron's collapse in December 2001, over 90 executives at more than 19 companies have been indicted for various kinds of financial fraud. The following are among the most prominent examples. At Enron, the prosecutorial focus has been on the use of special purpose entities to hide deteriorating results and produce misleading disclosures. Prosecutors won convictions against an Enron executive and former Merrill Lynch & Co. officials who had conspired to disguise a loan (of energy-generating barges) as a sale in order to permit Enron to book the profit on sale. Enron executives Jeffrey Skilling and Kenneth Lay were convicted on multiple criminal charges for their roles in the Enron fraud; however, Lay's conviction was revoked after he died before exercising his right to appeal. The Fifth Circuit Court of Appeals subsequently overturned some of the convictions against the Merrill Lynch executives. *See United States v. Brown*, 459 F.3d 509 (5th Cir. 2006), *cert. denied*, 550 U.S. 933 (2007). At HealthSouth, allegations make out a pattern of fraudulent accounting since the 1980s. Although the CEO, Richard Scrushy, was acquitted of accounting fraud charges, he was convicted of bribery, mail fraud and conspiracy in connection with bribes paid to obtain a seat on an influential state commission in Alabama. He also agreed to an $81 million settlement with the SEC. *SEC v. Scrushy*, SEC Litigation Release No. 20084 (Apr. 23, 2007). At WorldCom, as much as $11 billion in expenses were misclassified as capital expenditures. Former WorldCom Chairman Bernard Ebbers was sentenced to 25 years in federal prison for orchestrating that fraud, which toppled the telecommunications company he founded. *See* Ken Belson, *WorldCom Head Is Given 25 Years For Huge Fraud*, N.Y. TIMES, July 14, 2005. At Adelphia Communications, founders were convicted of taking more than $1 billion from the company and having misled investors and regulators. The founder John Rigas and his son (the Chief Financial Officer of Adelphia Communications) were sentenced to 20 and 15 years in prison, respectively. *See also United States v. Rigas*, No. S10CR.1236 (LBS), 2004 WL 2601084 (S.D.N.Y. Nov. 15, 2004); Press Release, DOJ, Adelphia Communications Agrees to Pay $715 Million to Government Victim Compensation Fund (Apr. 25, 2005) (announcing Adelphia Communications settlement with the DOJ and the SEC for the accounting fraud schemes that had defrauded investors). At Qwest Communications, the former Chief Executive Officer and eight other former Qwest officers and employees were prosecuted for engaging in a multifaceted fraudulent scheme designed to mislead the investing public about Qwest's revenue and growth. *See SEC v. Nacchio*, SEC Litigation Release No. 19136 (Mar. 15, 2005). At Tyco International, the former Chief Executive Officer and Chief Financial Officer were found guilty of looting the company of over $600 million. *See* Andrew Ross Sorkin, *Ex-Chief and Aide Guilty of Looting Millions at Tyco*, N.Y. TIMES, June 18, 2005.

604 An assistant director of the FBI said that the bureau was investigating potential options backdating practices at 55 companies as of October 2006. *See* Shaheen Pasha, *FBI Sees More Indictments From Backdating*, CNNMONEY.com, Oct. 12, 2006. The United States Attorney for the Northern District of California created a task force to investigate backdating allegations. *See* Press Release, DOJ, U.S. Attorney Kevin V. Ryan Creates Local Stock Option Backdating Task Force (July 13, 2006).

605 *See, e.g.*, Press Release, DOJ, SAC Capital Portfolio Manager Mathew Martoma Found Guilty In Manhattan Federal Court Of Insider Trading Charges (Feb. 6, 2014) (announcing conviction of former portfolio manager at SAC Capital for insider trading involving approximately $274 million in illegal profits and avoided losses); Press Release, DOJ, Former Credit Suisse Managing Director Sentenced In Manhattan Federal Court To 30 Months In Prison In Connection with Scheme To Hide Losses In Mortgage-Backed Securities Trading Book (Nov. 22, 2013) (discussing 30-month prison term, $1 million forfeiture, and $150,000 fine imposed on former Global Head of Structured Credit at Credit Suisse for hiding more than $100 million in losses in a mortgage-backed securities trading book); Press Release, DOJ, Manhattan U.S. Attorney Announces Guilty Plea Agreement With SAC Capital Management Companies (Nov. 4, 2013) (announcing agreement under which SAC Capital agreed to plead guilty to insider trading, pay a $1.8 billion penalty, cease accepting outside investor funds, and shut down operations as an investment adviser); Press Release, DOJ, Allen Stanford Convicted in Houston for Orchestrating $7 Billion Investment Fraud Scheme (Mar. 6, 2012) (announcing conviction of former chairman of Stanford International Bank for orchestrating a 20-year investment fraud scheme in which he misappropriated $7 billion from the bank to finance personal businesses); Press Release, DOJ, Hedge Fund Billionaire Raj Rajaratnam Found Guilty in Manhattan Federal Court of Insider Trading Charges (May 11, 2011) (discussing conviction of managing member of Galleon Management for insider trading following an eight-week trial); Press Release, DOJ, Bernard Madoff Sentenced to 150 Years in Prison (June 29, 2009) (announcing 150-year sentence and $170 billion forfeiture against Madoff in connection with Ponzi scheme).

606 *See, e.g.*, Jordan Maglich, *Once Reserved For Drug Crimes, Wiretapping Takes Center Stage in White Collar Prosecutions*, FORBES, May 21, 2013 (discussing increasing use of wiretaps by federal prosecutors to investigate and prosecute white-collar crime, and quoting U.S. Attorney Preet Bharara as stating that the "aggressive use of wiretaps is important" because "[i]t shows that we are targeting white-collar insider trading rings with the same powerful investigative tools that have worked so successfully against the mob and drug cartels").

607 *United States v. Kordel*, 397 U.S. 1, 6 (1970).

608 *See, e.g.*, Jessica Silver-Greenberg and Ben Protess, *JPMorgan Settlement Offers Look Into Mortgage Machine*, N.Y. TIMES, Nov. 19, 2013 (describing $13 billion settlement between JPMorgan Chase and the DOJ concerning the sale of mortgage-related securities, which included a $4 billion payment to the agency overseeing Fannie Mae and Freddie Mac, a $2 billion fine paid to federal prosecutors, $4 billion in mortgage borrower relief, and other payments to the National Credit Union Administration and state attorneys general in California, New York and Illinois); Ben Protess and Mark Scott, *Barclays Settles Regulators' Claims Over Manipulation of Key Rates*, N.Y. TIMES, June 27, 2012 (describing Barclays' agreement to pay $450 million in fines to resolve investigations relating to the alleged manipulation of LIBOR, including a $160 million penalty imposed by the DOJ, a $200 million penalty by the CFTC, and a $92.8 million fine by the Financial Services Authority in London).

609 *See, e.g.*, Landon Thomas Jr., *Jury Finds Bank of America Liable in Mortgage Case*, N.Y. TIMES, Oct. 23, 2013 (discussing verdict in civil trial filed by DOJ concerning alleged misstatements made in connection with mortgages sold by Countrywide to Fannie Mae and Freddie Mac); Press Release, DOJ, Department of Justice Sues Bank of America for Defrauding Investors in Connection with Sale of Over $850 Million of Residential Mortgage-Backed Securities (Aug. 6, 2013) (announcing filing of civil complaint against Bank of America alleging fraud in connection with sale of mortgage-backed securities in 2008); Press Release, DOJ, Department of Justice Sues Standard & Poor's for Fraud in Rating Mortgage-Backed Securities in the Years Leading Up to the Financial Crisis (Feb. 5, 2013) (announcing filing of civil lawsuit against S&P for allegedly issuing inflated ratings to mortgage-backed securities and collateralized debt obligations between

2004 and 2007 in order to defraud investors).

610 *See, e.g.*, Aruna Viswanatha, *Banks to Pay $5.6 Billion in Probes*, WALL ST. J., May 20, 2015 (describing several banks' agreements with the DOJ to pay fines and plead guilty to criminal charges concerning foreign-currency rate manipulation, after previously agreeing to pay fines regarding the same conduct with the CFTC, Federal Reserve, OCC, New York State Department of Financial Services, U.K. Financial Conduct Authority, and Swiss Financial Market Supervisory Authority).

611 *See, e.g.*, Jed. S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. OF BOOKS, Jan. 9, 2014 (stating that, "[i]n striking contrast with" past prosecutions during economic scandals and crises, "not a single high-level executive has been successfully prosecuted in connection with the recent financial crisis" and attributing the failure to other government priorities, the government's involvement in the circumstances that led to the financial crisis, and the shift towards prosecuting companies rather than individuals); Ben Protess & Susanne Craig, *Inside the End of the U.S. Bid to Punish Lehman Executives*, N.Y. TIMES, Sept. 8, 2013 (discussing internal pressure and criticism concerning failure to prosecute or sue executives from Lehman Brothers).

612 Memorandum from Sally Quillian Yates, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Sept. 9, 2015).

613 In exchange for the payment of penalties and institution of corporate reform, the DOJ in deferred prosecution agreements normally files a criminal information and stays prosecution for a set period of time, at the end of which the charges are dismissed if the corporation is in compliance with the terms of the deferred prosecution agreement. By contrast, under a non-prosecution agreement, the corporation also agrees to pay criminal penalties and institute certain types of corporate reforms, but the DOJ does not file a criminal information and instead promises not to prosecute the company for the conduct under investigation. The 2003 memorandum by Deputy Attorney General Thompson explicitly instructed prosecutors to consider whether non-prosecution agreements would be proper under certain circumstances. *See* Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003).

614 *See In re Prudential Securities Inc. Limited Partnerships Litigation*, Fed. Sec. L. Rep. (CCH) ¶98,978 (S.D.N.Y. Nov. 20, 1995) (where $110 million was awarded to plaintiff class).

615 *See also* Press Release, DOJ, Deutsche Bank's London Subsidiary Agrees to Plead Guilty in Connection with Long-Running Manipulation of LIBOR (Apr. 23, 2015) (announcing deferred prosecution agreement regarding role in manipulating LIBOR and Yen LIBOR); Press Release, DOJ, Manhattan U.S. Attorney and FBI Assistant Director-in-Charge Announce Filing of Criminal Charges Against and Deferred Prosecution Agreement with JPMorgan Chase Bank, N.A. in Connection with Bernard L. Madoff's Multi-Billion Dollar Ponzi Scheme (Jan. 7, 2014) (announcing $1.7 billion payment by JPMorgan); Press Release, DOJ, RBS Securities Japan Limited Agrees to Plead Guilty in Connection with Long-Running Manipulation of Libor Benchmark Interest Rates (Feb. 6, 2013) (where RBS Japanese subsidiary agreed to pay a $50 million fine and RBS parent company paid a $100 million penalty); Press Release, DOJ, UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-Running Manipulation of LIBOR Benchmark Interest Rates (Dec. 19, 2012) (announcing penalties and fines of $500 million); Press Release, DOJ, HSBC Holdings Plc. and HSBC Bank USA N.A. Admit to Anti-Money Laundering and Sanctions Violations, Forfeit $1.256 Billion in Deferred Prosecution Agreement (Dec. 11, 2012) (announcing deferred prosecution agreement for willfully failing to maintain an effective anti-money laundering program, willfully failing to conduct due diligence on foreign correspondent affiliates, and violating the Bank Secrecy Act, the International Emergency Economic Powers Act and the Trading with the Enemy Act); Press Release, DOJ, Barclays Bank PLC Admits Misconduct Related to Submissions for the London Interbank Offered Rate and the Euro Interbank Offered Rate and Agrees to Pay $160 Million Penalty (June 27, 2012) (announcing fine for manipulation of LIBOR); Mark A. Stein, *Five Days; And Wall St. Was Filled With Settlements and Lamentations*, N.Y. TIMES, June 18, 2005 (where Bristol-Myers paid approximately $300 million to settle investigations by the Justice Department into its accounting practices); Press Release, DOJ, Monsanto Company Charged with Bribing Indonesian Government Official: Prosecution Deferred for Three Years

(Jan. 6, 2005) (where Monsanto was fined $1 million); Press Release, DOJ, America Online Charged with Aiding and Abetting Securities Fraud; Prosecution Deferred for Two Years (Dec. 15, 2004) (where Time Warner was fined $510 million); Press Release, DOJ, InVision Technologies, Inc. Enters Into Agreement with the United States (Dec. 6, 2004) (pursuant to which $800,000 in penalties was paid to the United States); *SEC v. GE InVision, Inc.*, SEC Litigation Release No. 19078 (Feb. 14, 2005) (requiring the company also to disgorge $589,000 in profits, plus $28,700 in prejudgment interest, and to pay a $500,000 civil penalty); Press Release, DOJ, American International Group Inc. Enters Into Agreements with the United States (Nov. 30, 2004) (where AIG was fined $80 million in penalties); Press Release, DOJ, Former Computer Associates Executive Indicted on Securities Fraud, Obstruction Charges (Sept. 22, 2004) (where $225 million was awarded to injured shareholders); Press Release, DOJ, Canadian Imperial Bank of Commerce Agrees to Cooperate with Enron Investigation, Exit Structured Finance Business, Implement Reforms, with Oversight By Monitor (Dec. 22, 2003) (where Canadian Imperial Bank was fined $80 million); Press Release, DOJ, Three Top Former Merrill Lynch Executives Charged with Conspiracy, Obstruction of Justice, Perjury in Enron Investigation (Sept. 17, 2003) (pursuant to which Merrill Lynch had to employ specific reforms and retain an independent auditor to monitor compliance); Press Release, DOJ, PNC ICLC Corp. Enters Into Deferred Prosecution Agreement with the United States (June 2, 2003) (where PNC ICLC agreed to pay $90 million to a restitution fund and $25 million in penalties to the United States); Press Release, DOJ, Banco Popular De Puerto Rico Enters Into Deferred Prosecution Agreement with the United States (Jan. 16, 2003) (where Banco Popular was fined $21.6 million).

616 Memorandum from Paul J. McNulty, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Dec. 12, 2006).

617 Memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Jan. 20, 2003).

618 *See* Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008).

619 *See, e.g.*, *United States v. Barford*, SEC Litigation Release No. 19240 (May 26, 2005). Former Charter Communications executives were ordered to serve prison terms and pay substantial fines after pleading guilty to conspiracy to commit wire fraud. The executives had knowingly participated in a scheme to defraud Charter's stockholders by causing Charter to materially inflate the number of subscribers that it reported to the public in press releases and filings with the SEC.

620 *See* 18 U.S.C. § 1341.

621 *See* 18 U.S.C. § 1343. The statutes are given a similar construction and are subject to the same substantive analysis. *See Carpenter v. United States*, 484 U.S. 19, 25 n.6 (1987).

622 *See, e.g.*, *Kehr Packages, Inc. v. Fidelcor, Inc.*, 926 F.2d 1406 (3d Cir.), *cert. denied*, 501 U.S. 1222 (1991).

623 *See, e.g.*, *United States v. Kelley*, 929 F.2d 582 (10th Cir.), *cert. denied*, 502 U.S. 926 (1991).

624 *See, e.g.*, *United States v. Nelson*, 988 F.2d 798 (8th Cir.), *cert. denied*, 510 U.S. 914 (1993); *United States v. Wallach*, 935 F.2d 445 (2d Cir. 1991); *United States v. Melton*, 689 F.2d 679 (7th Cir. 1982).

625 *See McNally v. United States*, 483 U.S. 350 (1987). However, no private right of action has been implied under either statute. *See*, *e.g.*, Ryan v. Ohio Edison Co., 611 F.2d 1170, 1178–79 (6th Cir. 1979); *Bell v. Health-Mor, Inc.*, 549 F.2d 342, 346 (5th Cir. 1977); *Napper v. Anderson, Henley, Shields, Bradford & Pritchard*, 500 F.2d 634, 636 (5th Cir. 1974), *cert. denied*, 423 U.S. 837 (1975); *Oppenheim v. Sterling*, 368 F.2d 516, 518–19 (10th Cir. 1966), *cert. denied*, 386 U.S. 1011 (1967).

626 18 U.S.C. § 1346.

627 *Carpenter v. United States*, 484 U.S. 19, 26 (1987).

628 *Skilling v. United States*, 130 S. Ct. 2896 (2010).

629 *Skilling v. United States*, 130 S. Ct. 2896, 2934 (2010).

630 *See United States v. Tallant*, 547 F.2d 1291, 1299 (5th Cir. 1977), *cert. denied*, 434 U.S. 889 (1977).

631 *See Williams v. United States*, 979 F.2d 844 (1st Cir. 1992); *United States v. Gay*, 967 F.2d 322, 326 (9th Cir.), *cert. denied*, 506 U.S. 929 (1992); *United States v. Brien*, 617 F.2d 299, 312 (1st Cir.), *cert. denied*, 446 U.S. 919 (1980); *see also United States v. Mackay*, 491 F.2d 616, 623 (10th Cir. 1973), *cert. denied*, 416 U.S. 972 and *cert. denied*, 419 U.S. 1047 (1974).

632 *See, e.g.*, *South Atlantic Ltd. Partnership of Tennessee, L.P. v. Riese*, 284 F.3d 518, 531 (4th Cir. 2002) ("Good faith is a complete defense to mail fraud."); *United States v. Dunn*, 961 F.2d 648, 650 (7th Cir. 1992); *United States v. Alkins*, 925 F.2d 541, 549–50 (2d Cir. 1991) ("Good faith is a complete defense to a mail fraud charge. If an individual believes that the information set forth in a mailing is true, it follows that he cannot have the requisite intent to defraud. The government must prove lack of good faith beyond a reasonable doubt." (citation omitted)); *United States v. Dupre*, 339 F. Supp. 2d 534, 539–40 (S.D.N.Y. 2004) ("Under the wire fraud statute, even false representations or statements or omissions of material facts do not amount to a fraud unless done with fraudulent intent. However misleading or deceptive a plan may be, it is not fraudulent if it was devised or carried out in good faith." (citations omitted)).

633 *See* 18 U.S.C. § 3571.

634 This imprisonment term was increased from five to 20 years by the Sarbanes-Oxley Act. *See* § 11.07[3][f].

635 *See* § 807 of the Sarbanes-Oxley Act.

636 18 U.S.C. § 1961(1) and (5).

637 18 U.S.C. § 1001.

638 *See* 18 U.S.C. § 1956.

639 *See* 31 U.S.C. § 5324(a)(3).

640 *See, e.g.*, § 32 of the Exchange Act (up to $25,000,000 for corporate offenders per § 1106 of the Sarbanes-Oxley Act).

641 *See* 18 U.S.C. § 3571.

642 For example, in the 1980s prosecution of E.F. Hutton & Co. on charges of "check kiting" arising from its aggressive cash management techniques, Hutton's use of the mails and wires was prosecuted as 2,000 separate violations of the federal mail and wire fraud statutes. *See Mix v. E.F. Hutton & Co.*, Civ. A. Nos. 85-3109, 85-3110, 1986 WL 25425, at *6 (D.D.C. Sept. 29, 1986). Consequently, had the current penalty statute been effective at that time the sentencing court would have been authorized to fine Hutton more than $1 billion.

643 U.S. Sentencing Commission, GUIDELINES MANUAL, § 8 (Nov. 2015).

644 *See United States v. Booker*, 543 U.S. 220 (2005) (directing courts to consult federal sentencing guidelines but specifically ruling that the guidelines advise but do not bind the courts).

645 U.S. Sentencing Commission, GUIDELINES MANUAL, § 8C2.5 (Nov. 2015); *see also* Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008) (updating prior memos on the principles of federal prosecution of business organizations).

646 U.S. Sentencing Commission, GUIDELINES MANUAL, § 8B2.1 (Nov. 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 11.10, SPECIAL LITIGATION ISSUES REGARDING FOREIGN DEFENDANTS AND OVERSEAS TRANSACTIONS

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 § 11.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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This section briefly surveys some of the special litigation issues that arise whenever a plaintiff seeks to apply the U.S. securities laws to foreign defendants and overseas transactions. [647] First, the court must determine whether it has the authority to exercise its adjudicative powers over the foreign defendants. That authority, known as "personal jurisdiction," is discussed in § 11.10[1]. If a court concludes that it has personal jurisdiction over the foreign defendants, it may nevertheless decline to hear the case based on the doctrine of *forum non conveniens*, which is discussed in § 11.10[2]. Second, the court must decide whether the plaintiff's claims entitle it to relief under the relevant statute, and this conclusion is discussed in § 11.10[3]. [648] Finally, § 11.10[4] discusses an aspect of U.S. litigation that often comes as an unpleasant surprise to foreign defendants: discovery, the process by which litigants may obtain a wide range of information from each other and from nonparty witnesses.

[1] Personal Jurisdiction

As noted, personal jurisdiction refers to the authority of a court to exercise its adjudicative powers over a defendant. A U.S. court may exercise personal jurisdiction over a foreign defendant only if authorized to do so by a statute or rule and only if such exercise satisfies the Due Process Clause of the U.S. Constitution.

Statutes authorizing the exercise of personal jurisdiction over foreign defendants are known as "long-arm statutes." Every state in the United States has enacted some form of long-arm statute or rule of court. Many state long-arm statutes confer personal jurisdiction to the full extent permitted by the Due Process Clause; others are more restrictive. On the federal level, the Securities Act and the Exchange Act both contain long-arm provisions that extend personal jurisdiction to the full extent permitted by the Due Process Clause. [649]

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Generally speaking, the Due Process Clause permits a U.S. court to exercise personal jurisdiction over a foreign defendant who possesses "minimum contacts" with the forum where the court is located "such that the maintenance of the suit does not offend ‘notions of fair play and substantial justice.’" [650] The analysis under the Due Process Clause distinguishes between two types of personal jurisdiction: "general" jurisdiction and "specific" jurisdiction.

[a] General Jurisdiction

"General" jurisdiction permits a court to adjudicate any claim against the defendant, including claims based on activities entirely unrelated to the forum. For example, if a state court in New York has general jurisdiction over XYZ Corporation, then it may adjudicate a claim against XYZ based on the corporation's activities elsewhere, even activities occurring outside the United States.

The Due Process Clause permits the exercise of general jurisdiction over foreign defendants whose affiliations with the state where the court is located are so "continuous and systematic as to render [them] essentially at home in the forum State." [651] For an individual, the paradigm forum for the exercise of general jurisdiction is the individual's domicile. For a corporation, it is the place of incorporation and principal place of business. [652]

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Although the Supreme Court has not foreclosed the possibility that a corporation's operations in a forum other than its place of incorporation or principal place of business may support the exercise of general jurisdiction, it has stressed that it would only find general jurisdiction in that circumstance in an "exceptional case" and that merely distributing goods to the forum, maintaining offices and other facilities in the forum, or having sizeable sales in the forum is insufficient. This general jurisdiction analysis further requires an appraisal of a corporation's activities in their entirety, "nationwide and worldwide," because "[a] corporation that operates in many places can scarcely be deemed at home in all of them." [653]

The Due Process Clause also permits the exercise of general jurisdiction over a foreign defendant who is personally served with process in the forum where the court is located, even if the defendant's presence in that forum is transitory. This method of obtaining general jurisdiction over a foreign defendant is often called "tag service." Perhaps the most extreme application of tag service occurred in a case where the defendant was served with a complaint while he or she was a passenger in an aircraft in flight through the airspace of the forum state. [654] Although tag service has been the subject of substantial criticism, most courts continue to recognize it as an effective way of obtaining general jurisdiction over a foreign defendant. [655]

[b] Specific Jurisdiction

"Specific" jurisdiction permits only the adjudication of claims "arising out of" or "relating to" the defendant's activities in the forum. For example, a defendant whose only contact with the forum is selling product X might be subject to the personal jurisdiction of the forum's courts with respect to claims arising out of those sales. But the defendant would not be subject to the personal jurisdiction of the forum's courts with respect to claims based on its activities outside the forum, such as the sale of product Y.

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Specific jurisdiction may be exercised when: (i) the defendant has "purposefully availed" itself of the benefits and protections of the forum's law such that it should reasonably anticipate being subject to judicial proceedings there, and (ii) the exercise of personal jurisdiction over the defendant would be "reasonable." [656] Application of this two-pronged test is neither predictable nor precise; whether a court will exercise specific jurisdiction over a particular foreign defendant will depend upon all the facts and circumstances of the case. Nevertheless, because of the unique burdens faced by foreign defendants litigating in the United States, the Supreme Court has cautioned that "great care and reserve" should be exercised in asserting personal jurisdiction over foreigners. [657] In addition, the Supreme Court has recently cautioned against using facts that permit the exercise of specific jurisdiction over a foreign corporation to exercise general jurisdiction over such corporation. [658]

[2] *Forum Non Conveniens*

Almost every litigation involving foreign parties or overseas transactions will to some degree pose the issue of *forum non conveniens*. [659] The doctrine of *forum non conveniens* permits a U.S. court to dismiss an action if the balance of conveniences weighs heavily in favor of an alternative forum. [660]

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There is ordinarily a strong presumption in favor of a plaintiff's choice of forum. However, that presumption applies with less force when the plaintiff is a foreigner, rather than a citizen or resident of the United States. When an alternative forum has jurisdiction to hear the case, and when trial in the chosen U.S. forum would be unduly burdensome to the defendant or its foreign aspects would add substantially to the court's own administrative and legal problems, the court may, in its discretion, dismiss the case. To guide the court's discretion, the Supreme Court has developed a list of private interest factors affecting the convenience of the litigants and a list of public interest factors affecting the convenience of the forum. The private and public interest factors must clearly point toward trial in the alternative forum before the plaintiff's choice of forum will be disturbed.

The factors pertaining to the private interests of the litigants include:

- the relative ease of access to sources of proof;
- the availability of a compulsory process for attendance of unwilling, and the cost of obtaining attendance of willing, witnesses;
- the possibility of a view of the premises, if a view would be appropriate to the action; and
- all other practical problems that affect whether trial of a case will be easy, expeditious and inexpensive.

The list of public interest factors includes:

- the administrative difficulties flowing from court congestion;
- the local interest in having localized controversies decided at home;
- the interest in having the trial of a diversity case in a forum that is at home with the law that must govern the action;
- the avoidance of unnecessary problems in conflict of laws, or in the application of foreign law; and
- the unfairness of burdening citizens in an unrelated forum with jury duty.

The doctrine of *forum non conveniens* is a flexible one. There are no hard and fast rules that require dismissal; each case turns on its facts. Nevertheless, a plaintiff may not defeat a motion to dismiss on the ground of *forum non conveniens* merely by showing that the substantive law that would be applied in the alternate forum is less favorable to the plaintiff than that of the present forum. The possibility of a change in substantive law is ordinarily not given substantial

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weight in the *forum non conveniens* inquiry. [661] By the same token, the possibility of a change in law favorable to the defendant is not considered. If the defendant is able to overcome the presumption in favor of the plaintiff by showing that trial in the chosen forum would be unnecessarily burdensome, dismissal is appropriate—regardless of the fact that the defendant may also have been motivated by a desire to obtain a more favorable forum.

[3] Extraterritorial Reach of the Securities Laws

Claims under the Securities Act and the Exchange Act generally fall within the federal question jurisdiction of the federal courts. However, because both statutes are silent as to their extraterritorial application, whenever a plaintiff brings an Exchange Act or Securities Act claim based on an overseas transaction, the court must ascertain whether the relevant statute reaches the challenged conduct.

In *Morrison v. National Australia Bank* [662] ("*Morrison*"), the Supreme Court rejected the longstanding and widely applied "conduct" and "effects" test for determining the extraterritorial reach of the federal securities laws, and instead held that § 10(b) of the Exchange Act gives rise to liability only for securities transactions on a U.S. exchange or otherwise occurring in the United States. This new test—a "transactional" test—does not turn on whether the alleged fraud produced substantial "effects" in the United States or whether the alleged fraud was "conduct[ed]" in the United States, but rather whether the purchase and sale "transactions" took place in the United States. The rule of *Morrison* is more categorical than the earlier standards and means that companies that sell securities outside the United States will have significant protection from U.S. securities law class action litigation. [663] For purposes of actions brought by

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the SEC, however, the Dodd-Frank Act effectively revives the prior "conduct and effects" test. [664]

The *Morrison* decision did not indicate—and lower courts will need to consider—what constitutes a purchase or sale of a non-listed security "in the United States." Transactions may be negotiated in the United States but paid from or delivered outside the United States, for example, and the Court's decision does not provide guidance for such circumstances. In *Absolute Activist Value Master Fund Limited v. Ficeto*, the Second Circuit held that a transaction in a security not listed on a U.S. exchange takes place in the United States where "irrevocable liability was incurred or title was transferred within the United States." [665] According to the *Absolute Activist* court, relevant considerations in determining whether irrevocable liability was incurred or title was transferred within the United States include "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money," rather than the identity of the parties, the type of security at issue, or whether each defendant engaged in conduct within the United States. On remand, the district court determined that the transactions at issue took place within the United States because the parties delivered the signed purchased agreement in the United States, the closing took place in the United States, and the trades were settled through a clearinghouse located in the United States. [666]

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The Second Circuit applied its *Absolute Activist* decision in *United States v. Vilar*. [667] In *Vilar*, the Second Circuit concluded that the transactions at issue qualified as "domestic" transactions because certain of the victims "entered into and renewed" their purchase agreements in the United States. In particular, the Second Circuit supported its conclusion by pointing to evidence that: (1) the parties met in the United States to discuss the securities; (2) the victims committed to the investments while in the United States; (3) the defendants sent a letter to the victims in the United States confirming the investments; (4) the victims were in the United States when they reinvested their money in the securities; and/or (5) the victims were in the United States when they received and signed commitment forms, and sent money to the defendants to open their accounts. In reaching this conclusion, however, the Second Circuit rejected the government's arguments that the relevant transactions were "domestic" merely because the securities were "marketed and sold to customers based in the United States" or the "investors were directed to wire funds to a New York bank, and the custodian of the fund was a New York securities firm." The court likewise rejected the defendants' arguments that the transactions were not "domestic" because the securities transactions at issue were "deliberately and carefully structured to occur outside the United States." According to the court, "[t]he parties' intention to engage in foreign transactions is entirely irrelevant" under *Morrison*.

More recently, the Second Circuit considered the scope of its *Absolute Activist* decision in the context of claims under the civil liability provisions of the Commodity Exchange Act in *Loginovskaya v. Batrachenko*. [668] In *Loginovskaya*, the Second Circuit affirmed the dismissal of the plaintiff's claims for failure to plead a domestic transaction. With respect to *Absolute Activist*'s title-transfer prong, the court held that the plaintiff could not rely on the allegedly domestic transfer of title to the assets underlying her investments because she did not directly hold title to those assets and instead only owned an interest in those assets through shares in an investment account, which were not transferred within the United States. With respect to the irrevocable-liability prong of *Absolute Activist*, the Second Circuit rejected as insufficient the plaintiff's allegation that she was required to wire transfer her funds to a bank account in the United States, concluding that those transfers "were actions needed to carry out the transactions, and not the transactions themselves—which were previously entered into when the contracts were executed in Russia." [669]

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The Second Circuit further considered the application of *Morrison* to swap transactions in *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*. [670] The case involved U.S. and foreign hedge funds that had entered into security-based swap agreements in the United States that referenced the share price of Volkswagen ("VW"), the German automaker. Their complaints alleged that Porsche, another German company, concealed its intention to acquire VW, and that plaintiffs relied on Porsche's statements when entering the swap agreements. Attempting to invoke § 10(b), plaintiffs alleged that they entered into the swap agreements in the United States with U.S.-based counterparties, and that the agreements contained New York choice-of-law provisions and forum selection clauses. They did not, however, allege that Porsche was a party to the swap agreements, that its deceptive conduct occurred primarily in the United States, or that the referenced VW shares were traded on a U.S. exchange. Because the swaps were not traded on any exchange, the Circuit had to decide whether entering into the swaps constituted "domestic transactions in other securities."

The Second Circuit construed *Morrison* as precluding the application of § 10(b) to the swap agreements at issue. The Circuit first rejected the argument that the *situs* of transactions was determinative of whether the claim was extraterritorial under *Morrison* because applying that principle to the swap agreements at issue "would subject to U.S. securities laws conduct that occurred in a foreign country, concerning securities in a foreign company, traded entirely on foreign exchanges, in the absence of any congressional provision addressing the incompatibility of U.S. and foreign law nearly certain to arise"—a result *Morrison* "plainly did not contemplate and … does not … permit." The Circuit next concluded that whether a swap transaction effected in the United States fell within *Morrison's* scope depended on the facts and circumstances and could not be decided based on any bright line rule. Thus, while a domestic transaction is a necessary element of a § 10(b) claim, it is not sufficient on its own to bring a particular claim within the confines of § 10(b). Rather, the Circuit held that whether conduct—some of which took place abroad—would be sufficient to invoke § 10(b) where there was a securities transaction in the United States

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depended on whether the Plaintiffs' claims were so "predominantly foreign as to be impermissibly extraterritorial." The Circuit held that, on the facts pleaded, the Plaintiffs did not plead a transaction that was sufficiently domestic to satisfy § 10(b). [671] The procedural history of the *Parkcentral* case also demonstrates the extent to which *Morrison* may direct securities litigation away from the federal courts. After the district court's decision in *Parkcentral*, certain plaintiffs refiled their common law fraud and unjust enrichment claims in New York state court, where the Appellate Division granted the defendants' motion to dismiss on the ground of *forum non conveniens*. [672] Those plaintiffs subsequently pursued their claims in Germany.

In a decision arising out of the Volkswagen diesel emissions scandal, however, a district court distinguished *Parkcentral* and held that the plaintiffs adequately alleged that their transactions in Volkswagen's sponsored Level 1 ADRs were subject to the federal securities laws as "domestic transactions in other securities." [672.1] The court concluded that the transactions at issue were not "predominantly foreign" under *Parkcentral*, reasoning that the ADRs were "not independent from Volkswagen's foreign securities or from Volkswagen itself" since "Volkswagen sponsored the ADRs and thus was directly involved in the domestic offering of the ADRs." The court also rejected the defendants' argument that the level of the ADRs—Level 1, as opposed to Level 2 or 3—warranted a conclusion that the transactions were "predominantly foreign"

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because, "[r]egardless of the level of the ADRs, Volkswagen took affirmative steps to make its securities available to investors here in the United States," including entering into deposit agreements governed by New York law with a bank in New York, submitting registration statements with the SEC, and complying with SEC rules that required it to provide on its website English-translated versions of market disclosure documents provided in its home country.

In another more recent case, *Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd.*, a lower court dismissed under *Morrison* the § 10(b) claims of U.S. investors in funds organized under the laws of the Cayman Islands. Plaintiffs argued that because the money to invest in the funds was wired to the fund managers *via* an account in New York, the transactions had taken place within the United States. The district court disagreed, noting that because the subscription agreements that the plaintiffs entered into to invest in the funds were sent to the fund manager in the Cayman Islands and were subject to final approval (or rejection) in that jurisdiction (in other words the "transaction was not completed" until the fund manager accepted an application in the Cayman Islands), the transaction at issue occurred outside the United States. [673]

Relying on reasoning similar to that of the *Cascade Fund* court, another lower court recently dismissed the SEC's § 10(b) claims against Fabrice Tourre, a U.S.-based Goldman Sachs employee, in connection with Goldman's creation and sale to U.S. and foreign investors of a synthetic collateralized debt obligation ("CDO") whose performance was tied to the performance of certain RMBSs. [674] The SEC alleged that Tourre marketed the CDO at issue out of his New York office, to investors in the United States and abroad. Tourre moved to dismiss the SEC's § 10(b) claims under *Morrison*, arguing that the SEC did not allege sufficient facts to establish that the "sale or purchase" of the security at issue had occurred in the United States. The district court agreed, noting that the SEC's allegations with respect to marketing conduct that occurred in the United States "is precisely that … just conduct," and that the Supreme Court in *Morrison* had soundly rejected any reliance on "conduct" within the United States to confer jurisdiction over § 10(b) claims. [675] Instead, the court reasoned, the question after *Morrison* for non-listed securities was where the "sale or purchase" was made, a question that in turn depends on where and when someone "incurred an *irrevocable* liability" to either take or deliver a security. [676] Because the SEC had not alleged that an

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irrevocable liability to sell the securities had arisen in the United States (and, indeed, Tourre had suggested that irrevocable liability arose when a trade confirmation for the security issued, which had occurred abroad with respect to both U.S. and foreign purchasers), the court dismissed the § 10(b) claims. [677]

[4] Discovery

[a] Overview of U.S. Discovery

Pretrial discovery in the United States often strikes foreign defendants as unusual and burdensome. First, unlike in most other countries, discovery in the United States is conducted by the litigants, rather than by the trial court. Plaintiffs' lawyers can be quite persistent in seeking information from foreign defendants. Second, the scope of discovery is much wider in the United States than in most other countries. U.S. litigants are entitled to obtain not only admissible evidence, but also any information that appears "relevant to any party's claim or defense and proportional to the needs of the case." [678] In addition to obtaining information from each other, parties can take discovery from nonparty witnesses.

There are various methods for conducting discovery in the United States. The most frequently used are oral depositions, subpoenas or demands for the production of documents and written interrogatories. Other methods include depositions on written questions, physical and mental examinations and requests for admissions. Parties are generally free to employ any combination of these discovery devices.

U.S. discovery is typically conducted with little judicial supervision. Parties are free to make discovery requests without prior court approval, and, in most cases, compliance with such requests is achieved through private negotiations among the parties and nonparty witnesses. If negotiations break down, the parties and witnesses can bring their discovery disputes to the court for resolution.

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Once a court has ordered a party or nonparty to provide discovery, failure to do so is a ground for sanctions. With respect to the litigants, courts have a wide array of sanctions at their disposal, including:

- finding particular facts against the disobedient party;
- precluding use of evidence by that party;
- dismissing that party's claims or defenses;
- ordering the recalcitrant party (or that party's lawyer) to pay the other side's attorney's fees; and

- treating the party's noncompliance as a contempt of court, punishable by a fine or, in truly egregious cases, imprisonment.

A nonparty who disobeys a discovery order of the court risks a finding of contempt of court, with its attendant severe penalties.

U.S. pre-trial discovery can be a long and expensive process. In a complicated securities case, discovery can easily take a year or more, require the production of hundreds of thousands of documents and entail the taking of scores of depositions. In recognition of the magnitude of these burdens and the fact that many securities cases ultimately are dismissed as a matter of law, in 1995, Congress passed legislation mandating the suspension of discovery in any private suit under the Exchange Act or Securities Act between the time a defendant moves for dismissal and the resolution of the motion by the court, barring a showing of "undue prejudice" by the plaintiff. [679] While this amendment provides welcome protection against some of the more egregious abuses of the previous discovery rules, such as the filing by plaintiffs of voluminous discovery demands at the outset of even frivolous suits to pressure defendants into settling for "nuisance value," the discovery process in securities cases that survive a motion to dismiss is likely to be time-consuming and expensive. [680]

[b] Extraterritorial Application of U.S. Discovery

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Under certain circumstances, parties to a U.S. lawsuit may obtain information from persons and entities located abroad simply by using the standard mechanisms of U.S. discovery.

For example, U.S. law entitles parties to obtain relevant documents within the custody or control of adverse parties. Accordingly, foreign defendants can be compelled to produce all relevant documents over which they have control, regardless of whether such documents are located abroad. Moreover, U.S. parent corporations generally must produce documents from their foreign subsidiaries, because parents generally are deemed to control their subsidiaries. The formalities of corporate organization, however, are not dispositive. On occasion, U.S. subsidiaries have been ordered to produce documents from their foreign parents because the facts established that, as a practical matter, the subsidiaries and parents shared control of the documents. Each case involving the "control" of corporate documents located abroad rests on its own particular facts. [681]

A foreign nonparty witness can also be compelled to produce documents located abroad, provided that the witness: (i) is properly served with a subpoena, (ii) is subject to the personal jurisdiction of the U.S. court, and (iii) has control of the documents. Even where these prerequisites are met, however, courts sometimes refrain from ordering production, presumably because they recognize the unfairness of forcing foreign companies to spend time and money producing documents located abroad in lawsuits in which the companies have no stake. [682]

Rules governing the oral depositions of foreign witnesses generally draw a distinction between party and nonparty witnesses. If the proposed witness is a party, then the court can compel a deposition of the witness. When the party is a corporation, the court's power to compel a deposition generally extends to the corporation's officers, directors and managing agents. The court has broad discretion to select a convenient place for the deposition; whether it will order a foreign witness to travel to the United States depends on the circumstances. As a general matter, courts require foreign plaintiffs to attend depositions in the United States; on the other hand, courts have sometimes excused foreign defendants from traveling to the United States where such travel would be

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unreasonable under the particular circumstances of the case. A foreign nonparty witness, by contrast, generally cannot be compelled to travel to the United States; however, some courts have ordered nonparty foreign companies over whom they have personal jurisdiction to make their overseas employees available for depositions by telephone.

Under certain circumstances, U.S. depositions can be conducted abroad. Generally, the deponent must agree to the deposition, and the deposition must be permissible under local law. U.S. law expressly provides for taking depositions in foreign countries and sets forth detailed procedures for conducting such discovery. [683]

[c] Blocking Statutes

A number of foreign countries have enacted so-called "blocking statutes," which prohibit the production of evidence located within the blocking country's territory. Although the scope of foreign blocking statutes varies widely from country to country, most carry criminal penalties. Some blocking statutes, such as the Swiss bank secrecy law, have existed for many decades and were designed to serve long-standing government policies. Other statutes were specifically intended to respond to efforts by U.S. litigants to take U.S.-style discovery abroad. Some of these statutes, such as that in France, flatly prohibit compliance with foreign discovery orders. Litigants seeking evidence located in France must go through official government channels. Other blocking statutes, such as those in the United Kingdom, Australia and Canada, authorize certain government agencies to prohibit compliance with any foreign discovery order that would infringe on the country's sovereignty or security. Finally, many foreign blocking statutes only prohibit disclosures relating to particular industries. For example, the Bahamas, the Cayman Islands, Bermuda, Liechtenstein and Panama all have blocking statutes that apply to the banking industry.

Blocking statutes are not the only way that foreign countries have expressed their interest in the nondisclosure of information located within their territory. [684] Some countries that do not have blocking statutes nevertheless

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recognize a right of confidentiality in the customer account records of financial institutions. In Belgium and the Netherlands, for example, that right is derived from the standard contract between a financial institution and its customer. In Hong Kong and Germany, by contrast, the right stems from judicial decisions holding that customers whose records are disclosed can recover civil damages from their financial institutions.

U.S. courts sometimes order foreign litigants and nonparty witnesses to produce information notwithstanding the fact that such production would violate a foreign country's blocking statute. Litigants and nonparty witnesses facing such discovery orders obviously find themselves in a difficult position: if they comply with the U.S. court order, they risk criminal prosecution for violating the blocking statute; on the other hand, if they comply with the blocking statute, they risk being sanctioned by the U.S. court. This dilemma can arise in the course of both civil and criminal proceedings. [685]

Courts generally balance several factors in deciding whether to issue discovery orders that conflict with a foreign blocking statute and whether to impose sanctions for noncompliance with such orders. These factors include:

- the vital national interests of the United States and the foreign country;
- the extent and the nature of the hardship that inconsistent enforcement actions would impose on the party from whom discovery is sought;
- the nationality of the person from whom discovery is sought; and

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- the importance of the evidence. [686]

In addition, in deciding whether to impose sanctions, most courts place substantial emphasis on whether the person from whom discovery is sought has acted in bad faith. Acts of bad faith include secreting documents in a jurisdiction where they cannot be produced legally, colluding with a foreign government to obtain passage of a blocking statute or failing to seek a waiver of the blocking statute from the foreign country.

In order to minimize the risk of sanctions, the party from whom discovery is sought should respond in a way that makes its good faith unquestionable. Acts of good faith include promptly making as much disclosure as applicable law permits, attempting to obtain a waiver of the blocking statute and seeking alternative means by which to provide the information at issue. [687]

Finally, U.S. courts have the authority, at least in criminal cases, to issue so-called "consent directives." A consent directive is a court order directing a person to consent to the production of his or her documents by a records custodian, often a financial institution, located overseas. Consent directives are designed to take advantage of foreign blocking statutes that permit the production of records if the owner of such records consents to the production. [688]

[d] Letters Rogatory

If the person or entity possessing relevant information is not subject to the personal jurisdiction or subpoena power of the U.S. courts, then those courts cannot order discovery directly and must instead seek the assistance of foreign courts in obtaining the information. The traditional method of obtaining such assistance is by letter rogatory—a formal request by the court of one nation to the courts of another for assistance in performing a judicial act. In the discovery context, a U.S. letter rogatory typically will ask a foreign court to compel an individual or entity in the foreign jurisdiction to provide testimony or documents to the foreign court, so that the foreign court can then forward the evidence to the U.S. court. Letters rogatory may be used in both civil and criminal cases. [689]

As a practical matter, letters rogatory are inefficient and cumbersome. First, foreign courts are under no obligation to execute letters rogatory. As a result, foreign courts sometimes refuse to execute letters rogatory in cases

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involving claims based on U.S. laws that conflict with the foreign jurisdiction's policy. Second, each nation has its own required form for letters rogatory. This often results in a lengthy series of rejections and resubmissions as the requesting party attempts to comply with the required form. Third, even when foreign courts execute U.S. letters rogatory, they often refuse to provide the full extent of the discovery sought. Foreign courts generally execute letters rogatory in accordance with their own procedures. Thus, oral testimony may be taken without an oath and without a transcript. In addition, foreign courts generally do not execute the wide-ranging document requests that are common in the United States. Fourth, the processing of letters rogatory is notoriously slow. The letters must be sent to the foreign court through diplomatic channels, which usually involves sending the letters to the U.S. State Department, which in turn will send them to the foreign affairs ministry, which then will send them to the foreign court. The information is sent back *via* the same route. Completing discovery *via* letters rogatory can easily take more than one year.

[e] The Hague Convention

In an effort to improve upon the letters rogatory mechanism in civil cases, the United States and nearly 20 other countries have become parties to the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters (the "Convention"). [690] Parties to the Convention are required to designate a "Central Authority." When a court in one member state seeks access to evidence located in another member state, it sends a "letter of request" to the Central Authority in the second state. Unlike letters rogatory, the receiving Central Authority is generally required by the Convention to execute foreign letters of request. In addition, the Convention provides that such letters should be executed expeditiously. The receiving Central Authority forwards the letters to the appropriate local court for execution and the evidence obtained thereunder is then returned to the requesting court. [691] The Convention applies to evidence sought from third parties as well as from the litigants themselves.

The general obligation of parties to execute letters of request is subject to several important exceptions. One such exception, pursuant to Article 23 of the Convention, permits parties to declare that they will not execute letters of request seeking pretrial discovery of documents. All the parties to the Convention except the United

States, Israel and Czech Republic have issued such declarations, most

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likely because they feared "fishing expeditions" by U.S. lawyers into the files of local companies.

The Convention does not provide exclusive or mandatory procedures for obtaining evidence located abroad; it establishes optional procedures for obtaining such evidence. Thus, the Convention does not deprive a U.S. court of the power to employ traditional methods of U.S. discovery with respect to a litigant or nonparty over whom the court has personal jurisdiction. Whether a court will employ the Convention, rather than traditional U.S. discovery methods, depends upon a particularized analysis of the facts of the case, the sovereign interests of the countries involved and the likelihood that use of the Convention will prove effective. [692] On the other hand, when discovery is sought from a nonparty that is not subject to U.S. personal jurisdiction, traditional U.S. discovery is not available, and the Hague Convention (or letters rogatory) must be used. [693]

[f] Mutual Legal Assistance Treaties, Executive Agreements and Memoranda of Understanding

The United States has entered into various agreements with foreign countries in order to facilitate the government's own ability to gather evidence abroad. Many of these agreements are specifically designed to pierce the blocking statutes of foreign countries.

First, the United States has entered into Mutual Legal Assistance Treaties ("MLATs") with a number of foreign countries. [694] MLATs generally apply only

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to criminal matters. Unlike the Hague Convention, each MLAT is a separately negotiated treaty, defining the countries' obligations to provide assistance, the scope of such assistance and the contents required in all requests for assistance. MLATs generally require that all requests be made by and sent to the Central or Competent Authority designated by each country. The U.S. Attorney General has been designated as the competent authority to make and receive such requests in the United States. Countries entering into MLATs generally reserve the right to deny a request if execution would prejudice their sovereignty, security or other essential public interest. In addition, most MLATs contain a dual criminality requirement: the offense under investigation must be punishable under the criminal laws of both countries. Some MLATs entitle a country to refuse a request for assistance if the offense in question is political or military in nature; other MLATs list specific offenses for which assistance will not be given.

Second, the U.S. government has also entered into "executive agreements" with certain countries in order to facilitate international criminal investigations in particular areas, such as drug trafficking and money laundering. [695] Executive agreements have also been negotiated on an *ad hoc* basis with respect to specific cases.

Finally, the SEC has entered into a variety of agreements, including multilateral and bilateral Memoranda of Understanding ("MOUs") and *ad hoc* arrangements, with a number of foreign governments to facilitate the SEC's ability to obtain information, such as account information from non-U.S. financial institutions, in securities law enforcement matters. [696] MOUs arose from the difficulty the SEC experienced in obtaining evidence through ordinary diplomatic channels or by means of international law enforcement, which posed a real obstacle to prosecuting transnational securities violations. [697] The increasing globalization of corporations, capital markets and securities transactions has necessitated the internationalization of enforcement. Without cooperative information-sharing agreements, it would be much easier for violators to escape prosecution by operating outside the enforcing jurisdiction. MOUs, which provide for mutual

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assistance and agreement between countries for the orderly exchange of information in pending investigations, are arguably the most effective of the above-listed tools for gathering international evidence and have facilitated increased international cooperation. [698] Prior to 2002, the SEC relied primarily on bilateral MOUs with foreign regulators, setting forth detailed guidelines for the sharing, use and confidentiality of information. The SEC has entered into such MOUs with 20 other securities regulators. [699] Although these bilateral MOUs formerly represented the SEC's primary means of securing international cooperation, since 2002 the SEC and other regulatory agencies have pursued a multilateral approach. Thirty-six securities regulators have signed the International Organization of Securities Commissions' (IOSCO's) Multilateral Memorandum of Understanding, which generally provides for information sharing similar to that established by the bilateral MOUs. [700] In addition, the SEC has negotiated *ad hoc* arrangements with foreign jurisdictions or regulators to cooperate in specific enforcement matters.

Footnotes

647 For purposes of this section, the term "foreign defendants" refers to (i) individuals who are neither citizens nor residents of the United States and (ii) companies that are neither incorporated nor have their principal places of business in the United States. The term "overseas transactions" refers to securities transactions that occur principally outside the United States.

648 Until recently, this analysis, which considers whether a plaintiff presents a claim for relief under U.S. law, was considered by courts to be an inquiry into subject matter jurisdiction.

649 *See* § 22 of the Securities Act; § 27 of the Exchange Act; *Bersch v. Drexel Firestone*, *Inc.*, 519 F.2d 974, 998 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975); *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326, 1339–40 (2d Cir. 1972).

650 *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945) (quoting *Milliken v. Meyer*, 311 U.S. 457, 463 (1940)). In a state court proceeding, the personal jurisdiction issue turns on whether the foreign defendant has sufficient "minimum contacts" with the individual state. In a federal court proceeding under the Securities Act or the Exchange Act, personal jurisdiction generally turns on whether the foreign defendant has sufficient "minimum contacts" with the United States, rather than with any one particular state. *See, e.g.*, *Securities Investor Protection Corp. v. Vigman*, 764 F.2d 1309, 1315–16 (9th Cir. 1985).

651 *Daimler AG v. Bauman*, 134 S. Ct. 746, 754 (2014).

652 Certain regulated entities, such as registered nonresident investment advisers and broker-dealers, must appoint the SEC as their agent in the United States for receipt of service of process. *See* Rule 15b1-5 under the Exchange Act and Rule 0-2 under the Advisers Act. The courts are divided as to whether a corporation that appoints an agent for service of process solely because it is required to do so by law thereby subjects itself to the general jurisdiction of the U.S. courts. *Compare Sternberg v. O'Neil*, 550 A.2d 1105 (Del. 1988) (upholding Delaware law requiring all foreign corporations doing business there to appoint agents to receive process in any action, thereby subjecting corporations to general jurisdiction), *with Ratliff v. Cooper Laboratories, Inc.*, 444 F.2d 745, 748 (4th Cir.), *cert. denied*, 404 U.S. 948 (1971) (Due Process Clause does not permit general jurisdiction based only on company's registration to do business and appointment of agent to receive service of process). *See generally Reynolds & Reynolds Holdings, Inc. v. Data Supplies, Inc.*, 301 F. Supp. 2d 545, 550–51 (E.D. Va. 2004) (collecting cases and holding that complying with registration statutes that require appointing an agent for service does not amount to consent to general personal jurisdiction).

653 *Daimler AG v. Bauman*, 134 S. Ct. 746, 762 n.20 (2014).

654 *See Grace v. MacArthur*, 170 F. Supp. 442 (E.D. Ark. 1959).

655 *See, e.g.*, *Burnham v. Superior Court of California*, 495 U.S. 604 (1990); *Amusement Equipment, Inc. v. Mordelt*, 779 F.2d 264 (5th Cir. 1985). The courts are divided, however, as to whether tag service on a corporate officer is sufficient to obtain general personal jurisdiction over the corporation. *Compare Aluminal Industries, Inc. v. Newtown Commercial Associates*, 89 F.R.D. 326 (S.D.N.Y. 1980) (tag service on managing partner established personal jurisdiction over out-of-state limited partnership), *with Scholz Research Development, Inc. v. Kurzke*, 720 F. Supp. 710 (N.D. Ill. 1989) (Due Process Clause does not

permit jurisdiction over company based on tag service on corporate officer).

656 *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980).

657 *Asahi Metal Industries Co. v. Superior Court of California*, 480 U.S. 102, 115 (1987) (quoting *United States v. First National City Bank*, 379 U.S. 378, 404 (1965) (Harlan, J., dissenting)); *see also SEC v. Unifund SAL*, 910 F.2d 1028, 1033 (2d Cir. 1990); *SEC v. Euro Security Fund*, Fed. Sec. L. Rep. (CCH) ¶90,433 (S.D.N.Y Feb. 17, 1999).

658 *See Goodyear Dunlop Tires Operations v. Brown*, 131 S. Ct. 2846 (2011). In *Goodyear*, the plaintiff sued a foreign corporation for the negligent design of tires that the plaintiff alleged had caused an accident abroad, and sought to establish jurisdiction over the foreign corporation based on the fact that some of its tires had been distributed in the United States. The Supreme Court rejected the exercise of general jurisdiction over the foreign corporation based on these facts, noting that "ties serving to bolster the exercise of specific jurisdiction do not warrant a determination that, based on those ties, the forum has general jurisdiction over a defendant." *Goodyear Dunlop Tires Operations v. Brown*, 131 S. Ct. 2846, 2855 (2011).

659 For an example of the application of *forum non conveniens* to a securities fraud action, *see Otor, S.A. v. Credit Lyonnais, S.A.*, No. 04-CV-6978 (RO), 2006 WL 2613775 (S.D.N.Y. Sept. 11, 2006) or *Alfadda v. Fenn*, 159 F.3d 41 (2d Cir. 1998).

660 *See generally Piper Aircraft Co. v. Reynolds*, 454 U.S. 235 (1981); *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501 (1947).

661 Only if the remedy provided by the alternative forum is so clearly inadequate or unsatisfactory that it is no remedy at all may the unfavorable change in law be given substantial weight. In that situation, the court may conclude that dismissal would not be in the interests of justice. *See, e.g.*, *In re Lernout & Hauspie Securities Litigation*, 208 F. Supp. 2d 74, 81 (D. Mass 2002) (holding that the lack of a fraud-on-the-market theory, when combined with the lack of a class action mechanism, "creates virtually insurmountable concerns regarding the adequacy of the foreign forum").

662 *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010).

663 After *Morrison*, the plaintiffs in *Cornwell v. Credit Suisse Group*, 729 F. Supp. 2d 620 (S.D.N.Y. 2010), attempted to revive the defunct "conduct and effects test" and limit *Morrison* to its facts, arguing that the transactional test it announced was limited to so-called "foreign-cubed" claims (*i.e.*, claims by a non-U.S. purchaser of securities of a non-U.S. entity on a non-U.S. exchange). Judge Marrero squarely rejected these arguments and held that *Morrison* also bars claims by U.S. plaintiffs who purchase securities on a non-U.S. exchange, regardless of whether the purchase was initiated in the United States or whether the plaintiff was enticed to purchase through acts committed in the United States. *See also In re Alstom SA Securities Litigation*, 741 F. Supp. 2d 469 (S.D.N.Y. 2010) (reaching same holding as *Cornwell*).

Also after *Morrison*, at least one set of plaintiffs argued that § 10(b) applies to purchases of securities on a foreign exchange if such security is also cross-listed on a U.S. exchange, relying on the Supreme Court's statement in *Morrison* that "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security *listed* on an American stock exchange." *Morrison v. National Australia Bank*, 130 S. Ct. 2869, 2888 (2010) (emphasis added). This argument has failed. *See, e.g.*, *City of Pontiac Policemen's & Firemen's Retirement Systems v. UBS AG*, 752 F.3d 173, 181 (2d Cir. 2014) (holding that "*Morrison* does not support the application of § 10(b) of the Exchange Act to claims by a foreign purchaser of foreign-issued shares on a foreign exchange simply because those shares are also listed on a domestic exchange").

At least one court has extended *Morrison* to bar claims based on purchases of ADRs on the U.S. over-the-counter market (as opposed to on a U.S. exchange), noting that trading in ADRs in such a context is a "predominantly foreign securities transaction." *In re Societe Generale Securities Litigation*, No. 08-CV-2495 (RMB), 2010 WL 3910286, at *4 (S.D.N.Y. Sept. 29, 2010) (citation omitted).

664 *See* § 929P(b) of the Dodd-Frank Act. For a discussion of applications of the "conduct and effects" test, *see, e.g.*, *Morrison v. National Australia Bank Ltd.*, 547 F.3d 167 (2d Cir. 2008) *aff'd on other grounds*, 130 S. Ct. 2869 (2010); *SEC v. Berger*, 322 F.3d 187 (2d Cir. 2003); *IIT v. Vencap, Ltd.*, 519 F.2d 1001 (2d Cir.

1975); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir.), *cert. denied*, 423 U.S. 1018 (1975). *See also* Edward Greene & Arpan Patel, *Consequences of Morrison v. NAB, securities litigation and beyond*, CAP. MKTS. L.J. (2016) 11 (2): 145–190.

665 *Absolute Activist Value Master Fund Limited v. Ficeto*, 677 F.3d 60 (2d Cir. 2012).

666 *Absolute Activist Value Master Fund, Limited v. Ficeto*, No. 09 Civ. 8862 (GBD), 2013 WL 1286170 (S.D.N.Y. Mar. 28, 2013).

667 *United States v. Vilar*, 729 F.3d 62 (2d Cir. 2013). In addition to interpreting the contours of "domestic" transactions under *Morrison*, the *Vilar* decision is also notable because the *Vilar* court held, in an issue of first impression, that *Morrison's* transactional approach applies to criminal actions under § 10(b) of the Exchange Act.

668 *Loginovskaya v. Batrachenko*, 764 F.3d 266 (2d Cir. 2014).

669 Building on this decision, a district court has held that the settlement of an unlisted security through The Depository Trust Company ("DTC"), by itself, does not establish a domestic transaction for the purposes of the federal securities laws. *See In re Petrobras Securities Litigation*, 150 F. Supp. 3d 337 (S.D.N.Y. 2015). The *Petrobras* court concluded that, "even assuming that DTC's bookkeeping affects a change in beneficial ownership in New York," "[t]he mechanics of DTC settlement are actions needed to carry out transactions," which were rejected as insufficient by *Loginovskaya*, but "involve neither the substantive indicia of a contractual commitment necessary to satisfy *Absolute Activist*'s first prong nor the formal weight of a transfer of title necessary for its second." In light of the parties' contention "that most securities transactions settle through the DTC or similar depository institutions," the court further observed that "the entire thrust of *Morrison* and its progeny would be rendered nugatory if all DTC-settled transactions necessarily fell under the reach of the federal securities laws."

670 *Parkcentral Global Hub Ltd. v. Porsche Automobile Holdings SE*, 763 F.3d 198 (2d Cir. 2014).

671 In *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *10 (C.D. Cal. May 20, 2016), a district court likewise held that transactions in unsponsored ADRs, including "securities transactions that occurred domestically [in that] they were both sold and purchased in the United States," "do not fall under the second [domestic-transaction] prong of *Morrison*" where the defendants are not "involved in those transactions in any way." In reaching this decision, the court reasoned that "nowhere in *Morrison* did the Court state that U.S. securities laws could be applied to a foreign company that only listed its securities on foreign exchanges but whose stocks are purchased by an American depositary bank on a foreign exchange and then resold as a different kind of security (an ADR) in the United States." *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *10 (C.D. Cal. May 20, 2016). The court further observed that applying the federal securities laws in such a circumstance would be "inconsistent with the spirit and law of *Morrison*" since it "would create essentially limitless reach of § 10(b) claims because even if the foreign defendant attempted to keep its securities from being sold in the United States, the independent actions of depositary banks selling on OTC markets could create liability." *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *10 (C.D. Cal. May 20, 2016). The court instead held that *Morrison* requires a plaintiff to establish that the defendant performed some "affirmative act in connection with securities sales in the United States" for the federal securities laws to apply against that defendant. *Stoyas v. Toshiba Corporation*, No. CV 15-04194 DDP (JCx), 2016 WL 3563084, at *11 (C.D. Cal. May 20, 2016).

672 *See Viking Global Equities, LP v. Porsche Automobile Holdings SE*, 101 A.D.3d 640 (1st Dep't 2012).

672.1 *In re Volkswagen "Clean Diesel" Marketing, Sales Practices, & Products Liability Litigation*, 3:15-md-02672-CRB, 2017 WL 66281 (N.D. Cal. Jan. 4, 2017). For a discussion of ADR sponsorship and the different levels of ADRs, *see* § 3.04 [1][b].

673 *Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd.*, Fed. Sec. L. Rep. ¶96,269 (D. Colo. Mar. 31, 2011).

674 *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988 (S.D.N.Y. June 10, 2011). Goldman settled the matter with the SEC without admitting or denying liability.

675 *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988, *8–9 (S.D.N.Y. June 10, 2011).

676 *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988 (S.D.N.Y. June 10, 2011) (citing *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Company*, 753 F. Supp. 2d 166, 177 (S.D.N.Y. 2010) (emphasis added).

677 The case is also notable because the district court held that *Morrison* also applies to claims under the Securities Act, given the Supreme Court's statement in *Morrison* that "the Exchange Act and the Securities Act share the same focus on domestic transactions." *SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988, *14 (S.D.N.Y. June 10, 2011) (citing *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869, 2885 (2010)) (internal quotation marks omitted). However, it refused to dismiss the SEC's § 17(a) claims against Tourre because that section "applies not only to the 'sale' but also to the ' *offer*… of any securities or any security-based swap agreement,'" and because the SEC had sufficiently alleged that Goldman's offer to sell securities to the foreign investors had originated within the United States. *See SEC v. Goldman Sachs & Co.*, No. 10-CV-3229 (BSJ), 2011 WL 2305988, *15 (S.D.N.Y. June 10, 2011) (citing 15 U.S.C. § 17(a)).

678 Fed. R. Civ. P. 26(b)(1). *See generally* Fed. R. Civ. P. 26 for the presumptive limitations on discovery in federal courts.

679 § 21D(b)(3)(B) of the Exchange Act and § 27(b)(1) of the Securities Act. This provision acts to suspend even the preliminary disclosure normally required in federal courts, such as the informal exchange of names and addresses of parties likely to have discoverable information and copies or descriptions of documents relevant to disputed facts. *See Medhekar v. U.S. District Court*, 99 F.3d 325, 328 (9th Cir. 1996) (*per curiam*) (noting that the Litigation Reform Act requires plaintiffs to "stand or fall based on [their] actual knowledge" rather than permitting "fishing expeditions" after filing aimed at revealing possible sources of liability).

680 After enactment of the Litigation Reform Act, there was a migration of securities claims to state courts, where, in some instances, discovery was permitted to proceed even pending resolution of motions to dismiss. Plaintiffs increasingly began to file parallel actions in federal and state courts, in the hope that the discovery obtained in the state court proceedings would enable them to better prosecute their federal court claims. In order to stop plaintiffs from using such tactics to circumvent the Litigation Reform Act's discovery stay provisions, Congress enacted § 101 of SLUSA, which enables federal courts to stay discovery in private state court actions when it is "necessary in aid of [the court's] jurisdiction, or to protect or effectuate its judgments." Courts have been willing to exercise their authority under this provision. *See, e.g.*, *In re Cardinal Health, Inc.*, 365 F. Supp. 2d 866, 877 (S.D. Ohio 2005); *In re Crompton Corp.*, Fed. Sec. L. Rep. CCH ¶93,330 (D. Conn. July 22, 2005).

681 *See, e.g.*, *In re Marc Rich & Co., A.G.*, 707 F.2d 663 (2d Cir.), *cert. denied*, 463 U.S. 1215 (1983); *United States v. First National City Bank*, 396 F.2d 897 (2d Cir. 1968); *Westinghouse Electric Corp. v. Rio Algom, Ltd. (In re Uranium Antitrust Litigation)*, 480 F. Supp. 1138 (N.D. Ill. 1979).

682 *See, e.g.*, *Minpeco, S.A. v. ContiCommodity Service, Inc.*, 116 F.R.D. 517 (S.D.N.Y. 1987); *Laker Airways, Ltd. v. Pan American World Airways Ltd.*, 607 F. Supp. 324 (S.D.N.Y. 1985).

683 The procedures for taking a deposition in a foreign country pursuant to the Federal Rules of Civil Procedure are set forth in Fed. R. Civ. P. 28(b).

684 The European Commission objected, for example, to the Sarbanes-Oxley Act's requirements that foreign accounting firms register with the Public Company Accounting Oversight Board (the "PCAOB") and therefore produce upon request all audit papers to the PCAOB and the SEC, on the grounds that this requirement generally duplicates existing local requirements and conflicts with European confidentiality statutes. *See* Carrie Johnson, *Accounting Panel, SEC Backs Registry for Foreign Auditors*, WASHINGTON POST, Apr. 1, 2003 (stating the SEC's rejection of the European Commission's suggestions to allow foreign auditors one year to register and warning British accountants that disclaimers of liability they used on European audit opinions were unacceptable for U.S. reports); Alan Obsorn, *EU Urges U.S. to Reconsider Rules*, ACCOUNTANCY AGE, June 12, 2003 (urging the United States not to apply the PCAOB process to

foreign auditors); Letter from the European Commission to Mr. Jonathan G. Katz, Secretary, SEC (Dec. 20, 2002) (same). The PCAOB does not require such firms to disclose information if such disclosure would violate foreign law. SEC Release No. 34-47990 (June 5, 2003). Recently, however, an SEC administrative law judge entered an initial decision censuring the Chinese affiliates of several accounting firms for refusing to provide audit work papers relating to U.S. issuers, and denying those affiliates the privilege of practicing or appearing before the SEC for a period of six months, notwithstanding the companies' argument that they were prevented from providing those materials by Chinese national security laws. *See In the Matter of BDO China Dahua CPA Co. Ltd., et al.*, SEC Initial Decision Release No. 553 (Jan. 22, 2014). Those affiliates subsequently agreed to pay $500,000 each to settle the dispute and also agreed to follow procedures designed to ensure that the SEC is able to obtain audit documents from them in the future. *See* Michael Rapoport, *SEC, Big Four Accounting Firms in China Settle Dispute*, WALL ST. J., Feb. 6, 2015.

685 *See, e.g.*, *Société Nationale Industrielle Aérospatiale v. U.S. District Court*, 482 U.S. 522 (1987); *Société Internationale Pour Participations Industrielles et Commerciales, S.A. v. Rogers*, 357 U.S. 197 (1958); *First American Corp. v. Price Waterhouse LLP*, 154 F.3d 16, 22 (2d Cir. 1998); *In re Sealed Case*, 825 F.2d 494 (D.C. Cir.), *cert. denied*, 484 U.S. 963 (1987); *CFTC v. Nahas*, 738 F.2d 487 (D.C. Cir. 1984); *United States v. First National City Bank*, 396 F.2d 897 (2d Cir. 1968); *Compagnie Francaise D'Assurance Pour Le Commerce Extérieur v. Phillips Petroleum Co.*, 105 F.R.D. 16, 31 (S.D.N.Y. 1984).

686 *See, e.g.*, *First American Corp. v. Price Waterhouse LLP*, 154 F.3d 16, 22 (2d Cir. 1998); *SEC v. Euro Security Fund*, No. 98-CV-7347 (DLC), 1999 WL 182598 (S.D.N.Y. Apr. 1, 1999).

687 *See, e.g.*, *In re Sealed Case*, 825 F.2d 494 (D.C. Cir.), *cert. denied*, 484 U.S. 963 (1987).

688 *See Doe v. United States*, 487 U.S. 201 (1988); *United States v. Davis*, 767 F.2d 1025 (2d Cir. 1985).

689 *See* 28 U.S.C. § 1781 ("transmittal of letter rogatory or request").

690 The Hague Convention was opened for signature on March 18, 1970 and signed by the United States on October 7, 1972. It is reprinted in 28 U.S.C. § 1781.

691 The Convention also permits specified alternative procedures for taking evidence that go beyond the basic Central Authority mechanism. These alternative procedures generally involve the taking of evidence by consuls or court-appointed commissioners.

692 *See Société Nationale Industrielle Aérospatiale v. U.S. District Court*, 482 U.S. 522 (1987).

693 The regime under which discovery is sought can have important implications not only for the procedures by which the discovery is obtained, but the scope of discoverable material. Because different discovery protocols involve different bodies of substantive law, material that is discoverable under one regime (*i.e.*, under the Federal Rules) may not be discoverable under another regime (*i.e.*, Hague Convention or letters rogatory). This tension is particularly acute in disputes over discovery of potentially privileged materials. *See, e.g.*, *Tulip Computers International B.V. v. Dell Computer Corp.*, 254 F. Supp. 2d 469, 475 (D. Del. 2003); *Renfield Corp. v. E. Remy Martin & Co., S.A.*, 98 F.R.D. 442 (D. Del. 1982).

694 MLATs are currently in force between the United States and Anguilla (United Kingdom), Antigua & Barbuda, Argentina, Australia, Austria, Bahamas, Barbados, Belgium, Belize, Brazil, British Virgin Islands (United Kingdom), Canada, Cayman Islands (United Kingdom), Cyprus, Czech Republic, Dominica, Egypt, Estonia, France, Greece, Grenada, Hong Kong, Hungary, Israel, Italy, Jamaica, Korea (South), Latvia, Liechtenstein, Lithuania, Luxembourg, Mexico, Montserrat (United Kingdom), Morocco, the Netherlands, Panama, Philippines, Poland, Romania, the Russian Federation, St. Kitts & Nevis, St. Lucia, St. Vincent and the Grenadines, Spain, South Africa, Switzerland, Thailand, Trinidad & Tobago, Turkey, Turks & Caicos Islands (United Kingdom), the United Kingdom and Uruguay. U.S. Department of State Index of MLATS and Other Agreements Currently in Force. The United States has also entered into Mutual Legal Assistance Agreements by executive agreement with countries such as the People's Republic of China and Nigeria.

695 For example, the United States has entered into Financial Information Exchange Agreements ("FIEAs"), which facilitate the exchange of information relating to currency transfers, with Colombia, Ecuador, Mexico, Panama, Paraguay, Peru and Venezuela. The U.S. Department of Treasury's Financial Crimes

Enforcement Network ("FinCEN") has entered into separate Memoranda of Understanding with similar units in 18 other countries. *See* Bureau for International Narcotics and Law Enforcement Affairs, International Narcotics Control Strategy Report 2006: Treaties and Agreements.

696 *See, e.g.*, *In re Dominick & Dominick Inc.*, SEC Release No. 34-29243 (May 29, 1991); *SEC v. Katz*, SEC Litigation Release No. 11185 (Aug. 7, 1986); *see also* § 14.03[3][i] for a further discussion of MOUs.

697 By way of example, the absence of dual criminality in the MLAT with Switzerland led the SEC to negotiate its first MOU with Switzerland, which dealt with cooperation in insider trading cases. *See* Memorandum of Understanding with the Government of Switzerland, Release No. 2, 1982 SEC LEXIS 2631 (Aug. 31, 1982).

698 *See generally* The SEC Speaks in 2001, INTERNATIONAL AFFAIRS, at 977, 994–5 (Practising Law Institute 2001); John K. Carroll & Herbert S. Washer, *Globalization Comes to Law Enforcement*, N.Y.L.J., July 10, 2000. The SEC has entered into MOUs (or comparable agreements in treaty form) with Argentina, Australia, Brazil, Canada, Chile, China, Costa Rica, Egypt, the European Community, France, Germany, Hong Kong, Hungary, India, Indonesia, IADB/UNECLAC, Israel, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Portugal, Russia, Singapore, South Africa, Spain, Sweden, Switzerland and the United Kingdom.

699 *See* SEC Index of Cooperative Arrangements with Foreign Regulators, http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml (last updated July 22, 2010).

700 *See* IOSCO List of Signatories to the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information.

U.S. Regulation of the International Securities and Derivatives Markets, § 11.11, SPECIAL LITIGATION ISSUES RELATING TO DERIVATIVES

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 § 11.11 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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This section briefly surveys certain issues that have arisen in suits concerning transactions in derivative instruments. For purposes of this section, "derivatives" or "derivative instruments" are instruments of the type described in U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 2. As discussed in U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 2, whether or not a particular derivative instrument is characterized by a court as, for example, a "security" or a "commodity future" or an "option contract," will determine the law to be applied to a dispute involving the derivative instrument, [701] and, perhaps, the court (*e.g.*, federal or state) where the litigation will proceed.

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When a party faces losses on a derivatives transaction, the result may be a lawsuit (usually against the counterparty—often a dealer) aimed at recovering the losses. In a situation where the party transacted on margin, a drop in value in the derivative may result in a margin call, which if unmet leads to the liquidation of the instrument or account. In such a situation, the dealer may bring suit to recover any deficiencies. Regardless of the posture of the litigation, issues that recur in these litigations, and that are surveyed in this section, include: first, enforceability; second, the relevance of a counterparty's sophistication and contractual disclaimers as defenses to a fraud, breach of duty or other tort claim; third, the scope of duties imposed by law on counterparties to derivatives transactions; fourth, the valuation of derivatives; and fifth, the treatment afforded derivatives in bankruptcy proceedings.

[1] Enforceability

[a] Local Law Considerations

In a cross-border dispute the parties may disagree over the threshold question of what law applies to the contract or conduct at issue. Differences in the laws of the relevant jurisdictions may have outcome-determinative effects. The ISDA Master Agreement allows the parties to set forth their choice of law in the Schedule to the Agreement, and as a general matter, sophisticated parties usually include choice of law provisions in agreements to which they are party. Such provisions, depending on their drafting, may not definitively resolve all of the choice of law questions that arise in a lawsuit. For example, in *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, [702] the Schedule to the ISDA Master Agreement signed by the parties specified New York law as governing "[t]his agreement." The Second Circuit held, however, that this choice of law clause did not reach the extracontractual setoff rights at issue in the dispute. [703] The court applied New York's choice of law analysis and held that Thai law was applicable because Thailand had the most significant contacts with the dispute, as well as a strong governmental interest in ensuring the stability of its economy following the late-90s financial crisis in Southeast Asia. [704] Under Thai

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law, the defendant was entitled to the setoff rights it had exercised without any equitable reduction in the setoff amount. [705]

Even where the scope of the contractual choice of law clause is not disputed, a party may invoke the law of a relevant jurisdiction to argue that the derivative instrument is unenforceable under local law. In *Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, [706] Lehman entities entered into foreign exchange swaps and forwards with a Chinese conglomerate that produced over $50 million in losses. When Lehman sued the defendants on various contractual theories, the defendants asserted as an affirmative defense that the agreements at issue were not enforceable because they were entered into without the relevant license required by Chinese law. [707] Even though the governing ISDA Master Agreement chose New York law, the court found the place of performance of the contracts to have been China, and explained that a "contract that is illegal in its place of performance is unenforceable in New York if the parties entered into the contract with a view to violate the laws of that other jurisdiction." [708] The court ruled that it was an issue of fact for trial whether the parties entered into the agreement with a view to violate Chinese law, and so denied summary judgment. [709]

The enforceability of jury trial waivers, which are typically included in ISDA Master Agreements, may be affected by the choice of forum in which to litigate. The California Supreme Court held in *Grafton Partners, L.P. v. Superior Court* that jury trial waivers are unenforceable in that jurisdiction. [710] However, arbitration clauses were held to be enforceable because they had been specifically authorized by the legislature. [711] A pre-litigation contractual agreement to the appointment of a judicial referee is also specifically authorized in California. [712] Parties facing any possibility of litigation in California should consider including such clauses in their agreements, as many adverse judgments and unfavorable settlements of derivatives disputes have resulted from jury verdicts or the threat of adverse jury verdicts.

[b] Transactional Authority

A party to a litigation may argue that a derivative is unenforceable either because it was *ultra vires* or otherwise entered into by an individual or entity lacking the authority to engage in the transaction. [713] So long as the challenged party had actual, implied or apparent authority to engage in the transaction, a challenge to enforceability based on lack of authority generally should fail. [714] An important exception to this doctrine exists in the case of certain entities created by statute, such as municipalities. For these entities, apparent authority is an insufficient basis on which to enforce contractual obligations where the entity lacks actual authority. [715] A party's actual authority to engage in certain types of transactions is by and large a legal question governed by relevant law, regulation or the party's constituent instruments. For example, in derivatives litigation involving Orange County, counsel for Orange County argued that its treasurer

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had acted *ultra vires* when he entered into reverse repurchase agreements in connection with billions of dollars in collateralized mortgage obligations ("CMOs") and CMO derivatives. This position was based on a California constitutional provision limiting a county's ability to create excess indebtedness or liability. The argument was rejected, however, based on California precedent holding that the debt limit is measured at the outset of a transaction and not in the period following the transaction. [716] Since each of the investments had been potentially profitable at the outset, they were not *ultra vires* assumptions of excessive debt. [717]

On the other hand, arguments that a party possessed apparent authority to enter into a transaction will involve an examination of the facts and circumstances of the particular case to determine whether, for example, the third party relied on some act or statement of the principal, cloaking the agent with the authority to take the action now challenged. [718]

[c] Possibility of Reclassification of a Derivatives Transaction

Occasionally issues arise between parties over the proper characterization of derivatives transactions. [719] A party to a litigation may seek to avoid an obligation by arguing that a derivatives transaction, or the combined effect of several derivatives transactions, actually constitutes an alternative transaction type (*e.g.*, a loan). [720] In *Mahonia Ltd. v. JP Morgan Chase Bank*, [721] defendant WestLB AG ("WestLB") sought to avoid a claim on a letter of credit it issued to Mahonia Ltd. ("Mahonia"), a special purpose vehicle established to participate in a series of energy derivative transactions with JP Morgan Chase Bank ("Chase") and an Enron subsidiary ("ENAC"). The economic effect of these derivative transactions was that $350 million was paid by Chase to Mahonia and

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by Mahonia to ENAC in September 2001, and ENAC was obliged, approximately six months later, to pay approximately $356 million to Chase. [722] WestLB argued that the figure of $356 million was calculated specifically by reference to rates of interest that would accrue on a $350 million loan over the relevant period. As a result, WestLB argued, related derivatives transactions constituted a loan of $350 million with an effective annual interest rate of 3.44%. WestLB maintained that these transactions should thus have been accounted for as a loan and that the composite transaction and its nature as a loan should have been disclosed prior to WestLB's issuance of the letter of credit. [723] The court rejected WestLB's attempt to recharacterize the derivatives transactions as a loan, finding that "other individual characteristics" of the derivatives transactions, including the existence of price and performance risks, supported Enron's accounting of them as "price risk management activities." [724]

[2] The Requirement of Reasonable or Justified Reliance

Whether brought under federal or state law, a fraud claim requires the plaintiff to establish "reasonable" or "justified" reliance on the alleged misrepresentation or omission. Claims of reliance on misstatements or omissions that might be deemed reasonable for an ordinary investor may not be reasonable where the investor is sophisticated. In this context, institutional investors and individuals with high net worth or investment experience are considered "sophisticated" in light of their knowledge, experience and ability to conduct due diligence of the risks inherent in investment. [725]

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In *Société Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Brothers International Ltd.*, the court found unpersuasive plaintiff's contention that it had relied on defendants' materially incomplete disclosure, because plaintiff was itself a sophisticated institutional investor and the governing contract contained a disclaimer of representations of value. [726] Indeed a buyer's sophistication may result in a transaction being exempted from particular regulations altogether, such as exemptions from the CEA for certain transactions with individuals whose assets exceed $10 million. The NASD Conduct Rules currently note that certain securities broker due diligence requirements do not apply to customers with assets greater than $50 million. [727]

Not only are the parties who transact in derivatives generally "sophisticated," but relevant documentation, *e.g.*, the ISDA Master Agreement and confirmations, contains representations specifically attesting to the parties' sophistication and general non-reliance on statements (written or oral) outside the documents. The parties also represent that they are not relying on communications by their counterparty as investment advice or recommendations to transact. [728] A party entering into a properly drafted agreement is therefore limited in its ability to claim fraud based on alleged misstatements outside the documents, when those statements are inconsistent with express contractual provisions, because such reliance would be unreasonable as a matter of law. [729]

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Even without explicit disclaimers, courts typically reject claims that a party reasonably relied on statements in marketing materials, or other "sales talk," that is contradicted by the relevant prospectus or offering document. [730]

A contractual disclaimer, however, is generally enforceable only if it "tracks the substance of the alleged misrepresentation." [731] In other words, the disclaimer must cover the alleged misrepresentation or omission. In *Caiola v. Citibank, N.A.*, the court held that the disclaimers in the ISDA Agreement and the confirmations governing the specific trades at issue did not cover alleged assurances made to the plaintiff since the disclaimers stated only in general terms that neither party would rely "on any advice, statements or recommendations (whether written or oral) of the other party." [732] According to the court, the disclaimer did not preclude plaintiff from claiming that it was misled by Citibank's alleged assurance that the parties' existing relationship would remain unchanged and that Citibank would continue to act as a hedging counterparty following Citibank's merger with the Travelers Group. [733]

[3] Primary/Secondary Liability Theories

[a] Limitation on Duties

In typical derivatives transactions, executed on a principal basis by arm's-length counterparties or on an agency basis for a nondiscretionary account, there is no general fiduciary duty that exists between the parties. [734] A fiduciary duty

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arises only where the customer has delegated discretionary trading authority to the broker, or if it is otherwise provided for in the governing agreements. [735] In nondiscretionary trading accounts, where the customer retains full responsibility for trading decisions, the parties ordinarily agree and understand that the broker has narrowly defined duties that begin and end with each transaction. [736] Any special duty owed by the broker to the client in a nondiscretionary trading account can arise only if "special circumstances" transform the broker-client relationship. Such "special circumstances" include a client with impaired faculties, a closer than arm's-length relationship between the client and broker or a client who is so lacking in sophistication that *de facto* control is deemed to rest in the broker. [737] Superior knowledge on the part of the dealer, standing alone, will generally be insufficient to create the "special circumstances" necessary for the court to impose fiduciary obligations. As the court explained in *Procter & Gamble v. Bankers Trust*, [738] the fact that Bankers Trust had "superior knowledge in the swaps transactions" did not convert the parties' "business relationship to one in which fiduciary duties are imposed."

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In *De Kwiatkowski v. Bear, Stearns & Co.*, a wealthy investor sued his broker for, *inter alia*, negligence and breach of fiduciary duty relating to currency futures trading. [739] A jury awarded De Kwiatkowski $111.5 million in damages. In reversing the verdict, the Second Circuit ruled that no "special circumstances" existed warranting holding the broker liable as a fiduciary or in negligence even though the broker performed substantial advisory functions with respect to the size, placement and timing of complex transactions that made and lost hundreds of millions of dollars within a span of a few months. [740] The Second Circuit noted that while the circumstances of the broker-client relationship were unusual, there was nothing in the relationship to render the client investor dependent on the broker. Instead, the investor's sophistication (his wealth, expertise and huge appetite for risk) precluded him from arguing that he was dependent on his broker's advice. [741] *De Kwiatkowski* has been followed by other courts in dismissing, on a motion directed to the pleadings, a fiduciary duty claim against a broker where the client employed "sophisticated traders of its own who made the decisions regarding the nature and timing of trades." [742] A party may nevertheless plead "special circumstances," or raise an issue of fact concerning the existence of such circumstances, sufficient to survive a pleadings motion or a motion for summary judgment. [743]

[b] Aiding and Abetting Liability

Where a dealer has not had direct contact with a party seeking to bring suit on a derivatives transaction, a theory of secondary liability may be the basis for a claim. [744] Under New York law, the elements of an aiding and abetting fraud claim are: (i) existence of a fraud, (ii) defendant's knowledge of the fraud and

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(iii) that defendant provided substantial assistance to advance the fraud's commission. [745] The elements of an aiding and abetting breach of fiduciary duty claim are: (i) breach by a fiduciary of obligations to another, [746] (ii) that defendant knowingly induced or participated in the breach and (iii) damages. [747]

[i] *Knowledge*

To satisfy the knowledge requirement, New York law requires that an aider/abettor have "actual knowledge" of the underlying fraud or breach of fiduciary duty. [748] Plaintiffs cannot meet the knowledge requirement by arguing for application of the lesser standard of recklessness. [749] However, in order to state a claim the defendant's knowledge and intent need only be "averred generally," and a plaintiff can satisfy the *scienter* pleading requirement when "circumstances indicating conscious behavior by the defendant" or a clear opportunity and a motive to aid the wrong is identified. [750] Pursuit of ordinary economic goals is not enough to support a claim of a motive for aiding and abetting. [751]

While a stricter *scienter* standard may apply to an aider or abettor rather than to a primary perpetrator since the "‘ *scienter* requirement scales upward when activity is more remote,’" the *scienter* requirement need not be more exacting where there are allegations that the primary and secondary actors worked closely together. [752] In the context of derivatives transactions—where dealers can play various roles in structuring, selling, valuing and lending with respect to any particular instrument—courts may be tempted to conclude that the dealer was not a distant actor in connection with the challenged transactions. [753] The court may therefore conclude that a plaintiff need not satisfy any heightened pleading requirement to plead *scienter* on the part of an alleged aider and abettor.

[ii] *Substantial Assistance and Participation*

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Under New York law, the meanings of "substantial assistance" and "participation" are synonymous, [754] and exist where a defendant "‘affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed.’" [755] Inaction is "actionable participation only when the defendant owes a fiduciary duty directly to the plaintiff." [756] Substantial assistance can take many forms, but the closer the activities are to ordinary course trading, the less likely that a determination will be made that substantial assistance was provided. [757] Courts will consider in totality an alleged aider and abettor's conduct in deciding whether it "substantially assisted" the primary wrongdoers. [758]

There is no bright line rule for what is or is not substantial assistance, and so the practitioner must review available precedent for the most comparable fact patterns. "Substantial assistance" has been found in cases where a bank "insisted" that the wrongdoer continue the fraud; [759] where brokers allegedly provided false "performance marks" to a CMO fund manager for dissemination to investors; [760] and where brokers participated in the creation of a document that contained false statements, while others substantially assisted the fraud by reviewing and approving the document, devising the marketing and financial scheme for the fraud, and engaging in "atypical" financing transactions. [761] "Substantial assistance" has not been found where a clearing broker merely clears trades, even if the trades are for a primary broker who is acting in violation of the law; [762] for a failure to enforce margin requirements or for continuing to

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execute trades despite margin violations; [763] and for executing trades in order to reduce "a loan of money under margin." [764]

[4] Valuation Issues

Litigation may also result following the termination of a trading relationship and the liquidation or settlement of open positions. The liquidating party may commence litigation to recover any shortfalls resulting from the liquidation; the liquidated party may challenge the propriety of the liquidation and claim damages.

The propriety of the liquidation will be analyzed according to the terms of the governing documentation. [765] The court will analyze whether the liquidating party adhered to any procedures required by the relevant contracts. [766] The valuation methodology set forth in the ISDA Master Agreement has evolved over successive versions of the Agreement, with the 2002 ISDA Master Agreement providing for a single measure of damages standard, "Close-out Amount." This standard replaces the "Market Quotation" and "Loss" methodologies contained in the 1992 ISDA Master Agreement, which were subject to criticism and arguably misapplied by courts. [767]

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Given that the law of all states implies in every contract a covenant of good faith and fair dealing, the court may also enquire whether the liquidating party acted in good faith in conducting the liquidation, including in exercising any discretion granted it under the relevant contract. [768] The 2002 ISDA Master Agreement specifically provides that the party determining the "Close-out Amount" for a terminated transaction "will act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result." The Agreement allows flexibility to the party making the valuation determination, listing nonexclusive sources of "relevant information" (*e.g.*, quotations and market data) and types of "commercially reasonable procedures" that may be utilized. [769]

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If a party is held to have breached the relevant agreement, damages must be determined. As in any other breach of contract situation, the damages are "determined by the loss sustained or the gains prevented at the time and place of breach." [770] As a practical matter, this standard means that the litigation of damages would involve a "battle of experts" concerning the value that should have been obtained in a proper liquidation of the derivative instrument in question. [771]

[5] Bankruptcy Issues

Upon the filing of a petition for relief under the Bankruptcy Code (the "Code"), the Code automatically stays proceedings against the debtor and prevents parties, without permission of the bankruptcy court, from acquiring or obtaining assets of the debtor. [772] The Code provides exceptions to the automatic stay for certain actions in connection with protected contracts. Thus, the Code does not stay:

- the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right … under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract,

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  forward contract or securities contract, or of any contractual right … to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts; or [773]
- the exercise by a repo participant or financial participant of any contractual right … under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right … to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements. [774]

In addition, the Code excludes certain categories of contracts (*e.g.*, securities contracts, forward contracts, commodities contracts, repurchase agreements, swap agreements and certain margin and settlement payments) from the reach of a trustee's avoidance powers and so allows for transfers under such contracts without concern that the transfer can be set aside as a fraudulent transfer or preference. For transfers made prior to the bankruptcy petition, and except for fraudulent transfers as defined in Code § 548(a)(1) (transfers made within two years of the petition date with actual intent by the broker to hinder or defraud), [775] a trustee may not avoid: (i) margin or settlement payments made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency, [776] (ii) margin or settlement payments made by or to a repo participant or financial participant in

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connection with a repurchase agreement, [777] (iii) transfers by or to a swap participant or financial participant, under or in connection with any swap agreement, [778] or (iv) transfers made by or to a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered by the master netting agreement. [779] Additionally, the Code

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generally protects contractual rights of liquidation in securities contracts, commodities contracts, forward contracts, repurchase agreements and swap agreements. [780]

The Code limits the reach of the bankruptcy trustee's avoidance powers as applying only against "the initial transferee" of the transfer sought to be avoided, "the entity for whose benefit such transfer was made," or "any immediate or mediate transferee of such initial transferee." [781] The Code does not define "initial transferee." The Seventh Circuit in *Bonded Financial Services Inc. v. European American Bank* held that a bank that received a check for the benefit of a customer's checking account was simply an intermediary and not an initial transferee because it had no "dominion over" the property at issue. [782] Recently, the Seventh Circuit characterized its approach to the initial transferee questions as "track[ing] the function of the bankruptcy trustee's avoiding powers: to recoup money from the real recipient of preferential transfers" and held that the trustee of a securitization vehicle did qualify as an initial transferee because a charge against the trustee would "draw from the corpus of the trust, not from [the trustee's] corporate assets." [783]

A party should be aware of a counterparty's status under the Bankruptcy Code; if a counterparty qualifies as a "stockbroker," it cannot be a debtor eligible for reorganization under Chapter 11 [784] and is instead subject to liquidation under the Securities Investor Protection Act ("SIPA") and Chapter 7 of the

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Code. [785] A stockbroker's "customers" have an important priority over other creditors under the Code, including most derivatives creditors. [786] In *In re Refco, Inc.*, the bankruptcy court found an off-shore unregulated financial intermediary, RCM, to be a stockbroker. [787] The court found that the Code's definition of broker-dealer, which includes the language "engaged in the business of effecting transactions in securities with the general public," [788] did not exclude a broker-dealer who traded with sophisticated parties. [789] Many of the derivatives creditors who had contracted with RCM had failed to appreciate that they were doing business with a stockbroker.

A decision in 2010 also cast doubt on the enforceability of provisions in swap agreements (or documents referenced in swap agreements) that purport to modify the priority of payments made from a derivative structure following an event of default caused by a bankruptcy filing by a counterparty (or an entity related to a counterparty). In *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Brothers Holdings Inc.) ("Dante")*, [790] the court found that the *ipso facto* provisions of the Code [791] invalidated contractual clauses that subordinated the counterparty's priority payment as a result of the counterparty's or its parent entity's filing for bankruptcy. However, the *Dante* court itself recognized that its decision was "unprecedented" and potentially "controversial," and subsequent decisions have questioned its reasoning. [792]

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A more recent decision arising out of the Lehman Brothers bankruptcy held that, while the enforcement of payment priority provisions in swap agreements may violate the *ipso facto* provisions of the Code, such distributions are nonetheless protected by a safe harbor in § 560 of the Code, [793] provided that the contractual provisions are either explicitly part of a swap agreement or incorporated into a swap agreement. [794] The court explained that, under recent Second Circuit precedent, a "broad and literal interpretation" must be given to the Code's safe harbors, and § 560 protects the right to "liquidation," which includes enforcement of provisions that modify the priority of payments and distributions of proceeds following that modification. [795] In a related decision, the court held that the right to "liquidation" protected by the safe harbor in § 560 also extended to protect the methodology specified in a swap agreement for carrying out that liquidation (*i.e.*, the method for determining the amount due and payable to the parties). [796]

Footnotes

701 U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, §§ 2.02–2.07.

702 *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 332 (2d Cir. 2005).

703 *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 335 (2d Cir. 2005). The court did note that if the Master Agreement and Schedule had created the setoff right, the choice-of-law clause would reach the dispute and New York law would be applicable. *Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 336 (2d Cir. 2005).

704 *See Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 336–39 (2d Cir. 2005).

705 *See Finance One Public Company Limited v. Lehman Brothers Special Financing, Inc.*, 414 F.3d 325, 344–45 (2d Cir. 2005).

706 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118 (S.D.N.Y. 2000).

707 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 139 (S.D.N.Y. 2000). The defendants also argued that because the transactions were illegal under Chinese law, they were invalid under Article 8 of the International Monetary Fund's Articles of Agreement, which states: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member." *See* Articles of Agreement of the International Monetary Fund, Dec. 27, 1945, 60 Stat. 1401, 2 U.N.T.S. 39, art. VIII, sec. 2(b). The court did not reach this argument, however, because China did not become subject to Article 8 until after the transactions at issue in the litigation. *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 143 (S.D.N.Y. 2000).

708 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 138 (S.D.N.Y. 2000).

709 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 143 (S.D.N.Y. 2000). The matter ultimately settled after 39 days of trial. At the time of settlement (June 12, 2002), the case was the oldest ongoing U.S. derivatives litigation, having commenced in 1994.

710 *See Grafton Partners, L.P. v. Superior Court*, 116 P.3d 479 (Cal. 2005). Pre-litigation jury trial waivers are also unenforceable in Georgia and North Carolina. *See Bank South, N.A. v. Howard*, 444 S.E.2d 799 (Ga. 1994); N.C. GEN. STAT. § 22B-10 (2006).

711 *Grafton Partners, L.P. v. Superior Court*, 116 P.3d 479 (Cal. 2005).

712 *Grafton Partners, L.P. v. Superior Court*, 116 P.3d 479 (Cal. 2005).

713 The English case *Hazell v. Hammersmith and Fulham LBC*, [1992] 2 A.C. 1, brought significant attention to the power of the *ultra vires* defense. There, the House of Lords (the highest court in England) held that a

London borough council acted outside the scope of its borrowing authority, as authorized under the Local Government Act of 1972, when it entered into various swap transactions; the House of Lords consequently voided the contracts.

714 *See Three Valleys Municipal Water District v. E.F. Hutton & Co. Inc.*, 116 F.3d 486 (9th Cir. 1997) (finding that the municipalities had delegated their investment authority to the person signing the contracts and holding that "a delegation of authority to bind a municipality to arbitration need not be express, but rather can be implied from a grant of authority to contract"); *Community College District No. 508 v. Westcap Government Securities*, No. 94 C 1920, 1994 WL 530849 (N.D. Ill. Sept. 29, 1994) (where community college district board had given its treasurer the authority to invest on its behalf, the executed investment agreements and their arbitration provisions were valid and enforceable).

715 *See* RESTATEMENT (THIRD) OF AGENCY § 2.03 cmt. g (2006).

716 *See In re County of Orange v. Fuji Securities, Inc.*, 31 F. Supp. 2d 768, 776–79 (C.D. Cal. 1998).

717 *See In re County of Orange v. Fuji Securities, Inc.*, 31 F. Supp. 2d 768, 785 (C.D. Cal. 1998). The court in *Orange County* implied that *quantum meruit* might exist as a basis for relief on the part of the County in light of the fact that the County's acts were not *ultra vires*.

718 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 148 (S.D.N.Y. 2000) (alleged agent lacked actual and inherent authority because his acts were unauthorized and illegal, but a question of fact remained as to whether apparent authority could be established).

719 *See generally* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 2.

720 In addition to private litigation, there have been governmental actions surrounding the proper characterization of derivatives transactions. In a July 2003 civil action against J.P. Morgan Chase & Co. in the Southern District of Texas, for example, the SEC based its fraud argument on the theory that "[t]he structural complexity of [the derivatives] transactions had no business purpose aside from masking the fact that, in substance, they were loans." *SEC v. J.P. Morgan Chase & Co.*, SEC Litigation Release No. 18252 (July 28, 2003).

721 *Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm).

722 *Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm).

723 *Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm). WestLB argued that Mahonia and Chase were party to a conspiracy with Enron to devise a scheme to enable Enron to illegally account for the "loan." Such accounting, WestLB argued, breached U.S. securities law and hence WestLB was entitled not to pay the demand on the letter of credit it issued. WestLB also argued that it was fraudulently induced to rely on the apparent financial strength of Enron and the apparent legality of the purpose behind the derivative transactions when issuing the letter of credit.

724 *See Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] EWHC 1938 (Comm). Justice Cooke rejected WestLB's invitation to "collapse" into a single lending transaction what were in his view separate swap transactions between, respectively, Chase and Mahonia, Mahonia and ENAC, and ENAC and Chase. The court found the transactions to be "independent" of each other, noting the lack of "offsetting, netting or cross-default provisions between them." Justice Cooke noted that had he found the accounting to be illegal, he "would have accepted [WestLB's] contention that the [letter of credit] was directly tied to the illegal purpose since it was an important part of the scheme which was to give rise to the unlawful accounting."

725 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 497 (S.D.N.Y. 2001). The *Primavera* court rejected the argument that institutional investors who lacked specific experience with CMOs were "unsophisticated" for purposes of a claim that they were defrauded in connection with investments in a CMO hedge fund.

726 *See Société Nationale d'Exploitation Industrielle des Tabacs et Allumettes v. Salomon Brothers International Ltd.*, 268 A.D.2d 373, 374 (App. Div. 2000); *see also Lazard Fréres & Co. v. Protective Life*

Insurance Co., 108 F.3d 1531, 1543 (2d Cir. 1997) ("As a substantial and sophisticated player in the bank debt market, [defendant] was under a further duty to protect itself from misrepresentation.").

727 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1309 n.14 (2d Cir. 2002) (citing 7 U.S.C. §§ 1a(12), 2; NASD Conduct Rules, Rule 2310, NASD MANUAL). The NASD rule will be withdrawn upon the effectiveness of a successor FINRA rule, which provides that the exemption will not apply unless the broker-dealer has reason to believe that "the institutional customer is capable of evaluating investment risks independently." FINRA Rules, Rule 2111, FINRA MANUAL (effective July 9, 2012).

728 Language regarding investor nonreliance, investor sophistication and the nonfiduciary and nonadvisory role of the counterparty is commonly found in either the ISDA Master Agreement or accompanying Schedules. Such language usually varies little from the language provided in Part 4(m)(i) of the model ISDA Schedule to the 2002 Master Agreement. Parties can include additional representations in separately negotiated confirmations.

729 *See St. Matthew's Baptist Church v. Wachovia Bank National Association*, No. Civ. A. 04-4540 (FLW), 2005 WL 1199045, at *5–7 (D.N.J. May 18, 2005) (dismissing claims of fraudulent and negligent misrepresentation in connection with interest rate swap unwind fee given contractual language regarding requirement to pay such fee); *Republic National Bank v. Hales*, 75 F. Supp. 2d 300, 315 (S.D.N.Y. 1999), *aff'd sub nom*. *HSBC Bank USA v. Hales*, 4 F. App'x 15 (2d Cir. 2001) ("[R]easonable reliance is precluded when an express provision in a written contract contradicts a prior alleged oral representation in a meaningful fashion."); *see also Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940 (2d Cir. 1998) (finding no reasonable reliance in light of "warnings in the Offering Circulars and Prospectuses regarding the risks associated with the investments and the provisions in those documents disavowing any outside representations").

730 *See, e.g.*, *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993) ("An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth.").

731 *Caiola v. Citibank, N.A.*, 295 F.3d 312, 330 (2d Cir. 2002); *Grumman Allied Industries, Inc., v. Rohr Industries, Inc.*, 748 F.2d 729, 735 (2d Cir. 1984).

732 *Caiola v. Citibank, N.A.*, 295 F.3d 312, 330 (2d Cir. 2002). The *Caiola* court relied on the rule cited in *Manufacturers Hanover Trust Co. v. Yanakas*, 7 F.3d 310, 316 (2d Cir. 1993), that a valid disclaimer provision "must contain explicit disclaimers of the particular representations that form the basis" of the fraud claim. *See also Hunt v. Alliance North American Government Income Trust, Inc.*, 159 F.3d 723, 728–29 (2d Cir. 1998) (a general disclaimer that a fund's hedging strategy might fail was insufficient to defeat a fraud claim based on an allegation that the fund had, in fact, no opportunity to hedge at all).

733 *Caiola v. Citibank, N.A.*, 295 F.3d 312, 319 (2d Cir. 2002).

734 Even where there is no fiduciary duty, applicable securities law requires that information disclosed not contain any material misstatement or omission. Parties to a contract also are bound by a duty to deal fairly and in good faith. *See Procter & Gamble v. Bankers Trust*, 925 F. Supp. 1270, 1289–91 (S.D. Ohio 1996) (even though no fiduciary duty existed between the parties, the defendant had a "duty to disclose material information to plaintiff before the parties entered into the swap transactions and in their performance, and also a duty to deal fairly and in good faith"). In *In re BT Securities Corp.*, SEC Release No. 33-7124 (Dec. 22, 1994), the SEC found that Bankers Trust violated § 17(a) of the Securities Act and §§ 10(b) and 13(a) of the Exchange Act, and Rules 10b-5, 13a-1 and 12b-20 thereunder, because BT Securities misrepresented the value of derivatives sold to the company, Gibson Greetings. The SEC found that Gibson lacked the expertise to value derivatives accurately and relied on the numbers provided by BT Securities to decide whether to purchase more derivatives and to prepare financial statements.

735 *See Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940–41 (2d Cir. 1998); *see also St. Matthew's Baptist Church v. Wachovia Bank National Association*, No. Civ. A. 04-4540 (FLW), 2005 WL 1199045, at *10 (D.N.J. May 18, 2005) (finding no fiduciary duty as a matter of law, relying, *inter alia*, on language in Schedule and swap documentation disclaiming the existence of a fiduciary

relationship); *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, No. 03-2217 MI/V, 2005 WL 1329538, at *5 (W.D. Tenn. May 10, 2005) (in dispute involving an interest rate swap, dismissing on summary judgment a fiduciary duty claim by a bank borrower since Tennessee law does not impose fiduciary duties on the bank-customer relationship and the borrower failed to produce "any evidence that Defendants entered into a written agreement with Plaintiff to act as a fiduciary"). While the plaintiff in *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, abandoned its breach of fiduciary duty claim on appeal, it challenged the dismissal of its negligence claim on the grounds that "it [had] asserted a claim for 'professional negligence' for which a duty to exercise reasonable care arises as a matter of law." *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, 447 F.3 923, 932 (6th Cir. 2006). The Sixth Circuit rejected this argument on the grounds that the plaintiff "ha[d] not demonstrated that defendants owed it a legal duty to advise it on the appropriateness of the swap transactions distinct from the agency and breach of fiduciary duty claims." *Power & Telephone Supply Company, Inc. v. Suntrust Banks, Inc.*, 447 F.3 923, 933 (6th Cir. 2006).

736 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002). These duties include, for example, diligence and competence in executing the client's trade orders.

737 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1306 (2d Cir. 2002).

738 *Procter & Gamble v. Bankers Trust*, 925 F. Supp. 1270, 1289 (S.D. Ohio 1996).

739 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1295–96 (2d Cir. 2002).

740 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1307–09 (2d Cir. 2002).

741 *See De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1309 (2d Cir. 2002).

742 *See, e.g.*, *Salomon Brothers International Ltd. v. Eagle Cayman International, L.P.*, No. 601872/01 (N.Y. Sup. Ct. Mar. 13, 2003).

743 *See Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co.*, 179 F. Supp. 2d 118, 150–52 (S.D.N.Y. 2000) (finding questions of fact as to the "true nature" of the parties' "very strong relationship" were sufficient to deny defendant's motion for summary judgment).

744 Plaintiffs who wish to bring claims of aiding and abetting fraud must now rely on state law theories of liability, in light of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), which found no private right of action to exist for aiding and abetting a violation of § 10(b) of the Exchange Act, and *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), which significantly limited the circumstances under which a secondary actor could be found liable for a violation of § 10(b) in a private cause of action. *See also* § 11.04[2][b][ii] for discussion of the different tests for determining when a secondary actor may be found to be primarily liable.

745 *See Wight v. BankAmerica Corp.*, 219 F.3d 79, 91 (2d Cir. 2000); *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001).

746 The New York Court of Appeals has held that the fiduciary duties owed by a limited partnership's attorney to that entity do not extend to the limited partners. *Eurycleia Partners L.P. v. Seward & Kissel, LLP*, 12 N.Y.3d 553, 561–62 (2009).

747 *See In re Sharp International Corp.*, 403 F.3d 43, 49–50 (2d Cir. 2005); *Kolbeck v. LIT America, Inc.*, 939 F. Supp. 240, 245 (S.D.N.Y. 1996), *aff'd*, 152 F.3d 918 (2d Cir. 1998).

748 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 494 (S.D.N.Y. 2001).

749 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 495 n.28 (S.D.N.Y. 2001).

750 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 494–95 (S.D.N.Y. 2001).

751 *See Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 494–95 (S.D.N.Y. 2001).

752 *Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 508 (S.D.N.Y. 2001) (quoting *ABF Capital Management v. Askin Capital Management, L.P.*, 957 F. Supp. 1308, 1331 n.5 (S.D.N.Y. 1997)) (reciting allegations that brokers aided and abetted the purported fraud by hedge fund manager).

753 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 508 (S.D.N.Y. 2001).

754 *Kolbeck v. LIT America, Inc.*, 939 F. Supp. 240, 247 (S.D.N.Y. 1996) (defining "participation" as "substantial assistance").

755 *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 470 (S.D.N.Y. 2001) (quoting *Nigerian National Petroleum Corp. v. Citibank, N.A.*, No. 98-CV-4960 (MBM), 1999 WL 558141, at *8 (S.D.N.Y. July 30, 1999)).

756 *Kolbeck v. LIT America, Inc.*, 939 F. Supp. 240, 247 (S.D.N.Y. 1996).

757 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 511 (S.D.N.Y. 2001) ("Executing transactions, even ordinary course transactions, can constitute substantial assistance under some circumstances, such as where there is an extraordinary motivation to aid in the fraud.").

758 *Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 511 (S.D.N.Y. 2001) ("Where there is evidence of various types of activities by an alleged aider and abetter going to [the substantial assistance] issue, the evidence should be considered together.").

759 *Cromer Finance Ltd. v. Berger*, 137 F. Supp. 2d 452, 471 (S.D.N.Y. 2001) (citing *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 803 (3d Cir. 1978)).

760 *ABF Capital Management v. Askin Capital Management, L.P.*, 957 F. Supp. 1308, 1329–30 (S.D.N.Y. 1997).

761 *In re Gas Reclamation, Inc. Securities Litigation*, 659 F. Supp. 493, 504 (S.D.N.Y. 1987).

762 *Greenberg v. Bear, Stearns & Co.*, 220 F.3d 22, 29 (2d Cir. 2000), *cert. denied*, 531 U.S. 1075 (2001).

763 *See Dillon v. Militano*, 731 F. Supp. 634, 637, 639 (S.D.N.Y. 1990); *Stander v. Financial Clearing & Services Corp.*, 730 F. Supp. 1282, 1286–87 (S.D.N.Y. 1990).

764 *Ross v. Bolton*, 639 F. Supp. 323, 327 (S.D.N.Y. 1986).

765 *See Drexel Burnham Lambert Products Corp. v. MCorp*, Civ. A. No. 88C-NO-80 (SCDP), 1989 WL 16981 (Del. Super. Ct. Feb. 23, 1989) (upholding on summary judgment Drexel's calculation of "Agreement Value damages" where contract made such calculation "conclusive in the absence of manifest error" and counterparty proffered no evidence of any error); *see also The First National Bank of Chicago v. Ackerley Communications, Inc.*, No. 94 Civ. 7539 (KTD), 2001 WL 15693 (S.D.N.Y. Jan. 8, 2001), *aff'd*, 28 F. App'x 61 (2d Cir. 2002) (applying the plain terms of the agreement in determining whether the plaintiff had properly exercised its option to extend the swap agreement).

766 In *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 300–02 (S.D.N.Y. 1998), the court declined to apply Article 9's "commercial reasonableness" standard to a liquidation of instruments subject to repurchase agreements, holding that such agreements qualify as "purchase and sales" and not "secured loans" subject to UCC Article 9. If the agreements governing repurchase transactions are ambiguous as to whether the transactions are loans or purchases and sales, courts will look to extrinsic evidence. *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 543 (S.D.N.Y. 2001).

767 Given the frequency with which disputes involving derivatives settle prior to litigation, there is little case law applying the Market Quotation and Loss methodologies. Two such cases— *Peregrine Fixed Income Ltd (In Liquidation) v. Robinson Department Store Plc*, [2000] Lloyd's Rep. Bank. 304 (QBD (Comm Ct)), and *Enron Australia Finance Pty Ltd v. Integral Energy Australia*, [2002] NSWSC 753—were roundly criticized for failing to reflect market practice or the parties' intent as evidenced by the relevant agreements. In *Peregrine*, the court rejected as "commercially unreasonable" the Market Quotation calculation of the nondefaulting party, and instead required the parties' settlement amount to be calculated under the ISDA Loss methodology. The court reached this conclusion despite the fact that the nondefaulting party—which the court recognized as the best party to determine commercial reasonableness—had not judged the result under the Market Quotation methodology as commercially unreasonable. Many believe that *Peregrine* should be limited to its unique facts: Peregrine had performed its side of the bargain and had it not appointed provisional liquidators and triggered a default, the other party, in financial distress itself, would likely have defaulted and hence Peregrine would have been in the position of determining whether the result produced by the Market Quotation method was reasonable. In *Enron Australia Finance*, the court

noted that although it is commonly understood in the derivatives market that the defaulting party bears the cost of the bid/offer spread, the electricity market in Australia was so illiquid that the bid/offer spread was artificially wide and, accordingly, the Market Quotation, measure of damages produced a commercially unreasonable result. The court then imposed a measure of damages not contemplated by either party. *See also Peregrine Fixed Income Limited v. JP Morgan Chase Bank*, No. 05 Civ. 4351 (RMB) (THK), 2006 U.S. Dist. LEXIS 8766, at *4–8 (S.D.N.Y. Jan. 26, 2006) (denying defendant's motion to dismiss on the grounds that the ISDA Master Agreement was ambiguous as to the date when market quotations should be obtained); *High Risk Opportunities HUB Fund (In Liquidation) v. Credit Lyonnais*, M-2375, M-2463, 2006 N.Y. App. Div. LEXIS 7788 (June 6, 2005) (unpublished opinion) (good faith clause of the ISDA Master Agreement was violated when the defendant "interfered with the Market-makers' independence in valuing the [non-deliverable forward contracts] as of the termination date").

768 *See* Restatement (Second) of Contracts § 205 (1981); *see also Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 305 (S.D.N.Y. 1998) (citing *Dalton v. Educational Testing Service*, 87 N.Y.2d 384, 389, 663 N.E.2d 289, 292, 639 N.Y.S.2d 977, 979 (1995)). A party, however, may not use the implied covenant to create additional, unbargained-for rights otherwise not present in the contract. *See JPMorgan Chase Bank, N.A. v. IDW Group, LLC*, No. 08-Civ-9116 (PGG), 2009 WL 321222, at *4 (S.D.N.Y. Feb. 9, 2009) ("An implied covenant of good faith and fair dealing, however, arises out of the known reasonable expectations of the other party which arise out of the agreement entered into. The covenant does not create duties which are not fairly inferable from the express terms of that contract." (citation omitted)); *Granite Partners, L.P. v. Bear, Stearns & Co., Inc.*, 17 F. Supp. 2d 275, 306 (S.D.N.Y. 1998).

769 The flexible approach to valuation reflected in the 2002 ISDA Master Agreement replaced the 1992 ISDA Master Agreement's "Market Quotation" definition, which required a terminating party to obtain five dealers' price quotes for closed-out transactions. The definition of Market Quotation was deemed unworkable during times of market dislocation or liquidity shocks, when market participants, struggling to maintain their own positions, are limited in their ability to value trades for others. *See* Counterparty Risk Management Policy Group, *Improving Counterparty Risk Management Practices* 42–43 (June 1999) (criticizing the definition of Market Quotation).

770 *Lucente v. IBM Corp.*, 310 F.3d 243, 262–63 (2d Cir. 2002). The court in *Lucente* specifically rejected the use in contract cases of the "highest intermediate value rule" (where damages are determined by identifying the highest intermediate value of a security between the commission of the alleged wrongful act and some reasonable time thereafter). *See also The First National Bank of Chicago v. Ackerley Communications, Inc.*, No. 94 Civ. 7539 (KTD), 2001 WL 15693 (S.D.N.Y. Jan. 8, 2001), *aff'd*, 28 F. App'x 61 (2d Cir. 2002) (dismissing plaintiff's damages claim because no evidence was proffered to establish lost profit or to demonstrate any attempt to mitigate damages).

771 *See Primavera Familienstifung v. Askin*, 130 F. Supp. 2d 450, 522–30 (S.D.N.Y. 2001) (reviewing admissibility of proposed expert testimony concerning CMO values and valuation procedures).

772 *See* 11 U.S.C. § 362. In 2005, the President signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Pub. L. No. 109-8, 119 Stat. 23. Title IX of the Act clarifies the treatment of certain financial contracts upon the insolvency of a counterparty and in so doing makes amendments to the Bankruptcy Code, the Securities Investor Protection Act, the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation Improvement Act of 1991, and the Federal Credit Union Act. Most significant among these amendments is the expansion of the Code's definitions of "forward contract," "repurchase agreement," "swap agreement," "commodity contract" and "securities contract" to account for relevant market developments and the introduction of the phrase "or any other similar agreement" to allow for greater flexibility in the Act's application. Additionally, the counterparties that are eligible for financial contract protection are expanded to include "financial participants"—defined as entities engaged in a certain minimum gross dollar value of enumerated transactions. The Code also now provides for bilateral "cross-product" netting across financial contracts and clarifies the measurement of damages in the event of a debtor's rejection of a financial contract.

773 11 U.S.C. § 362(b)(6).

774 11 U.S.C. § 362(b)(7).

775 A trustee cannot avoid transfers where the transferees took "for value and in good faith." 11 U.S.C. § 548(c). "To establish a lack of 'good faith,' on the part of securities customers under § 548(c)… the trustee must show that the customer either actually knew of the broker's fraud or 'willfully blinded' himself to it." *Picard v. Avellino*, 469 B.R. 408, 412 (S.D.N.Y. 2012). "Willful blindness" is a "subjective standard"—the investor must "intentionally choose[] to blind himself to the 'red flags' that suggest a high probability of fraud." *Picard v. Katz*, 462 B.R. 447, 455 (S.D.N.Y. 2011), *abrogated on other grounds in Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 513 B.R. 437 (S.D.N.Y. 2014).

776 *See* 11 U.S.C. § 546(e). In *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011), the Second Circuit recently held that § 546(e) prevented a bankruptcy trustee from avoiding payments made to retire the debtor's unsecured commercial paper prior to maturity. The court reasoned that the definition of "settlement payments" under § 741(8) of the Bankruptcy Code is broad, and that the phrase "commonly used in the securities industry" in that definition was meant to act as a catchall and not to impose any requirement that a transaction be a common occurrence. The court also noted that there was nothing in § 741(8) or anywhere else in the Bankruptcy Code to support imposing a requirement that a payment result in the acquisition of title to a security, as opposed to merely retiring debt, to be properly considered a "settlement payment." Extending this reasoning further, the Second Circuit held that "settlement payments" made by a broker pursuant to a contract to buy or sell securities cannot be avoided under § 546(e) even if the broker did not actually trade securities or the contract did not specify information about the securities to be traded. *See In re Bernard L. Madoff Inv. Secs. LLC*, 773 F.3d 411 (2d Cir. 2014). *See also In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009) (§ 546(e) prevented bankruptcy trustee from avoiding payments made to corporate debtor's shareholders in connection with leveraged buyout of privately held securities); *In re Olympic Natural Gas Co.*, 294 F.3d 734 (5th Cir. 2002) (§ 546(e) prevented bankruptcy trustee from avoiding settlement payments by debtor to forward contract merchant); *Nagel v. ADM Investor Services, Inc.*, 217 F.3d 436, 441 (7th Cir. 2000) (contract is forward if eventual delivery of commodity is reasonably assured). But see *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996) (§ 546(e) inapplicable when payments not "made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency" (quoting 11 U.S.C. § 546(e)); *Grafton Partners, L.P. v. Circle Trust F.B.O.*, 321 B.R. 527, 529 (B.A.P. 9th Cir. 2005) (holding that nonpublic transactions in illegally unregistered securities are not "commonly used in the securities trade" and therefore are avoidable preferences ineligible for protection under § 546(e)); *American Tissue, Inc. v. Donaldson, Lufkin & Jenrette*, 351 F. Supp. 2d 79 (S.D.N.Y. 2004) (denying defendant's motion to dismiss a fraudulent conveyance claim in part because it doubted whether the payments qualified as "transfer payments" under § 546(e) because their disruption did not threaten a market collapse). In the context of a Ponzi scheme, a trustee can avoid settlement payments, even those made before the two year petition date, when the trustee shows that the transferee had "actual knowledge" of the Ponzi scheme, meaning "actual knowledge of, and indeed participation in, every aspect of [the] scheme." *See, e.g.*, *Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 2013 WL 1609154 (S.D.N.Y. Apr. 15, 2013).

777 *See* 11 U.S.C. § 546(f); *In re Hamilton Taft & Co.*, 114 F.3d 991, 993 (9th Cir. 1997) (meaning of "settlement payment" includes initial transfer of securities to stockbroker under reverse repurchase agreement); *In re Bevill, Bresler, & Shulman Asset Management Corp.*, 878 F.2d 742, 752–53 (3d Cir. 1989) (meaning of "settlement payment" includes transfer of securities under repurchase agreement); *In re David*, 193 B.R. 935, 941 (Bankr. C.D. Cal. 1996) (payments applied principally to settle debts for securities purchases or margin calls are either "settlement payments" or "margin payments" even if they cannot be traced to specific settlements or margin calls).

778 *See* 11 U.S.C. § 546(g); *Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 505 B.R. 135 (S.D.N.Y. 2013) (holding that redemption payments transferred pursuant to a swap agreement could not be avoided, and giving a broad interpretation for transfers "in connection with" any swap agreement, as used in the Bankruptcy Code); *In re National Gas Distributors, LLC*, 556 F.3d 247, 250–59 (4th Cir. 2009) (holding that

gas supply contracts qualified as non-avoidable swap agreements as "commodity forward agreements," by giving a broad reading to the term "commodity forward agreements" as used in the Bankruptcy Code); *In re Interbulk, Ltd.*, 240 B.R. 195, 202 (Bankr. S.D.N.Y. 1999) (attachment of counterparty's assets to enforce the obligations owed under a swap agreement is not a transfer "under" that swap agreement and therefore not protected by § 546(g)). Unlike "settlement payments" pursuant to § 546(e), "the issue of knowledge is irrelevant to the application of section 546(g)." *Secs. Inv. Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC*, 505 B.R. 135, 142 n.6 (S.D.N.Y. 2013).

779 *See* 11 U.S.C. § 546(j).

780 *See* 11 U.S.C. §§ 555, 556, 559, 560; *In re Enron Corp., Debtors*, 306 B.R. 465, 473 (Bankr. S.D.N.Y. 2004) (§ 560 protects rights triggered by *ipso facto* clauses in swap agreements but does not permit a nondefaulting counterparty to terminate a swap agreement because of some other reason); *In re Thrifty Oil Co.*, 322 F.3d 1039, 1048–54 (9th Cir. 2002) (affirming bankruptcy court holding that a claim for damages upon termination of an interest rate swap agreement was not a disallowable claim for unmatured interest); *In re Amcor Funding*, 117 B.R. 549, 551 (D. Ariz. 1990) (contractual rights protected under § 555 include only those based on the debtor's insolvency); *In re R.M. Cordova International, Inc.*, 77 B.R. 441, 448–49 (Bankr. D.N.J. 1987) (termination of contracts for purchase of coconut oil protected by § 556); *but see Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Brothers Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (limiting § 560 to clauses that address "liquidation, termination or acceleration," but not "the alteration of rights as they exist," and holding that § 560 only applies to provisions contained in a swap agreement itself and not to provisions contained in agreements referenced by a swap agreement).

781 11 U.S.C. § 550(a).

782 *Bonded Financial Services Inc. v. European American Bank*, 838 F.3d 890, 893–94 (7th Cir. 1988).

783 *Paloain v. LaSalle Bank, N.A.*, 619 F.3d 688, 692 (7th Cir. 2010).

784 11 U.S.C. § 109(d).

785 Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1686 (codified as amended at 15 U.S.C. §§ 78aaa to 78lll) (liquidation of SEC-regulated stockbrokers); Subchapter III of Chapter 7, 11 U.S.C. §§ 741 to 753 (liquidation of unregulated stockbrokers).

786 11 U.S.C. § 752.

787 Transcript of Record at 271, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. Jan. 20, 2006).

788 11 U.S.C. § 101(53A)(B).

789 Transcript of Record at 273–74, *In re Refco, Inc.*, No. 05-60006 (Bankr. S.D.N.Y. Jan. 20, 2006).

790 *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.* (*In re Lehman Brothers Holdings Inc.*), 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

791 *See* 11 U.S.C. §§ 365(e)(1) ("[A]n executory contract of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on the commencement of a case under this title."); 11 U.S.C. § 541(c)(1)(B) (providing that a debtor's interest in property "becomes property of the estate notwithstanding any provision in an agreement that is conditioned on the commencement of a case under this title and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.").

792 *See, e.g.*, *Lehman Brothers Special Financing Inc. v. BNY Mellon Corp.* (*In re Lehman Brothers Holdings Inc*.), Nos. 11 Civ. 2404(CM), 11 Civ. 2784(CM), 2011 WL 2651771, at *4 (S.D.N.Y. June 21, 2011), vacated on other grounds, 697 F.3d 74 (2d Cir. 2012) (noting that the *Dante* decision "has never been tested in a higher court").

793 11 U.S.C. § 560 ("The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title … shall not be stayed, avoided, or otherwise limited by

operation of any provision of this title or by order of a court … in any proceeding under this title.")

794 *Lehman Brothers Special Financing Inc. v. Bank of America National Association* (*In re Lehman Brothers Holdings Inc.*), No. 10-03547 (SCC), 2016 WL 3621180, at *17–21 (Bankr. S.D.N.Y. June 28, 2016).

795 *Lehman Brothers Special Financing Inc. v. Bank of America National Association* (*In re Lehman Brothers Holdings Inc.*), No. 10-03547 (SCC), 2016 WL 3621180, at *18, *20 (Bankr. S.D.N.Y. June 28, 2016) (quoting *Picard v. Ida Fishman Revocable Trust* (*In re Bernard L. Madoff Inv. Sec. LLC*, 773 F.3d 411, 419 (2d Cir. 2014)).

796 *Lehman Brothers Holdings Inc. v. Michigan State Housing Development Authority* (*In re Lehman Brothers Holdings Inc.*), 502 B.R. 383, 393–94 (Bankr. S.D.N.Y. 2013).

U.S. Regulation of the International Securities and Derivatives Markets, § 12.01, 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 § 12.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The threshold question in determining the applicability of the U.S. securities laws to a particular transaction is whether "securities" are involved. It is not always clear whether an instrument at issue is a security for purposes of these laws.

[1] Statutory Definitions of “Security”

The Securities Act defines the term "security" as:

unless the context otherwise requires … any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. [1]

Likewise, the Exchange Act defines "security" as:

unless the context otherwise requires … any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of

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interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. [2]

As can be seen, the definitions are essentially lists of categories of instruments. [3] Although the definitions differ slightly, the Supreme Court has consistently held that the respective definitions are essentially the same. [4] The Investment Company Act, the Advisers Act and state codes also contain definitions of security. [5] The Investment Company Act's definition of security, discussed in Chapter 15, is virtually identical to the definition in the Securities Act. Nevertheless, it has been interpreted by the SEC to include a broader group of instruments than is included in the Securities Act's definition or the Exchange Act's definition, such as, for example, certificates of deposit, commercial loans,

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interaffiliate loans and other loans made in the ordinary course of business by a financial or commercial institution. [6]

The definitions of "security" in the Acts list instruments (*e.g.*, stock, notes and bonds) that are within the public's general understanding of what a security is. However, even these instruments are not always securities for purposes of the Acts. The definitions are each prefaced by "unless the context otherwise requires" and courts have used this preface to exclude certain instruments listed in the definitions.

In addition, each definition contains the general catchall of any "instrument commonly known as a security." This catchall has been viewed as an indication that Congress intended courts to include instruments not specifically listed.

The process of determining the scope of the definitions of security in the Acts has been evolutionary. Throughout the process, the SEC has urged a broad interpretation of the definitions on the theory that a broad interpretation will better protect investors. Congress has occasionally amended the definitions. [7] Finally, since the enactment of the definitions in 1933 and 1934, substantial case law has developed concerning whether or not particular instruments are included. [8]

[2] Analysis of Certain Instruments Under the U.S. Securities Laws

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U.S. courts, in considering whether a particular instrument is a security, have interpreted the definitions with the understanding that "Congress intended the …[Acts] to cover those instruments ordinarily and commonly considered to be securities in the commercial world." [9] The courts have not articulated a single analytic framework for determining when an instrument would "ordinarily and commonly [be] considered to be a security." Instead, their analyses have varied depending on the type of instrument in question. [10] In the cases discussed below, the courts have analyzed certain notes, stock, certificates of deposit, investment contracts, loan participations, and options on securities in light of the definitions of security. However, these cases, as well as the related statutory and agency interpretations, illustrate the major issues that courts have considered when determining whether an instrument is a security.

[a] Notes

In *Reves v. Ernst & Young*, [11] the Supreme Court addressed the issue of when a "note" is a security. Guidance with respect to this issue was needed because, in spite of the inclusion of "note" in the definitions of "security" in the Acts, it was widely accepted that many notes were not securities. "Note" is a broad term with meanings ranging from an exchange-listed bond to a note given by a consumer purchasing a home appliance on credit. [12] The former is generally considered to be a security. The latter generally is not.

Before *Reves*, lower courts in the United States adopted a variety of approaches for determining whether a particular note was a security. Some courts, including the Eighth Circuit in its decision reviewed by the Supreme

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Court in *Reves*, adopted a test that first asked whether a note could be viewed as an "investment contract," as a precondition to its being classified as a security. Under this test, a note is a security if it evidences an investment in a common enterprise, with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. [13] Other courts inquired into whether the note was issued in an "investment" as opposed to a "commercial" or "consumer" context. Only the former was regarded as a security entitled to the protection of the securities laws. [14] A third approach of lower U.S. courts before *Reves*, the so-called "family resemblance" test that the Supreme Court adopted in a modified form in *Reves*, begins the analysis with a presumption that any note having a term of more than nine months is a security. [15] This presumption, however, was rebuttable and certain types of notes are recognized as self-evidently not securities. Thus, an issuer could rebut the presumption that a note is a security if it could show that its note had a strong "family resemblance" to a previously recognized judicial exception to the definition of a security.

As adopted by the Supreme Court in *Reves*, the list of instruments commonly denominated as "notes" that nonetheless are not regarded as securities includes, but is not limited to:

> [(i) a] note delivered in a consumer financing, [(ii) a] note secured by a mortgage on a home, [(iii) a] short-term note secured by a lien on a small business or some of its assets, [(iv) a] note evidencing a ‘character’ loan to a bank customer, [(v)] short-term notes secured by an assignment of accounts receivable, [(vi) a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of a customer of a broker, it is collateralized) [and (vii)] notes evidencing loans by commercial banks for current operations. [16]

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Recognizing that types of notes not listed under the test may also not be "securities," the Court listed four additional factors to be considered under the "family resemblance" test:

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security."
>
> Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment."
>
> Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction.
>
> Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Acts [*i.e.*, Securities Act and Exchange Act] unnecessary. [17]

In applying these standards to the facts of the *Reves* case, the Court had "little difficulty" in deciding that the notes at issue were securities. [18] In *Reves*, an agricultural cooperative (the "Co-op") sold promissory notes that were widely distributed, uncollateralized and uninsured. The proceeds of the notes were used for working capital. The Co-op advertised the notes as investments. After the Co-op went bankrupt, some of the noteholders sued the Co-op's auditors under the fraud provisions of the Exchange Act. The auditors claimed that they could not be found liable because the notes were not securities. [19]

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The Court concluded that the Co-op's notes were securities because, under the family resemblance test, (i) the notes did not closely resemble any of the seven listed types of notes that are not considered securities and (ii) a consideration of the notes in light of the four additional factors described above also indicated that the notes were securities. [20]

The Court rejected any resemblance to the listed types of notes that are not considered securities without any detailed discussion, but did discuss the application of the four factors. The Court held that the notes were likely to be securities in light of the first factor because the seller's motivation was to raise capital for its business and the buyer's motivation was to earn a profit in the form of interest. [21] It reached the same conclusion when it considered the notes in light of the second factor, finding that, even though the notes were not traded on an exchange, their distribution to a "broad segment of the public" was enough "to establish the requisite ‘common trading.’" [22] In considering the third factor, the Court found that the public would have perceived that the notes were securities because they had been advertised as "investments" and "there were no countervailing factors that would have led a reasonable person to question this characterization." [23] Finally, in considering the fourth factor, the Court found "no risk-reducing factor to suggest that [the notes were] not in fact securities." [24]

[b] Stock

In sharp contrast to the later approach the Supreme Court took in *Reves*, requiring a thorough analysis of the instrument, the Court had previously held in *Landreth Timber Co. v. Landreth* [25] that "stock" is generally a security for purposes of the Acts regardless of the economic circumstances surrounding its sale. In *Landreth Timber*, a family sold a timber mill to a small group of investors in a negotiated transaction. The sale was structured as a transfer of stock in the mill

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rather than as the sale of the business' assets. After the business failed, the buyers sued the sellers, alleging violation of the registration provisions of the Securities Act and fraud under the Exchange Act. The sellers argued that the Acts should not apply to the sale of 100% of the stock of a closely held corporation because the economic realities of the transaction indicate that the buyers were entrepreneurs taking over a business rather than passive investors in securities. [26] The Court rejected the sellers' arguments. The Court held that the mill's common stock was the paradigm of a security and that, therefore, there is no need to look beyond the characteristics of the instrument to the underlying economic realities of the transaction. [27] The Court's holding suggests that common stock, in whatever context it is sold, is *per se* a security within the ambit of the Acts so long as it "bears stock's usual characteristics[, including] (i) the right to receive dividends contingent upon an apportionment of profits; (ii) negotiability; (iii) the ability to be pledged or hypothecated; (iv) the conferring of voting rights in proportion to the number of shares owned; and (v) the capacity to appreciate in value." [28]

Thus, anyone who sells a U.S. business through a sale of stock should be aware that the U.S. securities laws will apply to the transaction. If the business

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subsequently fails or does not perform as well as expected, the buyer may sue the seller under Rule 10b-5 under the Exchange Act for fraud in connection with the purchase or sale of securities, claiming, for example, that the seller failed to disclose material risks of the business. [29]

[c] Bank Certificates of Deposit

As discussed above, the Supreme Court in *Reves* indicated that risk-reducing factors may indicate that a note is not a security. Such risk-reducing factors were the basis for the Court's prior decision in *Marine Bank*, where it ruled that a certificate of deposit issued by a federally regulated and insured bank is not a security. [30] In *Marine Bank* the plaintiffs purchased from the defendant bank a certificate of deposit (the "CD"), which was insured by a federal agency. The plaintiffs purchased the CD in order to pledge it to the bank to secure the bank's loan to a company. In exchange for the pledge, plaintiffs were to receive a percentage of the company's profits. Plaintiffs alleged that the bank had represented to them that the loan would be used as working capital for the company. In fact, the company was deeply indebted to the bank and to others, and the loan was principally used to pay off such indebtedness. When the company became bankrupt soon thereafter, plaintiffs sued, claiming *inter alia* that the bank had violated the fraud provisions of the Exchange Act because it had actively solicited their purchase and pledge of the CD without disclosing either the great indebtedness of the company or that the bank intended to repay itself from the proceeds of the loan. [31]

The Court held that the Exchange Act did not apply to the transaction because the CD was not a security. Although the Court noted that the CD shared several characteristics with other long-term debt obligations that are commonly viewed as securities, it concluded that the federal insurer virtually guaranteed payment on the CD and that holders of certificates of deposit issued by federally regulated banks thus are "abundantly protected under the federal banking laws." The Court held that federal insurance and regulation rendered it unnecessary to subject issuers of bank certificates of deposit to liability under the fraud provisions of the Acts. [32]

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The Court explicitly left open the possibility that certificates of deposit may be securities in other contexts. [33] This has led to speculation as to whether unconventional certificates of deposit are subject to the Acts. For example, the denomination of the CD in *Marine Bank* exceeded the applicable federal insurance limit by $10,000, [34] yet the Court held that federal insurance and regulation rendered application of the Acts unnecessary. It is the subject of speculation whether the Court would have reached the same conclusion if the denomination of the CD had been several times the federal insurance limit (federal insurance is currently limited to $250,000 per account). [35]

The *Marine Bank* analysis has prompted other U.S. courts to rule that certificates of deposit issued by state-regulated or foreign government-regulated institutions are also not securities subject to the Acts, although these extensions of *Marine Bank* have not been considered by the Supreme Court. [36] These courts declined to limit the *Marine Bank* exclusion to federally regulated institutions, with the Ninth Circuit concluding instead that it should apply whenever "a bank is sufficiently well regulated that there is virtually no risk that insolvency will prevent it from repaying the holder of one of its certificates of deposit in full." [37] In contrast, the Fourth Circuit reasoned that the *Marine Bank* holding must turn on the "comprehensiveness" of federal deposit insurance rather than its effectiveness; otherwise a court would have to inquire in each case "whether, at the time a given CD is issued, the regulatory and insurance schema in place was sufficiently well managed or well positioned … potentially lead[ing] to a court concluding that the same bank could one year issue a CD that was not a security, but that due to a change in effectiveness of the regulatory, insurance protection, the next year an identical CD would be a security." [38] The SEC argued against the extension of *Marine Bank* to foreign government regulated institutions in the Ninth Circuit case, stating both that Congress did not intend this result (as evidenced by the requirement in the Securities Act that foreign governments and central banks must register obligations sold to the public in the United States) and that such an application of *Marine Bank* would require a case-by-case analysis of the adequacy of foreign regulation (which the SEC and the courts are not well equipped to perform). [39]

[d] Investment Contracts

Investment contracts are included in the statutory definitions as a separate category of instruments that are securities. In *SEC v. W.J. Howey Co.*, [40] the Supreme Court defined investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." [41] *Howey* was one of the Supreme Court's first pronouncements on the definition of "security" under the U.S. securities laws. [42] After the decision, the *Howey* definition of investment contract (the so-called "*Howey* test") was invoked by some lower courts for decades to determine whether other instruments are securities. As discussed above, the Supreme Court has since held that in certain other contexts (*e.g., Reves*, with respect to notes, and *Landreth Timber*, with respect to stock), other tests apply. However, *Howey* can be expected to remain a potent analytical

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tool with respect to instruments to which no other tests have been held to apply. [43]

In *Howey*, defendants sold to plaintiffs parcels of land in citrus fruit groves and service contracts under which defendants cultivated and developed the groves, including harvesting and marketing the crops. The service contracts had terms of several years and gave defendants complete possession over the land and full discretion and authority over cultivation, harvesting and marketing. The purchasers had no right to enter their land and no right to specific fruit. Rather, the fruit from all land controlled by defendants was pooled and plaintiffs received checks at harvest time representing a proportionate share of profits. Purchasers generally resided far from the groves and lacked the equipment and experience needed to cultivate, harvest and market citrus products. [44]

Defendants argued that the land sales and service contracts were separate transactions and did not involve securities subject to the Securities Act. The Supreme Court disagreed. It held that plaintiffs invested money in a "common enterprise" (the citrus groves) with the expectation of receiving profits through the efforts of defendants. The transaction was an investment contract subject to the Securities Act, analogous to any other transaction (*e.g.*, purchase of common stock) where "investors provide the capital and share in the earnings and profits [and] the promoters manage, control and operate the enterprise." [45]

This "investment contract" concept has since been used as a catchall term under which claimants have argued that transactions that would otherwise not involve securities should be subject to the Acts. For example, in *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [46] the Second Circuit held, relying on a footnote in *Marine Bank* that explicitly left open the possibility that certificates of deposit could be securities under some circumstances, [47] that federally insured certificates of deposit were securities when they

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were sold in a manner that satisfied the Supreme Court's test for determining what constitutes an "investment contract." [48] The defendants sold certificates of deposit to plaintiffs under a marketing program (the "Program") in which defendants screened a variety of bank or savings and loan issuers against insolvency risks and negotiated rates of return on behalf of investors. Defendants also maintained a secondary market in certificates of deposit sold under the Program so that investors who wished to liquidate their investments would not have to incur penalties imposed by issuers for early redemption. Plaintiffs claimed that the defendants' promotional materials for the Program failed to disclose defendants' commissions from the issuers and thus violated the fraud provisions of the Acts. [49]

The *Gary Plastic* court noted that under *Marine Bank* a conventional certificate of deposit purchased from an issuing bank is not a security. However, the court held that certificates of deposit sold through the Program were investment contracts because investors expected to receive profits through the extra services provided by defendants. The court further held that the certificates of deposit sold through the Program represented essentially a joint effort by the issuers of the certificates of deposit and the defendants and distinguished the facts of *Marine Bank* by reasoning that, although federal banking laws may protect investors from the abuses and misrepresentations of the issuers, the Acts were necessary to protect investors from the abuses and misrepresentations of defendants. [50]

In *SEC v. Edwards*, [51] the Supreme Court, reversing the Eleventh Circuit, held that an arrangement for the sale and leaseback of pay telephones was an investment contract and thus a security for purposes of the Acts. Pursuant to the arrangement, investors would purchase a pay telephone from ETS Payphones and lease it back to ETS in exchange for a fixed monthly fee. Investors "were not involved in the day-to-day operation of the payphones they owned. [Instead,] ETS selected the site for the phone, installed the equipment, arranged for connection and long-distance service, collected coin revenues, and maintained and repaired the phones." [52]

The Eleventh Circuit had held that "profits" for the purposes of the *Howey* test "require[d] either a participation in earnings by the investor or capital appreciation." [53] Therefore, the investors' entitlement to a fixed return meant that they

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did not have the required expectation of profits. Moreover, because the investors had a contractually guaranteed entitlement to a fixed return, any "profits" on their part would not "be derived solely from the efforts of others." [54]

The Supreme Court rejected the Eleventh Circuit's analysis and conclusions. The Court held that "[t]here is no reason to distinguish between promises of fixed returns and promises of variable returns" for purposes of the *Howey* test. [55] The Court noted a particular concern that a different holding would permit evasion of the securities laws by promising a particular rate of return in an investment contract. [56] The Court also rejected the argument that a contractual entitlement to a return would not be derived solely from the efforts of others for purposes of the *Howey* analysis. [57]

Notably, in a footnote to the *Reves* decision, the Court had stated that although "profits" in the context of notes meant "a valuable return on investment," which included interest, "profit" was defined more restrictively in applying the *Howey* test. [58] That footnote suggested that the *Reves* test was the only appropriate framework to analyze a promise of fixed returns. In *Edwards*, however, the Court stated that the dictum in *Reves* was incorrect, and held that fixed returns could constitute profits for purposes of the *Howey* test. [59] This holding increases the probability that a fixed return investment scheme that does not constitute a security under the *Reves* test may nevertheless constitute an investment contract under *Howey*.

The Fourth Circuit, in *Robinson v. Glynn*, [60] refused to determine categorically whether membership interests in a limited liability company constitute investment contracts. [61] Instead, it focused principally on the extent to which LLC members were able to participate actively in the management of the entity, and thus were either passive investors in need of the protection of the securities laws or more active investors not in need of those protections. In *Robinson*, the fact that the investor had the power to appoint board members, was in fact a board member and officer and had to consent before the entity could incur indebtedness outside the normal course of business led the court to conclude that the interest was not an investment contract and a security, even though the investor did not have sole managerial control over the entity. [62] The court left open the

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possibility that LLC interests could constitute securities where members were unable as a practical matter to exercise any meaningful control over the entity.

Other circuits faced with fact patterns where investors had far less control than in *Robinson* have held that their respective ownership interests were investment contracts, and therefore securities. In *SEC v. Merchant Capital*, [63] the Eleventh Circuit relied on a pre-circuit split Fifth Circuit precedent to hold that interests in Colorado registered limited liability partnerships [64] were investment contracts where the partners (i) had powers similar to those of limited partners, (ii) were "completely inexperienced" in the relevant industry and (iii) were dependent on the manager to run the business. [65]

The Second Circuit in *United States v. Leonard* [66] also held that, notwithstanding the terms of an LLC's organizational documents, a jury trial's conclusion that the LLC interests were securities was supported by sufficient evidence. "'[I]nterim managers' [had]… decided almost every significant issue" regarding the enterprise before investors purchased interests in the LLC; investors did not negotiate the terms of the LLC organizational documents; investors had "no particular experience" in the relevant industry; "[a]nd their number and geographic dispersion left investors particularly dependent on centralized management." [67]

The District of Columbia Circuit, in *SEC v. Life Partners, Inc.*, [68] ruled that viatical settlement contracts [69] "are not securities … because the profits from their purchase do not derive predominantly from the efforts of a [third] party." [70] Life Partners, Inc. ("LPI") sold fractional interests in insurance policies to retail investors, either individually or through such investors' Individual Retirement Accounts ("IRAs"). In LPI's programs, LPI performed certain pre-purchase functions, such as evaluating the insured's medical condition, reviewing his policy and negotiating a purchase price. In certain versions of the programs, LPI also engaged in post-purchase activities, including administration and distribution of death benefits. Under its original scheme, LPI was the record owner of the insurance policy, though investors remained the beneficial owners. Other iterations of the program involved listing the individual investors as record owners and providing no post-purchase services, except to the extent that an investor chose to use an agent of LPI as its agent to settle the insurance contract. [71]

In considering whether LPI's contracts were properly characterized as securities for purposes of the Securities Act, the court applied the *Howey* test. Looking first at the issue of profits, the court held that the investor in a viatical settlement has an expectation of profits because it is not purchasing the unmatured policy claims for current consumption. Rather, the investor seeks a financial return on its investment. [72] The court also held that a "common enterprise" was present because LPI's viatical settlements involved a pooling of funds to purchase an insurance policy that may result in a profit or loss to investors depending upon the life span of the insured. [73] The court concluded, however, that none of LPI's or its agents' pre- or post-purchase functions—amounting to no more than finder-promoter and simple ministerial activities—qualified as the entrepreneurial "efforts of others"; consequently, this element of the *Howey* test was not satisfied. [74] The court also held that the notes issued to IRAs by trusts investing in the viatical settlement contracts were not securities for purposes of the federal securities laws. [75]

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Relying in part on the reasoning, though not the result, in *Life Partners*, the District of Columbia Circuit in *Liberty Property Trust v. Republic Properties Corp.* [76] held that two individuals who were board members and officers of a real estate investment trust ("REIT") that owned 88% of a limited partnership "did not exercise sufficient control of the limited partnership to disqualify their units as securities." [77] The court reasoned that the REIT had six trustees and ten executive officers at the time of its initial public offering of trust interests, and therefore the defendants' "two votes were a minority of the board." [78] Furthermore, although the defendants controlled the REIT board when it had just three members during its formation, the court noted that the defendants expected the board to expand as part of the transactions in connection with the public offering and that, under the *Howey* test, "they ‘expected’ to profit from the efforts of the independent trustees added" to the board. [79]

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Together with the Supreme Court's ruling in *SEC v. Edwards*, [80] these cases may be indicative of an increased willingness of federal courts, in certain circumstances, to characterize contractual arrangements as "investment contracts" for purposes of the securities laws. [81]

[e] Loan Participations

As the *Gary Plastic* decision demonstrates, a transaction may be subject to the Acts even if an underlying instrument would not be a security if sold in other contexts. Transactions therefore must be examined in their entirety to determine whether they involve securities. For example, even if a note issued to a commercial bank by its customer is not a security under *Reves*, a separate analysis is required to determine whether loan derivative products (such as loan participations or syndications) [82] based on the note and sold by the originator are securities. Although the Supreme Court has not yet ruled on loan participations or syndications, lower courts have almost unanimously held that loan participations and syndications made in the normal course are not securities. Some of these courts based their decisions on the "commercial" nature of the underlying transactions, stating that the Acts were intended to apply to instruments issued in an "investment" context but not to instruments issued in a "commercial" context. [83]

Other courts have considered and rejected arguments that a participation or syndication satisfies the *Howey* "investment contract" test described above because participants are receiving profits (in the form of interest paid on the loan) from the efforts of the originating bank, which negotiated (and presumably provided monitoring and administrative services for) the loan. [84] In light of the

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Supreme Court's decision in *Edwards*, [85] however, the applicability of the investment contract test would appear to turn *not* on whether the participants are receiving interest rather than equity appreciation as a profit return, but, as discussed above, whether the underlying arrangement is commercial or investment in nature. [86]

Future plaintiffs will undoubtedly also argue that loan derivative products should be analyzed as notes under *Reves* (in addition to investment contracts under *Howey*). For example, in *Banco Espanol de Credito v. Security Pacific National Bank*, [87] the Second Circuit analyzed certain loan participations under *Reves* and concluded that such participations were not securities. The participations were sold by Security Pacific as part of a loan note program that, according to the SEC, was marketed to borrowers by Security Pacific as being a more profitable alternative to the issuance of commercial paper. [88] Under the program, Security Pacific loaned money to Integrated Resources, Inc. and immediately resold pieces of the loan to institutional investors. The investors sued Security Pacific under the fraud provisions of the Securities Act after Integrated failed to repay the loan, claiming that Security Pacific had concealed material nonpublic information about Integrated's deteriorating financial condition from them. The Second Circuit ruled that the investors could not claim under the fraud provisions of the Securities Act because the participations were analogous to loans

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issued by banks for commercial purposes, which, under *Reves*, are a type of note that is not a security. [89] The court also considered the participations in light of the four standards articulated by the Supreme Court in *Reves* for determining whether a note is a security and found that the motivation of the participants was for commercial (rather than investment) purposes, the participations were offered exclusively to institutional and corporate entities and not to the general public, the investors were on notice through contractual provisions that the participations were not investments in business enterprises and the existence of a regulatory scheme over the purchase and sale of loan participations of national banks makes application of the federal securities laws unnecessary. [90]

The SEC strongly disagreed with the court's analysis, arguing among other points that only the most "traditional" loan notes or participations should fall outside the definition of "security." [91] The SEC distinguished the Security Pacific loan participation program in *Banco Espanol* from a traditional program on the basis of the number and type of participants, the sales approach and the availability of information regarding the borrower. It stated that in a traditional program there would be only a small number of financial institutions as participants, financial institutions would become participants through referrals from the initiating bank's loan department and all information available to the initiating bank would be made available to participants. In the Security Pacific program, on the other hand, there were large numbers of diverse participants (including mutual funds and money managers), potential participants were contacted through "cold calls" from a sales desk and, although the initiating bank provided publicly available information to participants on request, it withheld nonpublic information from participants.

The participations sold under the Security Pacific program resemble commercial paper more than they resemble traditional loan participations in the way they were marketed and in the group of investors targeted. Commercial paper is well recognized as a security under the Securities Act. [92] Many other banks have

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loan participation programs similar to Security Pacific's [93] and, at least in the Second Circuit, investors are now in the anomalous position that they are protected by the fraud provisions of the securities laws when they buy commercial paper but are not so protected when they buy notes that are economically virtually identical to commercial paper from commercial banks. [94]

Other courts may disagree with the Second Circuit's *Banco Espanol* analysis that loan derivative products such as loan participations are not securities under *Reves*. [95] It is questionable whether such loan derivative products have a family resemblance to any of the instruments in the family resemblance test's list of exceptions to the definition of a security. And under the four additional standards articulated by the Supreme Court in *Reves*, some of these instruments may not escape categorization as securities.

First, it may be difficult to prove that the motivations of the buyer are for a "commercial" rather than an "investment" purpose, especially if not all of the participants are financial institutions.

Second, if the documentation for the loan derivative product is standardized and the product is offered to a large number of prospective investors without restrictions on transfer (both within and outside the commercial banking

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community), it may be difficult to prove that there is no "common trading market." [96]

Third, it will be difficult to predict whether the loan derivative products will be viewed as securities by nonbank investors because this view is a subjective one.

Fourth, these instruments are not federally insured and may not be covered by some other regulatory scheme that could obviate the need for the protection of the securities laws. [97]

Finally, the transactions may appear to a court more like repackaging of the loan, which, as discussed below, is thought to involve the sale of a security separate from the underlying loan itself.

In addition, loan participations that do not convey a beneficial interest in the underlying loan may be regarded as a swap or security-based swap under the Dodd-Frank Act. [98]

[f] Options on Securities and the Status of Swaps as "Securities"

[i] *Introduction*

[ii] *Background*

In contrast to certain other jurisdictions, the fundamental differences in approach to the regulation of securities, futures contracts, over-the-counter ("OTC") derivatives, banking products and insurance products in the United States have made the categorization of new financial instruments a prerequisite to the evaluation of the regulatory consequences of transacting in them, including which regulator has regulatory authority over a particular financial instrument.

The two principal U.S. regimes of historical significance are the regulation of securities under the U.S. securities laws and the regulation of futures contracts under the Commodity Exchange Act ("CEA"). [98.1] These regimes fundamentally

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differ in structure, approach and regulatory objective. Whether, and the extent to which, an instrument is subject to one regime or the other (a security, subject to regulation under the U.S. securities laws, a futures contract subject to regulation under the CEA, or both) has historically determined whether, and the circumstances under which, the instrument may be offered, sold or entered into in the United States or to or with U.S. persons. Title VII of the Dodd-Frank Act, which created new regulatory categories for "swaps" (subject to regulation under the CEA), "security-based swaps" (subject to regulation under the U.S. securities laws) and "mixed swaps" (subject to regulation under both the CEA and the U.S. securities laws), has further complicated the determination of the regulatory consequences of financial instruments categorization. [98.2]

As described below, over the years these regulatory regimes have applied to various extents to (i) derivatives referencing securities or securities indices, and (ii) securities products (such as structured notes) embedding exposure to non-securities reference assets or measures.

[iii] *The 1974 Amendments to the CEA*

Prior to 1974, the differences in regulatory schemes applicable to securities, on the one hand, and futures contracts, on the other hand, had no appreciable effect on the U.S. capital markets. In 1974, Congress, through an amendment to the CEA (the "1974 Amendments"), granted the CFTC exclusive jurisdiction over financial futures and options on certain financial interests (in addition to the agricultural commodities traditionally regulated under the CEA). [98.3] The expanded scope of the CEA, together with the proliferation of derivative financial instruments, gave rise to regulatory problems relating to whether the SEC or CFTC could properly exercise regulatory authority over a particular instrument, including whether the CEA applied to derivative or hybrid

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instruments that were not contemplated at the time of the 1974 Amendments. The determination that the CEA applies to an instrument has historically been significant because the exclusive jurisdiction provision of the CEA may preempt regulatory regimes that otherwise would be applicable, such as the U.S. securities laws. In addition, the CEA generally prohibits transactions in futures contracts (and prior to the Dodd-Frank Act, prohibited transactions in commodity options) that are not entered into on or subject to the rules of CFTC-regulated or non-U.S. trading facilities (so-called "off-exchange transactions"), absent a specified exemption. As the securities and financial derivatives markets developed into a more integrated, global market, the CFTC's exclusive jurisdiction (and the limited exemptions therefrom) and the uncertain division of regulatory authority between the SEC and CFTC created serious problems for issuers, market professionals and the U.S. capital markets generally. The breadth of the CFTC's exclusive jurisdiction under the 1974 Amendments resulted in a number of disputes between the CFTC and the SEC.

[iv] *The Shad-Johnson Accord*

Shortly after the 1974 Amendments became effective, the SEC asserted that such amendments had not deprived the SEC of jurisdiction over a futures contract that involved a "security" within the meaning of the Securities Act or the Exchange Act, even if the futures contract was traded on a contract market (*i.e.*, a futures exchange regulated by the CFTC). In 1981, the SEC and the CFTC met to resolve their differences, and in 1983 Congress codified the resulting jurisdictional accord (the "Shad-Johnson Accord"). [98.4]

As a result of the Shad-Johnson Accord, the CFTC retained jurisdiction over: (i) options on all commodities other than securities, (ii) futures contracts and options on futures contracts, including futures contracts and options on futures contracts on permitted securities indices, foreign currencies and permitted individual exempt securities (*e.g.*, U.S. government and agency securities), [98.5] and (iii) futures contracts, options on futures contracts and options (other than options traded on a national securities exchange) on foreign currencies. [98.6] The Shad-Johnson Accord required any securities index or group of securities underlying a futures contract be broad-based in order for the CFTC to have exclusive jurisdiction over that futures contract, and mandated that the SEC and

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CFTC cooperate in determining, upon application by a contract market, whether particular stock index futures contracts met that test. [98.7] Futures on individual nonexempt securities (other than as referenced above) and narrow-based indices of such securities were prohibited. The SEC retained jurisdiction over (i) options on securities and securities indices (whether or not broad-based), [98.8] (ii) options on foreign currencies traded on a

U.S. national securities exchange and (iii) the offer and sale of securities issued by commodity pools. [98.9]

The Shad-Johnson Accord did not, however, completely settle jurisdictional disputes between the CFTC and the SEC. The increasing prevalence in the capital markets of hybrid instruments combining features of securities and derivative instruments [98.10] and OTC derivatives linked to the value of a security or a commodity reignited the debate over the jurisdiction of the CFTC. [98.11]

[v] *The Commodity Futures Modernization Act of 2000*

The Commodity Futures Modernization Act of 2000 ("CFMA") [98.12] addressed or eliminated the most significant uncertainties as to the applicability of the CEA under prior law by creating broad, clearly defined exclusions and exemptions from SEC and CFTC regulation for a wide range of OTC derivatives between qualifying counterparties and hybrid instruments indexed to the value, level or rate of a commodity, including OTC derivatives and hybrid instruments indexed to securities. Importantly, the CFMA eliminated the prohibitions created by the Shad-Johnson Accord by establishing a regulatory framework for the trading of futures contracts on individual nonexempt securities and narrow-based indices of such securities. Thus, while the CFMA did not address certain fundamental definitional issues, such as the futures contract definition, for a time the

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CFMA's broad exclusions and exemptive provisions provided practical relief for the capital markets and OTC derivatives markets.

[vi] *The Dodd-Frank Act Wall Street Reform and Consumer Protection Act*

In response to views that the unregulated nature of the OTC derivatives market contributed to the 2007-2008 financial crisis, the Dodd-Frank Act [98.13] repealed the CFMA's exclusions for OTC derivatives from substantive regulation under the CEA and the U.S. securities laws. In their place, Title VII of the Dodd-Frank Act established a regime of substantially parallel regulation for swaps involving single nonexempt securities, loans and narrow-based security indices ("security-based swaps") [98.14]—to be administered by the SEC—and swaps involving other financial interests and commodities ("swaps")—to be administered by the CFTC. At the same time, Title VII of the Dodd Frank Act preserved (and excluded from regulation as swaps or security-based swaps) those categories of derivatives based on or referencing securities that were already subject to regulation as "securities" under the U.S. securities laws, including: securities options; [98.15] security future products; [98.16] contracts for the purchase or sale of a security on a fixed, variable or contingent basis, such as a forward contract providing for the deferred physical delivery of securities; [98.17] and notes, bonds or other evidences of indebtedness regulated as securities. [98.18]

[vii] *Options on Securities*

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[A] Generally

Any put, call, straddle, option, or privilege on any security, certificate of deposit or group or index of securities (including any interest therein or based on the value thereof) is expressly included in the definition of "security." [98.19] Any such instrument is also generally excluded from regulation under the CEA [98.20] and is expressly excluded from the Dodd-Frank Act's definition of "swap" [98.21] (and, as a result, "security-based swap"). As a result, options on securities, unlike futures contracts, swaps or security-based swaps, are not subject to exchange-trading or clearing requirements under the CEA or the Exchange Act. Accordingly, the question of whether an instrument should be respected as an option on a security, rather than a futures contract, swap or security-based swap, is critical. This is particularly the case for derivatives based on broad-based security indices because the determination of whether such a derivative constitutes an option on securities, on the one hand, or a futures contract or swap, on the other, also determines whether it is subject to SEC or CFTC jurisdiction.

Several courts (and the agencies) have had occasion to evaluate whether certain derivatives constituted options on securities. Although some of those precedents pre-date the CFMA and the Dodd-Frank Act, their analysis remains relevant in distinguishing options on securities from futures contracts, swaps and security-based swaps.

In *Procter & Gamble*, [98.22] the U.S. District Court for the Southern District of Ohio analyzed an interest rate swap—referred to as the "5s/30s swap" —pursuant to which Bankers Trust ("BT") agreed to pay the plaintiff, Procter & Gamble ("P&G"), for five years a specified percentage on a notional amount of $200 million, in exchange for P&G's agreement to pay BT a floating rate of interest tied to the commercial paper rate plus, after the first six months, a spread that was to be based on the then-prevailing five-year constant maturity U.S. Treasury yield and the price of 30-year U.S. Treasury bonds. [98.23] When interest rates

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in the United States and Germany rose substantially, putting P&G's position significantly "out-of-the-money," P&G unwound the swap and brought suit alleging, among other claims, securities fraud.

The threshold question for the court in considering the claim of securities fraud was whether the "5s/30s swap" was a security for purposes of the federal securities laws. As part of its analysis, the court considered whether the swap was an option on securities. [98.24] Five-year notes and 30-year Treasuries are securities; therefore, P&G argued, the "5s/30s swap" was an option on securities.

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According to the court, however, because the optionee had no right to exercise an option or take possession of any securities, the swap could not be regarded as an option. [98.25]

This element of the court's ruling in *Procter & Gamble* departs from an earlier administrative decision by the SEC involving a swap that had some similarities to the "5s/30s swap." In *In re BT Securities Corp.* ("*Gibson*"), [98.26] Gibson Greetings, Inc. ("Gibson Greetings") entered into what was called a "Treasury-Linked Swap" with BT Securities Corporation ("BT Securities") in order to hedge against losses under another swap transaction. Under this agreement, Gibson Greetings was to pay to BT Securities a variable rate on a notional amount and was to receive that same variable rate plus a fixed spread on the same notional amount. This structure provided, in substance, for nothing more than a payment of a fixed amount, the spread, by BT Securities to Gibson Greetings. At maturity, Gibson Greetings was to pay the notional amount and was to receive the lesser of (i) 102% of the notional amount or (ii) an amount calculated

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based on a formula whose value depended on the spread between a 30-year Treasury security and the average of the bid and offered yields of a two-year Treasury note. Although the transaction was in the form of a bilateral swap agreement, the SEC, presumably looking through the form to the economic substance of the transaction, which lacked bilateral exposure, characterized this transaction as essentially a cash-settled put option, written by Gibson Greetings, on a group or index of government securities. [98.27] Such put options are among those instruments listed in the definition of "security" and, accordingly, the Treasury-Linked Swap was found to be subject to the federal securities laws. [98.28]

The swap agreements in *Procter & Gamble* and in *Gibson* can be distinguished on their facts. As noted above, the payment obligations in the *Gibson* swap resulted not in bilateral executory payment obligations, but in an obligation of one party to make a fixed payment to the other that is not dissimilar to a delayed payment option premium. Moreover, it was the aggregate of the cash flows under the "swap" in *Gibson* that was characterized by the SEC as a put option. By contrast, the *Procter & Gamble* swap involved an option-like payment feature embedded in an otherwise bilateral executory interest rate swap. The dicta in the court's decision in *Procter & Gamble* and the SEC's administrative decision in *Gibson* cannot be reconciled, however, insofar as the court in *Procter & Gamble* opined that an option on a security, in order to be a security, must involve the actual right (not subject to automatic exercise) to purchase or sell a security. [98.29]

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In *Caiola v. Citibank* ("*Caiola*"), [98.30] the U.S. Court of Appeals for the Second Circuit, reversing a decision of the district court [98.31] that relied in large part on the conclusion expressed in *Procter & Gamble*, held that a cash-settled option on a security is a security. Caiola had alleged that Citibank violated § 10(b) of the Exchange Act in connection with a series of synthetic securities trading arrangements (essentially forms of equity swaps and cash-settled options) by, among other actions, shifting from a "delta hedging" strategy to a strategy in which Citibank purchased and held the securities underlying Caiola's synthetic positions and thereby affecting the value of the underlying securities and of Caiola's synthetic positions. The transactions at issue were structured to permit Caiola to replicate certain economic characteristics of positions in Phillip Morris stock and listed options. Under the equity swap arrangements, Caiola was entitled to receive from Citibank the amount of appreciation in the underlying security (as well as any dividends payable with respect to that security) but was required to pay to Citibank the amount of any depreciation in the value of the underlying security, along with "interest" on the notional value of the contract.

As in *Procter & Gamble*, a threshold question in assessing the securities fraud claim was whether the transactions involved the purchase or sale of a security. Caiola raised two arguments in this regard: (i) that Citibank was acting as his agent in effecting transactions in the underlying security as part of its hedging activity and (ii) that the synthetic trading arrangements were themselves securities. [98.32]

The district court had dismissed Caiola's claims on the grounds that, among other reasons, (i) he lacked standing because he was not a purchaser or seller of securities and (ii) his synthetic transactions were not "securities" as defined in the Exchange Act (relying on the conclusion in *Procter & Gamble*).

With respect to Caiola's first claim, the Second Circuit found that Caiola's complaint sufficiently alleged that Citibank had acted as agent for Caiola's account in its hedging transactions in the underlying security.

With respect to the question of whether the synthetic transactions were themselves securities, the Second Circuit found that Caiola's cash-settled OTC options on the value of a security were securities under § 3(a)(10) of the Exchange Act. The court rejected the reasoning in *Procter & Gamble*, finding that the language of § 3(a)(10) covered an option based on the value of a single

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security as well as a group or index of securities and cash-settled as well as physically-settled options. [98.33]

[viii] *Treatment of Collars and Deep-in-the-Money Options; Distinction Between Equity Swaps, Equity Futures and Equity Options*

Another set of issues involves determining when a transaction documented as an equity collar [98.34] or deep-in-the-money option [98.35] may be subject to recharacterization as a swap or security-based swap (or a futures contract) or, conversely, when the transfer of less than all of the price risk under a cash-settled

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swap or security-based swap may subject the swap or security-based swap to potential recharacterization as one or more securities options.

There is no dispositive precedent as to the point at which the two exercise levels of a collar are sufficiently close that the collar would not be viewed as a pair of options but would instead be viewed as a swap or security-based swap (or a futures contract). Conversely, there is no dispositive precedent as to the circumstances, if any, in which the two exercise levels of a collar are sufficiently far apart that the collar may be viewed as a pair of options, rather than as a swap or security-based swap (or a futures contract). [98.36]

Similarly, there is no dispositive precedent as to the point at which an "option" is sufficiently deep-in-the-money to raise the possibility that it would not be respected as a securities option and instead be viewed as a swap or security-based swap (or a futures contract). Conversely, there is no dispositive precedent as to the point, if any, at which a swap or security-based swap has a sufficiently option-like payout profile to raise the possibility that it may be viewed as a securities option that is excluded from regulation as a swap or security-based swap.

Applicable securities and commodities law precedents have consistently purported to categorize instruments based on the underlying economic substance of the particular transactions in question and, while not necessarily disregarding the form of a transaction entirely, have rejected the proposition that form should be dispositive. [98.37]

Precedents addressing whether a deep-in-the-money option should be respected as an option have consistently looked to whether the exercise price of the option was so low as to make exercise of the option a virtual certainty as a matter of rational economic behavior. [98.38] (An analogous approach, in the context

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of a collar, would be to look to whether the exercise prices are so close together as to make exercise of one of the component options a virtual certainty as a matter of rational economic behavior.)

Despite this consistent body of analogous precedent, [98.39] the CFTC staff, in the context of distinguishing between futures contracts and options, appears to have ignored this approach and to have adopted an approach implying a significantly narrower view of a *bona fide* option and a concomitantly broader view of the CFTC's potential jurisdictional authority under the CEA. [98.40]

Specifically, in a 1994 interpretive letter, [98.41] CFTC staff was requested to grant no-action relief for options in which the exercise price would, at issuance, be set in-the-money by an amount to be determined using a formula based primarily on a measure of the "annualized standard deviation of the natural logarithm of the daily returns on an investment in the stock" over the preceding year. [98.42] According to the request, this formula would have resulted in a "reasonable possibility" that the options would expire unexercised (*i.e.*, with the stock price out-of-the-money). [98.43]

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CFTC staff declined to grant relief on the basis requested and instead limited the amount that the options would be permitted to be in-the-money at the time of listing by requiring, in the case of a call option, that the exercise price of the option be set at a level no lower than the level resulting from rounding the then prevailing stock price downward to the nearest $2.50 increment, in the case of stocks priced below $25, or to the nearest $5.00 increment, in the case of stocks priced above $25. According to CFTC staff, the resulting options would have "predominantly option-like attributes rather than futures-like attributes because they should reflect a return based on one-way indexing as opposed to two-way indexing." [98.44]

Although the CFTC staff's no-action guidelines are both clear and simple to apply, the staff response did not provide a rationale or basis for its conclusion that a "predominance" test is the appropriate standard for determining whether an in-the-money option should be respected as an option. Nor did CFTC staff explain why the fundamental attribute of an option is "one-way" indexation. Finally, it is not clear from the CFTC staff’s analysis how the limitations imposed in the interpretive letter by virtue of the rounding guidelines result in indexation that is "predominantly" option-like—particularly in light of the fact that the guidelines do not appear to take account of considerations such as the term of the option, the amount of the premium for the option (in relation to the price of the underlying stock), the probability at issuance that the option will expire unexercised, or the price behavior (*e.g.*, volatility) of the underlying stock. For these and related considerations, the "likelihood of exercise" analysis employed in the other precedents cited above appears more persuasive than the approach adopted by CFTC staff.

[ix] *Status of Swaps as “Securities”*

Prior to the enactment of the CFMA, the status of swap agreements and similar derivatives linked to securities under the U.S. securities laws was subject

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to some uncertainty. Swaps and such other derivatives developed long after the enactment of the definitions of "security" and do not readily fit into any of the categories of instruments enumerated in the definitions.

The first attempt to resolve these issues statutorily came in the CFMA, which addressed certain jurisdictional questions by amending the Acts and the GLB Act to exclude certain qualifying "swap agreements" from the definition of security for purposes of those statutes. Those amendments also provided that qualifying swap agreements relating to securities, while not securities themselves, remained subject to the fraud, manipulation and insider trading prohibitions under those Acts.

In the Dodd-Frank Act, however, Congress repealed the CFMA exclusions and instead categorized a wide range of swaps and other derivatives relating to securities as security-based swaps. [98.45] In addition, the Dodd-Frank Act amended the definition of "security" in the Acts to include any "security-based swap." At the same time, the Dodd-Frank Act categorized certain swaps linked to securities both as "swaps" subject to plenary CFTC jurisdiction and also as "security-based swap agreements" subject to SEC antifraud jurisdiction, but not defined as "securities." Still other swap transactions are exclusively subject to CFTC jurisdiction. Finally, as noted above, options on securities are separately regulated as "securities," and excluded from regulation as a "swap" or "security-based swap."

[x] *Swaps on Single Nonexempt Securities and Narrow-Based Securities Indices*

The Dodd-Frank Act defines any swap based on a single nonexempt security or loan or based on a narrow-based security index as a "security-based swap." [98.46] It then defines any security-based swap as a security. [98.47] As a result, many instruments previously excluded by the CFMA from substantive regulation by the SEC are subject to the full range of federal securities laws and regulations and self-regulatory organization rules applicable to securities, although the SEC and FINRA have granted interim relief for security-based swaps. [98.48]

[xi] *Swaps on Single Exempt Securities and Broad-Based Securities Indices*

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The Dodd-Frank Act defines any swap based on a single exempt security (other than a municipal security) or based on a broad-based security index as a "swap." Swaps are subject to regulation by the CFTC and are not defined as "securities." However, the Dodd-Frank Act also defined swaps based on a single exempt security (other than a municipal security) or based on a broad-based security index as "security-based swap agreements," which are subject to SEC antifraud and antimanipulation jurisdiction.

[xii] *Other Swaps*

Swaps based on interests or measures, such as interest rate swaps or swaps based on nonfinancial interests, are categorized under the Dodd-Frank Act as "swaps." They are also subject to exclusive CFTC jurisdiction if traded on a designated contract market ("DCM") or swap execution facility ("SEF"). [98.49] As a result, such instruments should not be subject to SEC jurisdiction or regulation as securities.

[g] Other Instruments

The cases discussed in this section demonstrate that the definitions of "security" in the Acts enumerate instruments that would not ordinarily be considered securities when examined in their commercial contexts. It is also true that instruments that are not enumerated may nonetheless be securities subject to the Acts.

Claimants (including the SEC) wishing to bring a non-enumerated instrument within the definitions have generally argued that the instrument shares so many characteristics with an enumerated security that it should be considered equivalent to the enumerated security. Where the non-enumerated instrument is not similar to an enumerated security, claimants have often argued instead that the instrument should be treated as an "investment contract" or an "instrument commonly known as a security" (terms that are often used together as catchall provisions in the definitions). In each case, the relevant factors in the analysis may include the manner of the offering, type of investor audience, manner of promotion, expectation of the parties and nature of the return on the investment. For example, as is demonstrated in the cases discussed above, an instrument is more likely to be considered a security if it is marketed to the general public, its purchasers are passive investors without expertise in the particular business area

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involved, [99] the parties or the public would generally consider the instrument a security or, with respect to investment contracts, the return on the investment is contingent on the profits of the enterprise.

In recent years, a host of new instruments has been developed that represent "repackaged" underlying instruments. The underlying instruments may not be securities when examined individually. However, a separate analysis of the new instrument is necessary.

For example, many originators of residential mortgage loans have repackaged their mortgage loans as mortgage-backed securities. Typically, ownership of a pool of mortgages is transferred to a trust that issues instruments evidencing a right to receive a proportional share of future payments on the pool of loans. The loan originator thus transfers the risk of loss on the loans and earns cash from the sale of the instruments. In addition, the originator often retains a contractual right to "service" the loans (*i.e.*, collect payments, run foreclosure proceedings, *etc.*), for which it receives a fee. Under *Reves*, the underlying mortgage loans are not securities. [100] However, instruments evidencing interests in a pool of mortgage loans typically are considered securities under an "investment contract" analysis because investors anticipate a profit that is based at least partially on the efforts of the originator and servicer of the loans. [101]

Footnotes

1 § 2(a)(1) of the Securities Act.

2 § 3(a)(10) of the Exchange Act.

3 In addition to listing categories of instruments that are securities, both Acts list "exempted securities." Exempted securities listed in the Securities Act include *inter alia* securities issued or guaranteed by the United States, any state or any political subdivision of a state, certain securities issued by banks or savings and loan associations, certain short-term commercial paper, certain insurance company securities and certain security futures. *See* § 3 of the Securities Act. Security futures are generally defined as futures contracts on individual nonexempt securities or narrow-based groups or indices thereof. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5][c]. Security futures are exempted securities for purposes of the Securities Act if they are listed on a national securities exchange or national securities association and are cleared by a registered securities clearing agency or derivatives clearing organization. § 3(a)(14) of the Securities Act. Exempted securities listed in the Exchange Act include *inter alia* certain securities issued or guaranteed by the United States, municipal securities (a term that includes certain securities issued or guaranteed by a state or an agency, instrumentality or political subdivision of a state) and certain insurance company securities. *See* § 3(a)(12) of the Exchange Act. Notwithstanding their categorization as "exempted securities," these securities generally may not be exempt from certain provisions of the related Act. For example, municipal securities that are exempted securities under the Exchange Act are not exempt from certain provisions of that Act relating to broker-dealer registration. *See* § 3(a)(12)(B)(ii) of the Exchange Act.

4 *Marine Bank v. Weaver*, 455 U.S. 551, 555 n.3 (1982) (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975). *But see Financial Security Assurance, Inc. v. Stephens, Inc.*, 500 F.3d 1276 (11 Cir. 2007) (rejecting the standing of an insurer of municipal bonds that became the owner of the bonds upon a default by the issuer to bring a Rule 10b-5 claim in part because guarantees are not within the definition of "security" in § 3(a)(10) of the Exchange Act).

5 *See* § 2(a)(36) of the Investment Company Act and § 202(a)(18) of the Investment Advisers Act; *see, e.g.*, CAL. CORP. CODE § 25019 and DEL. CODE ANN. tit. 6, § 73-103(20).

6 In fact, although bank certificates of deposit were effectively excluded from the Securities Act's definition of security in *Marine Bank v. Weaver*, 455 U.S. 551 (1982), Congress amended the Investment Company Act's definition in 1982 *inter alia* to make clear that such obligations would be included. Act of October 13, 1982, Pub. L. No. 97-303, § 5, 96 Stat. 1409 (1982).

7 For example, the Commodity Futures Modernization Act of 2000 ("CFMA") expanded the definitions to expressly include any "security future." *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16. More recently, § 761(a) of the Dodd-Frank Act has expanded the definition to include any "security-based swap," which had formerly been excluded from the definition of "security" by the CFMA. In addition, the SEC has in the past called for legislative amendment of the definition of "security" to include loan participations under certain circumstances. SEC TODAY, Vol. 94-190, Oct. 5, 1994. Because the Commodity Exchange Act ("CEA") vests the Commodity Futures Trading Commission ("CFTC") (and not the SEC) with exclusive jurisdiction over certain commodity options, such options are not securities. These commodity options, as well as other instruments that may be subject to the commodities laws, are discussed more fully in U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.17[2].

8 It is fair to say that participants in financial transactions in the United States assert often self-serving interpretations of the definitions that may vary over the course of a transaction and from transaction to transaction. Thus, many transactions have been characterized in complaints as the purchase and sale of securities, requiring the courts to decide what types of instruments should be included in the Acts' definitions of "security."

9 *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982). The U.S. Supreme Court has further articulated this congressional intent as a balance between the following two concerns: Congress intentionally defined "security" in broad and general terms because it intended its definition of "security" to be "sufficiently broad to encompass virtually any instrument that might be sold as an investment." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990), *reh'g denied*, 494 U.S. 1092 (1990). However, Congress could not have intended its definitions to be all-inclusive because it did not want the Acts to "provide a broad federal remedy for all fraud." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990), *reh'g denied*, 494 U.S. 1092 (1990) (quoting *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982)).

10 The Supreme Court has stated, for example, that it would be inappropriate to subject a "note" to the same analysis under which it had determined that an "investment contract" was a security in *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *Reves v. Ernst & Young*, 494 U.S. 56, 64 (1990), *reh’g denied*, 494 U.S. 1092 (1990).

11 *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh’g denied*, 494 U.S. 1092 (1990).

12 *See, e.g.*, *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 (1985) ("‘[N]ote’ may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context.").

13 *See, e.g.*, *Arthur Young & Co. v. Reves*, 856 F.2d 52, 54 (8th Cir. 1988), *rev'd sub nom. Reves v. Ernst & Young*, 494 U.S. 56, *reh'g denied*, 494 U.S. 1092 (1990). Investment contracts are discussed in § 12.01[2][d].

14 *See, e.g.*, *Futura Development Corp. v. Centex Corp.*, 761 F.2d 33, 40–41 (1st Cir. 1985), *cert. denied*, 474 U.S. 850 (1985). The Supreme Court noted in *Reves* that it regarded this "investment versus commercial" test as merely another way of "formulating the same general approach" as the "family resemblance" test it adopted. *Reves v. Ernst & Young*, 494 U.S. 56, 64 (1990), *reh’g denied*, 494 U.S. 1092 (1990).

15 *See, e.g.*, *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984), *cert. denied*, 469 U.S. 884 (1984) (modifying *Exchange National Bank holding*).

16 *Reves v. Ernst & Young*, 494 U.S. 56, 65 (1990), *reh’g denied*, 494 U.S. 1092 (1990) (adopting the list of

notes identified by the Second Circuit as not being securities in *Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126, 1137 (2d Cir. 1976) and *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984)) (internal quotation marks and citations omitted).

17 *Reves v. Ernst & Young*, 494 U.S. 56, 66–67 (1990), *reh'g denied*, 494 U.S. 1092 (1990) (internal quotation marks and citations omitted).

18 *Reves v. Ernst & Young*, 494 U.S. 56, 67 (1990), *reh'g denied*, 494 U.S. 1092 (1990); *see also Stoiber v. SEC*, 161 F.3d 745 (D.C. Cir. 1998) (finding certain promissory notes to be securities under the *Reves* test despite their distribution to a limited number of individuals and the absence of any secondary trading), *cert. denied*, 526 U.S. 1069 (1999).

19 *Reves v. Ernst & Young*, 494 U.S. 56, 58–59 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

20 *Reves v. Ernst & Young*, 494 U.S. 56, 67–68 (1990), *reh'g denied*, 494 U.S. 1092 (1990); *see also SEC v. Smart*, No. 2:09-CV-00224 (DAK), 2011 WL 2297659 (D. Utah, June 8, 2011), *aff'd*, 678 F.3d 850 (10th Cir. 2012); *SEC v. Novus Technologies, LLC*, No. 2:07-CV-235-TC, 2010 WL 4180550 (D. Utah Oct. 20, 2010), *aff'd*, 732 F.3d 1151 (10th Cir. 2013) (each holding that instruments an issuer called "promissory notes" were securities under both the *Reves* and *Howey* tests).

21 *Reves v. Ernst & Young*, 494 U.S. 56, 67–68 (1990), *reh'g denied*, 494 U.S. 1092 (1990). *See also* § 12.01[2][d] for a discussion of "profits" in the context of notes.

22 *Reves v. Ernst & Young*, 494 U.S. 56, 68 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

23 *Reves v. Ernst & Young*, 494 U.S. 56, 69 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

24 *Reves v. Ernst & Young*, 494 U.S. 56, 69 (1990), *reh'g denied*, 494 U.S. 1092 (1990).

25 *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) ("*Landreth Timber*").

26 *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 684–85 (1985).

27 *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 687 (1985).

28 *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 (1985) (citing *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 851 (1975)). The Court emphasized that such "usual characteristics" were derived from common stock and that "[v]arious types of preferred stock may have different characteristics and still be covered by the Acts." *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 686 n.2 (1985); *see also, Bass v. Janney Montgomery Scott, Inc.*, 210 F.3d 577 (6th Cir. 2000) (concluding that stock warrants received by an investor in exchange for bridge loans qualified as securities, regardless of the circumstances in which they changed hands); *cf. Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001) (assuming in an action under Rule 10b-5 under the Exchange Act, citing plaintiff's failure to challenge it on appeal, that an option to purchase stock on a cable television system was a "security"). In contrast, an instrument named "stock" that does not share the characteristics of common stock is not *per se* a security. The Supreme Court held in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), that shares of stock in a government-subsidized cooperative apartment corporation were not securities. The shares lacked several characteristics of common stock: they did not carry the right to receive dividends upon an apportionment of profits, were not negotiable, could not be pledged or hypothecated, conferred no voting rights in proportion to the number of shares owned and could not appreciate in value. *See also Giuffre Organization Ltd. v. Euromotorsport Racing, Inc.*, 141 F.3d 1216 (7th Cir. 1998) (holding a "share of stock" in Championship Auto Racing Teams, Inc., not to be a security for purposes of the federal securities laws because the linkage between investment and participation in automobile racing competition resulted in the share being more similar to a franchise than to an investment in corporate securities). Courts have also rejected the argument that equity interests similar to stock in certain respects, such as membership interests in limited liability companies or limited partnerships, constitute stock for purposes of the definition of security, while either leaving open the possibility that such interests may be investment contracts under appropriate circumstances, *see Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003), or holding that such interests were investment contracts, *see Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335 (D.C. Cir. 2009); *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008); *SEC v. Merchant Capital, LLC*, 483

F.3d 747 (11th Cir. 2007). *But see Haddad v. RAV Bah., Ltd.*, 240 F. App'x 821 (11th Cir. 2007) (holding that an interest may be considered a security where the agreement between the parties is titled "Shareholder's Agreement," discusses securities, and refers to holders of the interest as "stockholders").

29 Rule 10b-5 under the Exchange Act is discussed in § 11.04[2].

30 *Marine Bank v. Weaver*, 455 U.S. 551, 559 (1982); *see also Dubach v. Weitzel*, 135 F.3d 590, 592 (8th Cir. 1998) (applying *Marine Bank* to a certificate of deposit issued by a credit union). A certificate of deposit is a time deposit with a specific maturity evidenced by a certificate. Certificates of deposit issued by U.S. banks or savings and loan associations are usually federally insured. Many foreign certificates of deposit are also government insured.

31 *Marine Bank v. Weaver*, 455 U.S. 551, 553–54 (1982).

32 *Marine Bank v. Weaver*, 455 U.S. 551, 557–59 (1982).

33 *Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982).

34 At that time, the federal insurance limit was $40,000. The face amount of the CD in *Marine Bank* was $50,000.

35 The Court in *Marine Bank* appeared to take some comfort in the 1980 Annual Report of the Federal Deposit Insurance Corporation ("FDIC"), which, according to the Court, stated that since inception of federal banking insurance, "nearly all depositors in failing banks insured by the FDIC have received payment in full, even payment for the portions of their deposits above the amount insured." *Marine Bank v. Weaver*, 455 U.S. 551, 558 (1982). The FDIC's 2009 Annual Report emphasized that even with the increase in bank failures in 2009, all insured deposits were paid, and depositors with account values in excess of the insurance limit nevertheless received $21 million in disbursements. 2009 Annual Report of the [FDIC] 46 (2010), *available at* http://www.fdic.gov/about/strategic/report/2009annualreport/AR09final.pdf. Similarly, all insured deposits were also paid in connection with bank failures in 2010, and depositors with account values in excess of the insurance limit received a total of $5 million. 2010 Annual Report Highlights of the [FDIC] (2011), *available at* http://www.fdic.gov/about/strategic/report/2010highlight/chpt1-03.html.

36 *See, e.g.*, *Wolf v. Banamex*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985) ("*Banamex*"); *Tafflin v. Levitt*, 865 F.2d 595 (4th Cir. 1989); *contra Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772 (10th Cir. 1989), *vacated and remanded*, 494 U.S. 1014, *aff'd on reh'g*, 900 F.2d 1485 (10th Cir. 1990), *cert. denied*, 498 U.S. 958 (1990) ("*Holloway*").

37 *Wolf v. Banamex*, 739 F.2d 1458, 1463 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985). *See generally* Randall W. Quinn, *After Reves v. Ernst & Young*, *When are Certificates of Deposit Notes Subject to Rule 10b-5 of the Securities Exchange Act?*, 46 BUS. LAW. 173 (Nov. 1990) ("*Quinn*").

38 *Tafflin v. Levitt*, 865 F.2d 595, 599 (4th Cir. 1989). Note also the discussion of *Gary Plastics Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc*. at *infra* Note 46 and accompanying text, where the Second Circuit distinguished the facts of *Marine Bank* and held that the certificates of deposit at issue were securities because the court found them to be investment contracts entered into pursuant to a marketing program.

39 Quinn at 182, citing Brief for the SEC as Amicus Curiae, *Wolf v. Banamex*, 739 F.2d 1458 (9th Cir. 1984), *cert. denied*, 469 U.S. 1108 (1985), at 10. This article also notes that the SEC has sidestepped the issue of the interplay between *Marine Bank* and state regulation, stating that "[the SEC's] brief in *Holloway* argued that because Oklahoma trust company regulation was not as comprehensive as Oklahoma bank regulation, the court need not reach the question of whether state regulation might ever be sufficient to invoke the *Marine Bank* exclusion." Quinn at 182.

40 *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("*Howey*").

41 *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

42 In a case decided three years before *Howey*, the Court held that an investment scheme involving the assignment of oil leases and the drilling of test wells by the promoters was an investment contract under the Securities Act. *See SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943).

43 *See, e.g., Matassarin v. Lynch*, 174 F.3d 549 (5th Cir. 1999), *reh'g en banc denied*, 189 F.3d 471 (1999), *cert. denied*, 528 U.S. 1116 (2000) (holding interests in an employee stock ownership plan not to be securities under the *Howey* test because the interest did not involve a voluntary investment choice); *Allen v. Lloyd's of London*, 94 F.3d 923 (4th Cir. 1996) (holding neither the initial investment by Lloyd's Names nor their interests under a Lloyd's settlement plan to restructure insurance underwriting interests to be securities under the *Howey* test); *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1282–83 (S.D. Ohio 1996) ("*Procter & Gamble*") (finding that two leveraged derivatives did not satisfy the *Howey* criteria and thus were not "investment contracts" or "instruments commonly known as securities"); *In re J.P. Jeanneret Associates, Inc.*, 769 F. Supp. 2d 340 (S.D.N.Y. 2011) (finding discretionary investment management contracts to be "securities" under the *Howey* test).

44 *SEC v. W.J. Howey Co.*, 328 U.S. 293, 295–96 (1946).

45 *SEC v. W.J. Howey Co.*, 328 U.S. 293, 300 (1946).

46 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985) ("*Gary Plastic*").

47 *See Marine Bank v. Weaver*, 455 U.S. 551, 560 n.11 (1982).

48 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 240 (2d Cir. 1985).

49 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 232 (2d Cir. 1985).

50 *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 239–42 (2d Cir. 1985).

51 *SEC v. Edwards*, 540 U.S. 389 (2004).

52 *SEC v. Edwards*, 540 U.S. 389, 391–92 (2004).

53 *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1284 (11th Cir. 2002) (*per curiam*).

54 *SEC v. ETS Payphones, Inc.*, 300 F.3d 1281, 1285 (11th Cir. 2002) (*per curiam*).

55 *SEC v. Edwards*, 540 U.S. 389, 394 (2004).

56 *SEC v. Edwards*, 540 U.S. 389, 395 (2004).

57 *SEC v. Edwards*, 540 U.S. 389, 397 (2004).

58 *Reves v. Ernst & Young*, 494 U.S. 56, 68 n.4 (1990), *reh’g denied*, 494 U.S. 1092 (1990).

59 *SEC v. Edwards*, 540 U.S. 389, 396–97 (2004).

60 *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003).

61 The court also rejected the argument that an LLC membership interest constituted stock. *See supra* Note 29.

62 *Robinson v. Glynn*, 349 F.3d 166, 170–71 (4th Cir. 2003).

63 *SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007).

64 The Eleventh Circuit characterized registered limited liability partnerships as a "hybrid between general and limited partnerships." *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 756 (11th Cir. 2007).

65 *SEC v. Merchant Capital, LLC*, 483 F.3d 747, 765–66 (11th Cir. 2007) (applying a test set forth in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), to determine when partnership interests are investment contracts); *see also United States v. Wetherald*, 636 F.3d 1315, 1326 (11th Cir. 2011) (relying on *Williamson v. Tucker* to hold that partnership interests were securities where investors in those interests had no industry experience, were not asked to vote on important decisions, sat on partnership committees that "were largely symbolic," had a "minimal" time commitment, "did not control disbursement of funds," were not consulted in filing a petition for bankruptcy and "had no say in the operations of the company").

66 *United States v. Leonard*, 529 F.3d 83 (2d Cir. 2008).

67 *United States v. Leonard*, 529 F.3d 83, 90–91 (2d Cir. 2008) (citing *SEC v. Merchant Capital, LLC*, 483 F.3d

747 (11th Cir. 2007); *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003); and *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981)). *Accord Affco Investments 2001 LLC v. Proskauer Rose L.L.P.*, 625 F.3d 185, 191 (5th Cir. 2010) (holding that LLC interests were securities because the investors who held them were "passive" and "depended—both in reality and according to their investment contracts—upon the efforts of others for their profits").

68 *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir. 1996), *reh'g denied*, 102 F.3d 587 (D.C. Cir. 1996), *on remand*, 986 F. Supp. 644 (D.D.C. 1997).

69 Viatical settlement contracts are investment contracts in which the investor purchases an interest in the life insurance policy of a terminally ill individual, usually at a discount. Upon the death of the insured, the investor receives the proceeds of the insurance less certain costs and expenses. Viatical settlements first became increasingly common in the context of the AIDS epidemic.

70 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 538 (D.C. Cir. 1996); *see also Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144 (3d Cir. 1997) (holding an interest in a highly structured securitization transaction not to be a security under the *Howey* test because the investor retained "pervasive control" over the investment).

71 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 539–40 (D.C. Cir. 1996).

72 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996).

73 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543–44 (D.C. Cir. 1996).

74 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 548 (D.C. Cir. 1996).

75 *SEC v. Life Partners, Inc.*, 87 F.3d 536, 549 (D.C. Cir. 1996). Significantly, the Eleventh Circuit and at least three federal district courts have declined to follow *Life Partners* and have held that viatical settlements are securities. *SEC v. Mutual Benefits*, 408 F.3d 737, 744. In *SEC v. Tyler*, No. A3:02-CV-0282-P, 2002 WL 32538418 (N.D. Tex. Feb. 21, 2002), the District Court for the Northern District of Texas distinguished *Life Partners* and held that the viatical settlements sold by the defendants were securities, based on the post-purchase efforts of the defendants to provide liquidity and despite the fact that many of the elderly purchasers were in fact unaware that they were buying viatical settlements or that the value of their investment derived in part from the defendants' post-purchase functions. Later, the District Court for the Northern District of Ohio observed in *Wuliger v. Christie*, 310 F. Supp. 2d 897 (N.D. Ohio 2004), that state courts in Arizona, Colorado, Indiana, Michigan and Ohio that had considered viatical settlements under their state securities laws had either rejected or distinguished *Life Partners*. The court found the reasoning in *Life Partners* unpersuasive, on the ground that "it is not the date of the viator's death which establishes the success of the investment but the selection by the promoter of the policy into which the investor's money is placed, based upon its expertise in assessing the viator's life expectancy and other variables, which drives the success of the investment." *Wuliger v. Christie*, 310 F. Supp. 2d 897, 907 (N.D. Ohio 2004). Accordingly, the court held the last prong of the *Howey* test to be satisfied. In 2013, the District Court for the Northern District of Illinois acknowledged recent challenges to the *Life Partners* holding and chose to adopt the Eleventh Circuit's reasoning in *Mutual Benefits*, holding that life settlements should be considered securities under federal and Illinois securities laws. *See Giger v. Ahmann*, Fed. Sec. L. Rep. (CCH) ¶ 97,773 (N.D. Ill. 2013). In 2015, the Texas Supreme Court held that viatical settlements do constitute securities under Texas securities laws, abrogating a prior decision by a Texas appellate court that had followed *Life Partners*. *See Life Partners, Inc. v. Arnold*, 464 S.W.3d 660 (Tex. 2015); *Griffitts v. Life Partners, Inc.*, No. 10-01-00271-CV, 2004 Tex. App. LEXIS 4844, 2004 WL 1178418 (Tex. Ct. App. May 26, 2004).

76 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335 (D.C. Cir. 2009).

77 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 337, 341 (D.C. Cir. 2009).

78 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 341 (D.C. Cir. 2009); *see also Shirley v. JED Capital, LLC*, 724 F. Supp. 2d 904, 911–12 (N.D. Ill. 2010) (finding that LLC interests held by a 20% equity holder constituted an investment contract because another equity holder owned two-thirds of the LLC and served as its manager with veto power over any change in manager).

79 *Liberty Property Trust v. Republic Properties Corp.*, 577 F.3d 335, 341 (D.C. Cir. 2009).

80 *SEC v. Edwards*, 540 U.S. 389 (2004).

81 *But see* CFTC Order Exempting the Trading and Clearing of Certain Products Related to SPDR ® Gold Trust Shares, 73 Fed. Reg. 31,981 (June 5, 2008), and CFTC Exemptive Order for SPDR ® Gold Futures Contracts, Comm. Fut. L. Rep. (CCH) ¶ 30,863 (June 5, 2008) (implicitly questioning whether certain exchange-traded funds owning commodity interests satisfy the "efforts of others" prong of the *Howey* investment contract criteria).

82 In a loan participation, a single bank makes a loan and assigns interests in the loan to other financial institutions. However, there is no direct contractual relationship between the borrower and the other institutions. A syndication has a similar structure, but each institution is a direct lender with respect to its portion of the loan. Commercial banks sell loan participations, arrange syndicated loans and use various other loan derivative products (*e.g.*, the fractional assignment of pieces of loans) to diversify risk, improve liquidity or comply with capital requirements and lending limits.

83 *See, e.g.*, *Union Planters National Bank of Memphis v. Commercial Credit Business Loans, Inc.*, 651 F.2d 1174 (6th Cir. 1981), *cert. denied*, 454 U.S. 1124 (1981) ("*Union Planters*"). *Compare Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144 (3d Cir. 1997) (holding that a securitization transaction did not constitute an investment contract because the investor had significant powers to control the business enterprise).

84 *See, e.g.*, *McVay v. W. Plains Service Corp.*, 823 F.2d 1395 (10th Cir. 1987).

85 *SEC v. Edwards*, 540 U.S. 389 (2004).

86 *Compare Union National Bank of Little Rock v. Farmers Bank*, 786 F.2d 881 (8th Cir. 1986) (holding that a fixed rate, short-term commercial note is not a security in part because there was no expectation of profit or capital appreciation) with *Southwest Investments I v. Midland Energy Co.*, 596 F. Supp. 219 (E.D. Mo. 1984) (holding that a contingent rate of return is expectation of profit under the *Howey* test).

Farmers Bank and similar cases turn on the underlying loan's being a normal commercial lending transaction. Therefore, loan participations not involving a normal commercial lending transaction (because, for example, the borrower is not creditworthy, there is inadequate collateral, returns on the loan are contingent on the borrower's profits, the loan participation trades at a steep discount (indicating that the "lender" probably seeks profits through increase in the resale value of the participation rather than from payment of interest on the loan)) or, where the lender is not institutional, may be investment contracts under *Howey*.

Even prior to *SEC v. Edwards*, 540 U.S. 389 (2004), plaintiffs could have argued that cases holding that a fixed rate of return fail to pass the investment contract test are no longer valid in light of the Supreme Court's statement in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), *reh'g denied*, 494 U.S. 1092 (1990), that "profit" includes a "valuable return on an investment" and specifically includes interest. In *Reves*, the court had noted that it was appropriate for "profit" to be defined differently depending on whether an instrument is being analyzed as a "note" or an "investment contract." In *Edwards*, however, the Court rejected this prior statement. *See supra* Note 59 and accompanying text.

87 *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993) ("*Banco Espanol*").

88 Brief of the SEC, *Amicus Curiae*, *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993).

89 *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 55–56 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993).

90 *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 55 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993). The lower court opinion, 763 F. Supp. 36 (S.D.N.Y. 1991), which the Second Circuit affirmed, had also ruled that the participations were not investment contracts under the *Howey* test. The Second Circuit did not consider the investment contract analysis.

91 Brief of the SEC at 3, *Amicus Curiae, Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993).

92 Some commercial paper is exempt from the registration requirements of the Securities Act pursuant to § 3(a)(3) thereof, and sales of other commercial paper may be structured to be exempt from registration in reliance on the exemptions provided by § 4(2) of the Securities Act or Rule 144A thereunder. *See* § 3.05[3]. However, notwithstanding these exemptions from registration, commercial paper is a security under the Securities Act, and issuers and sellers of commercial paper are subject to the fraud provisions of the Securities Act. If loan participations sold under programs like Security Pacific's were treated as securities, the sales could also be structured to be exempt from registration under the Securities Act.

93 Since the mid-1980s, banks have been selling "loan notes" similar to those sold by Security Pacific in an effort to compete with short-term commercial paper that was being offered by investment banks at a lower cost than traditional bank financing.

94 In *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808 (2d Cir. 1994), *cert. denied*, 513 U.S. 963 (1994), the Second Circuit applied the *Reves* test to mortgage participations that were sold to certain "unsophisticated investors" by way of a discretionary account. The court held that the instruments were securities, noting that (i) although it may have been a close question as to whether the sellers' motivation was accurately characterized as investment rather than commercial, the buyers' motivation was clearly investment-related, (ii) the broad-based, unrestricted nature of the sales of the instruments distinguished this case from *Banco Espanol* and supported a finding that the instruments were subject to the federal securities laws, (iii) the buyers could reasonably expect that the instruments were securities, particularly in light of their instructions to the broker for their discretionary account to make conservative, low-risk investments, most of which consisted of investment-grade bonds, and (iv) there were no other factors that reduced the risks inherent in the instruments, such as independent regulation or collateral. *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d 808, 812–15 (2d Cir. 1994).

95 In fact, the court in *Banco Espanol* recognized that some loan participations may be securities, stating explicitly that "even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled, or marketed might establish that such participations are securities." *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 56 (2d Cir. 1992), *cert. denied*, 509 U.S. 903 (1993) (citing *Gary Plastic*).

96 *See, e.g., Realtek Industries, Inc. v. Nomura Securities*, 939 F. Supp. 572 (N.D. Ohio 1996) (holding that, because the parties expressly intended to repackage mortgage loans and issue certificates to the general public, such certificates constituted securities).

97 For a general discussion of the treatment of loan participations under the U.S. securities laws, *see* Lee C. Buchheit, *When Is a Loan Not a Loan?*, 9 INT'L FIN. L. REV. 29 (1990).

98 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DRIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.17[6][c].

98.1 For a discussion of banking laws that may be applicable to certain financial instruments issued or entered into by banks, such as deposits, *see* Robert L. Tortoriello, Derek M. Bush and Hugh C. Conroy, Jr., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. West 2017).

98.2 For a more detailed discussion of swaps and security-based swaps, *see* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.15[b].

98.3 CEA § 1a(9). Prior to 1974, the term "commodity" included only specified agricultural products. Futures contracts and commodity options involving goods other than the agricultural products specified in the CEA were not regulated under the statute. As the markets for other "goods" (including derivative financial products) developed, exchanges came to trade regulated and unregulated futures contracts side by side. The 1974 Amendments amended the definition of the term "commodity" to include, in addition to specified agricultural products, all other "goods and articles … and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in" in order to bring all futures contracts under the CEA's statutory and administrative framework. *See* CEA § 1a(9). The 1974 Amendments also included a specific provision, proposed by the Department of the Treasury, to exclude from the CEA's otherwise expanded jurisdiction transactions in foreign currencies and specified financial instruments—as long as those transactions were not transactions involving "the sale thereof for future delivery conducted on a board of trade."

98.4 Futures Trading Act of 1982, Pub. L. No. 97-444, tit. 1, 96 Stat. 2294 (1983). The accord is named for the then-chairmen of the SEC and CFTC.

98.5 For these purposes the term "exempt securities" means certain securities exempted under § 3 of the Securities Act or § 3(a)(12) of the Exchange Act but does not include, among other securities, municipal securities.

98.6 *See* former CEA §§ 2(a)(1)(A)(i), 2(a)(1)(B)(ii) and (iv) and 4c(f) (as amended by the CFMA, current CEA §§ 2(a)(1)(A), 2(a)(1)(C)(ii) and (iv) and 4c(f)).

98.7 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.09[1].

98.8 The Shad-Johnson Accord excluded from regulation under the CEA any "put, call, or other option on one or more securities … including any group or index of such securities, or any interest therein or based on the value thereof." *See* former CEA § 2(a)(1)(B)(i) (now CEA § 2(a)(1)(C)(i)). *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.09 for more information.

98.9 CEA §§ 4c(f) and 4m(2).

98.10 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[4][c] for more detailed discussion of hybrid instruments.

98.11 In 1987, the CFTC published for comment an advance notice of proposed rule-making in which it asserted jurisdiction over virtually all hybrid instruments, with only limited exclusions or exemptions for hybrid instruments having "*de minimis*" or "incidental" futures or commodity option features.

98.12 Pub. L. No.106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000).

98.13 Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

98.14 Title VII of the Dodd-Frank Act also expanded the "security" definition in § 2(a)(1) of the Securities Act and § 3(a)(10) of the Exchange Act to cover security-based swaps.

98.15 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.15[1][a].

98.16 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5][c].

98.17 Under the CFMA, an agreement, contract or transaction between eligible contract participants that provided for the purchase or sale of one or more securities based on the occurrence of a *bona fide* contingency that might reasonably be expected to affect or be affected by the creditworthiness of a party other than a party to the agreement, contract or transaction was excluded from the definition of "security." This exclusion was generally regarded as covering credit default swaps. The Dodd-Frank Act repealed this exclusion, instead subjecting such an agreement, contract or transaction to regulation as a swap or security-based swap.

98.18 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.15.

98.19 *See, e.g.*, § 3(a)(10) of the Exchange Act.

98.20 CEA § 2(a)(1)(C)(i).

98.21 CEA § 1a(47)(B)(iii).

98.22 *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1274 (S.D. Ohio 1996).

98.23 The *P&G* court also analyzed a second swap—referred to as the "DM swap"—which, although documented as a "floating-for-floating" interest rate swap, effectively provided for BT to pay to P&G, for four years, 1% on a notional amount of approximately DM 160 million in exchange for the right to receive a "spread" after one year, if the prevailing level of German four-year interest rates (actually, the "DM four-year swap rate") ever traded outside a defined range during the one-year period. This spread would be the fixed rate periodically payable, under a four-year fixed-for-floating interest rate swap, in exchange for the right to receive a floating rate payment based on the DM four-year swap rate.

98.24 The *P&G* court also considered whether the "5s/30s swap" and the "DM swap" were investment contracts under *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) ("*Howey*"). The court ruled that the instruments did not satisfy the *Howey* test because "what is missing is the element of a 'common enterprise.'" *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1278 (S.D. Ohio 1996). In addition, the court observed, the value of both swaps depended upon market forces, not the entrepreneurial activities of BT. In reaching this conclusion, the court rejected P&G's arguments that P&G and BT had a course of dealing treating the swap agreements as securities and that the P&G swap agreements should be viewed in the context of all of BT's derivatives business.

Notably, the "investment contract" test has been used in lower courts to analyze interest rate futures, which are contracts to buy or sell government securities and which can serve the same general functions as rate protection transactions. In *P&C Investment Club v. Becker*, 520 F. Supp. 120 (E.D. Pa. 1981), the court found that the interest rate futures were not securities because their return was completely dependent on interest rate movements and did not depend on the efforts of others in a common enterprise. *But see Fisher v. Dean Witter Reynolds, Inc*., 526 F. Supp. 558, 560 (E.D. Pa. 1981) (an interest-rate futures contract is a security, as it is a contract for the sale of the underlying security). *See also SEC v. Belmont Reid & Co.*, 794 F.2d 1388, 1390–91 (9th Cir. 1986) (sale of gold coins did not involve profits "'solely' from the efforts of others" because "profits to the coin buyer depended upon the fluctuations of the gold market"). *But see SEC v. Eurobond Exchange, Ltd.*, 13 F.3d 1334, 1341 (9th Cir. 1994) (profits from interest-rate sensitive scheme attributable to promoter's efforts, rather than market movements).

For a more detailed discussion of the *Howey* "investment contract" test, *see* § 12.02[2][d].

In addition, the P&G court analyzed whether the swap agreements should be regarded as notes under *Reves*' "family resemblance test." *Reves v. Ernst & Young*, 494 U.S. 56, 61 (1990), *reh'g denied*, 494 U.S. 1092 (1990) ("*Reves*"). The court found that the swap agreements, unlike traditional notes, did not involve any payment or repayment of principal. The court opined that, on balance, the swap agreements were entered into more for commercial than investment purposes, were customized for P&G and not readily tradable, and the public and, more specifically, P&G did not have a reasonable expectation that the swap agreements were securities. Though the court conceded that there may be no other regulatory scheme designed to protect counterparties to swap agreements, nonetheless, the absence of such a scheme alone was not sufficient to bring the swap agreements within the definition of a note. *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1278 (S.D. Ohio 1996). Because the swap agreements were not notes for purposes of the securities laws, the court also held that the swap agreements were not evidences of indebtedness. *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1280 (S.D. Ohio 1996).

The conclusion that swaps more generally should not be treated as notes for purposes of the securities laws would seem to be correct for a number of other reasons. Historically, the major terms of each transaction have been individually negotiated in accordance with the business needs of the parties, making it unlikely that a transaction will have equivalent value to nonparties, and these transactions have not been amenable to trading. Moreover, trading of these instruments is commonly restricted by contractual provisions that require that both parties consent to any termination or assignment of the instrument. While what is sometimes referred to as a "secondary market" in swaps and rate protection transactions has developed, this is not a market in which these instruments are traded; rather, it is a source of quotations and other information for parties seeking to enter into new transactions. A party seeking to exit an existing transaction generally would not transfer or assign such transaction, but instead would terminate the transaction at a negotiated price. When an assignment of an existing transaction does occur, it is generally the product of negotiations between the parties. If a party wishes to get out of a transaction without seeking the consent of its counterparty, or in circumstances where such consent is not forthcoming, the party may enter into a new transaction that offsets its economic position in the original transaction. In light of these characteristics, it is clear that the so-called "secondary market" in swaps and rate protection transactions does not constitute a secondary trading market as that term is commonly understood in the context of securities trading. Although the amendments to the CEA by the CFMA permitting greater standardization, and electronic trading, of swap agreements led to the development of markets through which new swap agreements may be entered into, that development should not affect the conclusion that swaps should not generally be treated as notes for purposes of the securities laws. Moreover, the Dodd-Frank Act excluded "notes" subject to the Acts from the definition of "swap," thereby clearly expressing congressional intent that notes be distinguished from swaps. *See* CEA § 1a(47)(B)(vii).

For a more detailed discussion of the *Reves* "family resemblance" test, *see* § 12.02[2][d].

98.25 *See Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1281 (S.D. Ohio 1996). Although the definition of security includes "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (*including any interest therein or based on the value thereof*).…" (emphasis added), § 2(a)(1) of the Securities Act; § 3(a)(10) of the Exchange Act, the court concluded that the underscored parenthetical modified only the phrase "group or index of securities," and not the terms "security" or "any option." The court went on expressly to limit its holdings to the particular leveraged derivative instruments at issue in the case, observing that "[s]ome of these derivative instruments, because of their structure, may be securities." *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1283 (S.D. Ohio 1996); *see infra* Note 29.

98.26 SEC Release No. 33-7124 (Dec. 22, 1994).

98.27 SEC Release No. 33-7124, Fed. Sec. L. Rep. (CCH) ¶85,477, p. 86,112 n.6 (Dec. 22, 1994).

98.28 In addition to the numerous other transactions entered into between Gibson Greetings and BT Securities over a period of several years, BT wrote a cash-settled call option based on the yield of a particular 30-year Treasury security. The option was exercisable at maturity and would expire if the yield on the 30-year Treasury security dropped below a designated level. SEC Release No. 33-7124 (Dec. 22, 1994). It is apparent from the SEC's characterization of this transaction that because the yield on a given security is based on its price, the SEC regards an option based on the yield of a specified debt security as an option "on any security … or group or index of securities (including any interest therein or based on the value thereof)." § 2(a)(1) of the Securities Act.

98.29 The court in *Proctor & Gamble* might have based its holding that the P&G swap was not a security on the specific characteristics of the swap (*i.e.*, the fact that the option was an embedded, nonseverable component of a bilateral executory agreement). The court's articulated reasoning, however, is unsatisfactory in a number of respects. First, the court offered no predicate analysis of the statutory text justifying reference to the legislative history of the provision. In connection with its discussion of the provision's legislative history, the court also neglected to consider whether its holding was consistent with the jurisdictional framework established under the CFTC-SEC jurisdictional accord of which the relevant statutory text formed a part and ignored relevant text in parallel provisions of the CEA. Finally, the court's discussion of the statutory term "option" was largely conclusory.

98.30 *Caiola v. Citibank*, 295 F.3d 312 (2d Cir. 2002); *see also* § 11.11[2].

98.31 *Caiola v. Citibank*, 137 F. Supp. 2d 362 (S.D.N.Y. 2001), *rev'd*, 295 F.3d 312 (2d Cir. 2002).

98.32 Caiola also claimed that the provisions of the CFMA that amended § 10(b) of the Exchange Act to reach swap agreements should be applied retroactively even if the arrangements were not securities themselves. However, the Second Circuit declined to address the question of retroactivity as it found that Caiola failed to properly raise the issue in the district court. *See Caiola v. Citibank*, 295 F.3d 312, 327 (2d Cir. 2002).

98.33 *See Caiola v. Citibank*, 295 F.3d 312, 326 (2d Cir. 2002). The court noted that an option on an index of securities, which is defined as a security under § 3(a)(10), is settled by cash since physical delivery is not possible. The court continued that "there is no basis for reading into the term 'option' as used in the phrase [in § 3(a)(10)] 'option … on any security' a limitation requiring a particular method of settlement—a limitation that clearly does not apply to 'option' as used in the phrase 'option … on any … index of securities.'" *Caiola v. Citibank*, 295 F.3d 312, 327 (2d Cir. 2002). There are several other instances where the SEC has taken the position that options whose value is derivatively based on the value of a security or group of securities—even at multiple levels of abstraction—are securities. For example, the SEC has noted that it would treat options on the S&P 500 Dividend Index as securities. *See* CBOE Rule Change, SEC Tracker Daily, SR-CBOE-2009-022 (Dec. 10, 2009). In another release, the SEC has stated that it would treat options based on the occurrence of credit events in the debt securities of one or more issuers as securities: "the credit default options proposed by CBOE are securities because they are options based on the value of a security or securities and because they are options on an interest in, or based on the value of an interest in, a security or securities." *See* Order Granting Approval of a Proposed Rule Change to List and Trade Credit Default Basket Options, as Modified by Amendment No. 3, and Designating Credit Default Basket Options as Standardized Options under Rule 9b-1 of the Securities Exchange Act of 1934, SEC Release No. 34-56275 (Aug. 17, 2007). Lastly, we note that the SEC has treated options on volatility indices based on the value of securities as securities. *See* Order Granting Approval to the Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to Options on Certain CBOE Volatility Indexes, SEC Release No. 34-49563 (Apr. 14, 2004). In this order, the SEC does not explicitly state that such options are securities under § 3(a)(10) of the Exchange Act; however, the context of the order and the SEC's statement that "the CEA does not apply to the volatility index options CBOE proposes to list and trade" make it clear that the SEC believes they are. Order Granting Approval to the Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to Options on Certain CBOE Volatility Indexes, SEC Release No. 34-49563 (Apr. 14, 2004).

98.34 A collar has option-like characteristics in that, for example, one party's exposure to loss has been limited in the context of a decline in the price of the stock to the strike price of the put option. A collar has swap-like or futures-like features in that each party has contingent exposure to loss and contingent opportunity for gain. As the exercise prices of the two options converge, the instrument becomes more similar economically to an equity swap or futures contract.

98.35 An example of a deep-in-the-money option is an option in which Party A has the right to purchase from Party B in three months for $25 per share a stock that has a current market value of $100 per share. Such an agreement has option-like characteristics in that, for example, Party A's exposure to loss has been limited to its premium, Party A has no additional exposure to loss resulting from a decline in the price of the stock below $25, and Party A is not contractually obligated to purchase the stock. The agreement may be characterized as having swap-like or futures-like features in that each party has contingent exposure to loss and contingent opportunity for gain. Party A may be said to have prepaid its contingent future loss through the payment of the intrinsic value component (the "in-the-money"—as opposed to the "time value"—component) of the option premium.

98.36 This discussion is not intended to address situations in which similar economic results are obtained by the execution of two or more independent option transactions. An analysis of the circumstances in which multiple contemporaneous option transactions would be integrated for regulatory purposes would necessarily be fact-dependent. *Cf. In re Thrifty Oil Co.*, 212 B.R. 147 (Bankr. S.D. Cal. 1997) (declining to integrate related contemporaneous interest rate swap and loan transactions).

98.37 *See, e.g.*, Title VII Product Definitions Final Rule, 77 Fed. Reg. 48,208, 48,260 (Aug. 13, 2012) (explaining that the name or label used by the parties to refer to a transaction is not determinative of whether it is a swap or security-based swap); *In re Wright*, CFTC Docket No. 97-02 (Oct. 25, 2010) ("[T]he Commission applies a 'facts and circumstances' test rather than a bright-line test focused on the contract's terms.").

98.38 *See, e.g.*, *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (evaluating whether a particular instrument was a security); *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989); *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982) (evaluating whether particular transactions constituted futures contracts); *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537, 547 (7th Cir. 1989) ("Words are useful only to the extent they distinguish some things from others; symbols that comprise everything mean nothing").

98.39 *See, e.g.*, *Progressive Corp. v. United States*, 970 F.2d 188, 193–94 (6th Cir. 1992) (call option should be treated for tax purposes as the equivalent of a contractual obligation to sell where it is so deep-in-the-money that exercise is "virtually guaranteed"); IRS Revenue Ruling 82-150, 1982-2 C.B. 110 (taxpayer who purchased a call option with strike price equal to 30% of the fair market value of the underlying stock treated as the owner of the stock); *In re Berge*, 32 B.R. 370, 372 (Bankr. W.D. Wis. 1983) (equipment lease with an option to purchase was not a true lease where the purchase option was for a price so nominal that, at the time the lease was entered into, exercise of the option was "virtually certain" as a matter of rational business judgment); *Gordon & Co. v. Board of Governors of the Federal Reserve System*, 317 F. Supp. 1045 (D. Mass. 1970) (declining, based on improbability of success on the merits, to enjoin an interpretation of the Board that a 30-day call option on a stock with a strike price of 70% of the stock's market value constituted an extension of credit because the likelihood that the option would be exercised would render the transaction more akin to a present sale of the stock with a 30% down payment and an extension of credit for the remaining 70% of the purchase price).

98.40 CFTC Interpretative Letter No. 94-32, Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994); *see also* CFTC Interpretative Letter No. 94-93, Comm. Fut. L. Rep. (CCH) ¶26,249 (July 27, 1994) (status of financial Instruments indexed to individual stocks) (financial instruments economically equivalent to options on individual stocks—§ 2(a)(1)(B)(v)).

98.41 CFTC Interpretative Letter No. 94-32 (status of financial instruments indexed to individual stocks), Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994).

98.42 This is an amount, calculated on the basis of the historical price performance of the stock over the preceding one-year period, equal to the maximum deviation from the forward value of the stock over a one-year period that is likely to be exceeded only with a probability of roughly 32%. By way of example, given a mean forward stock price of $25 and an annualized standard deviation of 20% (or $5.00), there would be a 68% probability, at the end of one year, that the value of the stock would fall within the range bounded on the lower side by $20 ($25 minus $5) and on the higher side by $30 ($25 plus $5). Conversely, there would be a roughly 16% likelihood that the price of the stock would fall above, and a 16% likelihood that the price of the stock would fall below, the specified range. This translates, in the case of an individual option, to a probability of non-exercise roughly equal to 16%. If one were to employ the framework for analysis suggested by decisions such as those cited in *supra* Note 39, a compelling argument can be made that an option having a 16% probability of nonexercise (such as the options proposed in the no-action request) is not virtually certain of exercise and, accordingly, should be respected as an option.

98.43 CFTC Interpretative Letter No. 94-32, Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994), at 41,344.

98.44 CFTC Interpretative Letter No. 94-32, Comm. Fut. L. Rep. (CCH) ¶26,042 (Feb. 4, 1994), at 41,346 (citing *Chicago Mercantile Exchange v. SEC*, 883 F.2d 537 (7th Cir. 1989), and observing that the one-way indexing characteristic of an option derives from its having a strike price that is out-of-the-money).

98.45 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.14. Certain swaps based on loans are also security-based swaps under the Dodd-Frank Act. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.17[3].

98.46 § 3(a)(68) of the Exchange Act.

98.47 § 3(a)(10) of the Exchange Act.

98.48 *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.01.

98.49 CEA § 2(a)(1)(A).

99 For example, the Supreme Court implied in *Howey* that the land and service contract transactions might not

have been considered to involve securities if the investors had lived near the citrus groves and had expertise and equipment to manage the groves sufficient to lessen their reliance on defendants.

100 Analyzing the instruments under *Reves*, the court noted that the transaction was fundamentally commercial in nature in that the repackaged loans were effectively the seller's inventory rather than an investment whose outcome was tied to the profitability of the seller. In addition, the instruments were sold to a very specialized and sophisticated secondary market and the existence of collateral was a risk-reducing factor leading the court to hold that the instruments were not notes. *Resolution Trust Corp. v. Stone*, 998 F.2d 1534, 1528–29 (10th Cir. 1993). The court also found that the instruments were not investment contracts under the *Howey* test because investors received specified interest payments rather than dividends tied to the profitability of the seller. *Resolution Trust Corp. v. Stone*, 998 F.2d 1534, 1540–41 (10th Cir. 1993).

101 Several structures have been used to repackage mortgage loans. For example, the resulting instrument may evidence an equity-type interest in the pool of loans (such as mortgage pass-through certificates) entitling the holder to a proportional share of payments on the underlying loans. In other structures (for example, collateralized mortgage obligations), the instrument is characterized as a debt obligation that is collateralized by the underlying mortgage loans. *But see Resolution Trust Corp. v. Stone*, 998 F.2d 1534 (10th Cir. 1993) (holding that car loans, repackaged with enhancements such as a buy-back guarantee and insurance, and sold on the secondary market, were not securities).

U.S. Regulation of the International Securities and Derivatives Markets, § 13.01, 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 § 13.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The SEC has long recognized that U.S. disclosure requirements generally are the most rigorous in the world and that foreign issuers often have excluded the U.S. public from multinational securities offerings to avoid the need to comply with U.S. disclosure standards. The U.S. disclosure requirements for public offerings often require foreign issuers to expand their selling documents to include information not required under the rules of their home jurisdiction. The need to comply with U.S. disclosure rules as well as those of the home jurisdiction can add substantial costs to an offering and can cause delays—accountants and lawyers have to be retained in both jurisdictions and additional time is usually required because of the need to comply with two sets of rules. Any delay caused by U.S. regulatory requirements can be a significant impediment because advantageous market conditions for a particular securities issue may last for only a short period. These concerns are relevant not only for traditional public offerings but also for tender and exchange offers, offers in connection with business combinations and rights offerings. In these latter cases, the practical effect of the offeror's unwillingness to comply with U.S. requirements is that U.S. securityholders are not treated on an equal basis with non-U.S. holders.

The multijurisdictional disclosure system (the "MJDS") [1] between the SEC and provincial securities regulators in Canada (the "Canadian Securities Administrators," or the "CSA") was the SEC's first comprehensive effort toward

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meeting these concerns. [2] The MJDS, which became effective July 1, 1991, is a complex reciprocal initiative, adopted by the SEC and the CSA, intended to facilitate certain U.S./Canadian cross-border securities offerings, business combinations and tender and exchange offers by allowing such transactions to

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proceed in both jurisdictions on the basis principally of home country disclosures and rules, and by permitting issuers that have used the system (as well as other eligible issuers) to satisfy their ongoing disclosure obligations in both jurisdictions through the use of home country disclosures, supplemented as necessary by disclosures mandated by the Sarbanes-Oxley and Dodd-Frank Acts (and the equivalent regulations in Canada, where applicable). The MJDS also provides accommodations in related areas, including regulation of trust indentures and trustees and market regulation. In conjunction with the MJDS, the SEC extended its "foreign private issuer integrated disclosure system" (the "FPI System") to Canadian issuers on an equal basis with other foreign issuers, which, among other things, gives all Canadian foreign private issuers a complete exemption from the U.S. proxy requirements and insider reporting/short-swing profit recovery rules. [3]

The MJDS represented a significant milestone for the SEC in terms of its recognition of the securities laws of Canada. Since its adoption, the system has made it substantially easier for eligible Canadian issuers to access the U.S. capital markets and has encouraged the equal treatment of U.S. securityholders in

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rights offerings and offers in connection with business combinations, exchange offers and tender offers eligible for MJDS treatment. The mutual recognition premise of the MJDS has become an outlier in SEC regulatory policy, however, as following its adoption the SEC shifted away from mutual recognition and toward a unified system of disclosure for foreign private issuers. [4] The two most notable examples of this shift are the SEC's revised Form 20-F, which replaced almost all of the former Form 20-F requirements with international disclosure standards adopted by the International Organization of Securities Commissions ("IOSCO"), and the SEC's acceptance from foreign private issuers of financial statements prepared in accordance with the International Financial Reporting Standards ("IFRS") as issued by the IASB. [5]

An earlier indication of the SEC's ambivalence toward the MJDS mutual recognition approach was the so-called "Aircraft Carrier Release" of 1998, whose sweeping proposed revisions to the securities offering process likely would have eliminated the MJDS if they had been adopted. [6] The proposed elimination of the MJDS never occurred, partially due to criticism from both Canadian and U.S. groups, including Canadian securities regulators, Canadian issuers, the Investment Industry Regulatory Organization of Canada (formerly the Investment Dealers Association) and the Securities Law Committee of the Business Law Section of the New York State Bar Association, which argued that the elimination of the MJDS would increase disclosure costs, result in regulatory and

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administrative impediments to cross-border Canadian offerings (which had been eliminated for MJDS-eligible offerings) and effectively reduce U.S. investor access to securities of Canadian issuers. [7]

Footnotes

1 SEC Release No. 33-6902 (July 1, 1991) (the "Adopting Release"). The MJDS was initially introduced in Canada as National Policy Statement No. 45, 14 O.S.C.B. 2889 (June 28, 1991), which was replaced by National Instrument 71-101, The Multijurisdictional Disclosure System, 21 O.S.C.B. 5104 (Aug. 14, 1998) ("National Instrument 71-101") and Companion Policy 71-101CP, 21 O.S.C.B. 5136 (Aug. 14, 1998).

The development of the MJDS was initiated by the SEC in 1985 with the issuance of a concept release, SEC Release No. 33-6568 (Feb. 28, 1985), requesting comment on two alternative methods of facilitating multijurisdictional offerings: the "common prospectus" or "harmonization" approach, which would require participating jurisdictions to agree on a common set of disclosure requirements; and the "reciprocal prospectus" or "mutual recognition" approach, which would provide that a prospectus prepared pursuant to the requirements of the issuer's home jurisdiction would be accepted for securities offerings in every other participating jurisdiction. Originally proposed in July 1989 (SEC Release No. 33-6841 (July 24, 1989); Multijurisdictional Disclosure System (Outline) 12 O.S.C.B. 2919 (July 28, 1989); and reproposed in October 1990, SEC Release No. 33-6879 (Oct. 16, 1990); Draft National Policy Statement No. 45, 13 O.S.C.B. 4573 (Nov. 2, 1990)), the MJDS is a hybrid of the two approaches—although the SEC generally recognizes and accepts Canadian disclosures, it requires U.S. disclosures in limited (but important) areas, such as certain disclosures required under the Sarbanes-Oxley and Dodd-Frank Acts. The greatest burden historically faced by issuers was the requirement to include a Canadian GAAP to U.S. GAAP reconciliation of financial statements in certain offerings. However, for fiscal years beginning on or after January 1, 2011 (or January 1, 2012 in the case of certain issuers in rate-regulated industries), Canadian public companies are required to report under IFRS as issued by the International Accounting Standards Board ("IASB") rather than Canadian GAAP, pursuant to National Instrument 52-107, Acceptable Accounting Principles and Auditing Standards, and related amendments. As the SEC exempts foreign private issuers reporting under IFRS as issued by IASB from the requirement to provide a U.S. GAAP reconciliation, the transition from Canadian GAAP to IFRS has eliminated the need for Canadian foreign private issuers to provide a U.S. GAAP reconciliation under the MJDS. *See* 4.05[1] and § 13.02.

The SEC chose Canada as its initial partner for the MJDS because of the similarity of the U.S. and Canadian regulatory regimes and the significant presence of Canadian companies in the U.S. trading markets. In his opening statement at the meeting adopting the MJDS, then-SEC Chairman Breeden stated:

> [The] MJDS was developed initially in Canada due to its developed capital markets and strong regulatory tradition. While the disclosure requirements of the United States and Canada differ in detail, the regulatory systems share the common purpose of ensuring that investors are given information adequate to make an informed investment decision. This system represents in a sense reciprocity based on equality of reporting and disclosure.

Richard C. Breeden, Chairman, SEC, Opening Statement on Adoption of Rules, Forms and Schedules for Multijurisdictional Disclosure with Canada at Open Meeting (May 30, 1991).

Interestingly, the "equality" of Canadian and U.S. requirements was achieved in certain important respects by initiatives adopted in Canada during the negotiation of the MJDS. *See*, *e.g.*, Ontario Securities Commission ("OSC") Policy Statement 5.10, O.S.C.B. 4275 (1989) (adopting "management's discussion and analysis" requirement); National Policy Statement No. 44, 14 O.S.C.B. 1844 (1991) (adopting shelf and post-receipt pricing rules); Amendments to OSC Policy Statement 5.1 and OSC Policy Statement 5.6, 14 O.S.C.B. 2956 (1991) (requiring prospectus-level disclosure in proxy materials used for business combinations); Market Regulation Amendments to OSC Policy Statement 5.1, 14 O.S.C.B. 4137 (1991); Policy Statement Q-26, Volume XXII, Issue 35, Quebec Securities Commission Bulletin 2 (Aug. 30, 1991) (adding certain market regulation requirements). Each of the foregoing has been amended, reformulated or replaced one or more times since it was originally issued.

2 The SEC's efforts in this area continued with its adoption in 2000 of a number of exemptions to the tender offer rules and registration requirements under the U.S. securities laws to facilitate the extension of a broad class of cross-border tender and exchange offers, business combinations and rights offerings to U.S. holders, regardless of the issuer's home jurisdiction. Effective January 24, 2000, these rules established principally: (i) an exemption from most of the rules under the Exchange Act governing tender offers for securities of non-U.S. companies if U.S. ownership is 10% or less, (ii) more limited relief from rules under the Exchange Act to eliminate conflicts between U.S. and foreign takeover regimes in tender offers where U.S. ownership is 40% or less, and (iii) an exemption from the registration requirements of the Securities Act for securities issued to holders of securities in non-U.S. companies in exchange offers, business combinations and rights offerings, in each instance if U.S. ownership is 10% or less. *See* SEC Release No. 34-42054 (Oct. 22, 1999). In 2008, the SEC further amended these rules and provided additional guidance on how U.S. registration and tender offer rules legitimately may be avoided in cross-border business combination transactions. *See* SEC Release No. 33-8957 (Sept. 19, 2008); *see also* text accompanying *infra* Notes 28, 48 and 54; § 10.05[2] (for a discussion of cross-border rights offerings in light of the 1999 and 2008 SEC releases and resulting reforms); § 9.05 (for a discussion of cross-border tender and exchange offers). As noted in §§ 13.04 and 13.05, for certain Canadian companies, utilizing the MJDS for business combinations/exchange offers may be a superior alternative.

Securities regulators in Canada are working towards the creation of a national cooperative regulatory regime expected to come into force no earlier than 2018. Current drafts of the rules and regulations of the cooperative regulatory regime adopt the current MJDS system with conforming/ consequential amendments to reflect the new regime and provide for certain additional exemptions available to issuers who comply with National Instrument 71-101.

3 The extension of the FPI System to Canadian foreign private issuers was the culmination of a shift in SEC policy toward equal treatment of Canadian foreign private issuers. Historically, the SEC had taken the position that, due to the geographical proximity of the United States, Canada and Mexico and the substantial economic links among the three countries, Canadian and Mexican companies should be treated similarly to U.S. companies for certain purposes under the U.S. securities laws. As a result, Canadian and Mexican

foreign private issuers were generally required to comply with U.S. domestic issuer registration forms and reporting requirements. In SEC Release No. 33-6437 (Nov. 19, 1982), the SEC eliminated its definition of "North American issuer" and began treating Mexican foreign private issuers the same as other foreign private issuers; however, the special treatment of Canadian foreign private issuers was retained. With the adoption of Regulation S under the Securities Act in April 1990 (Regulation S governs offers and sales of securities outside the United States), the SEC signaled its changing position toward Canada by treating offers and sales of securities in Canada (and by Canadian issuers) the same as offers and sales involving other foreign countries. *See* the discussion of Regulation S in § 8.02.

The SEC historically accorded special treatment in one respect to Canadian issuers not filing under either the MJDS or the FPI System. Whereas other non-U.S. issuers not meeting the definition of foreign private issuer were required to prepare financial statements included in Securities Act registration statements in accordance with U.S. GAAP, the SEC allowed non-MJDS, nonforeign private issuer Canadian issuers to prepare their financial statements under Canadian GAAP, but file Securities Act registration statements on U.S. domestic forms (the "S" forms), provided they also prepared a U.S. GAAP reconciliation pursuant to Item 18 of Form 20-F. In connection with Canada's transition to IFRS, the SEC determined that "[a] Canadian company that is not a foreign private issuer that has historically used Canadian GAAP and Canadian dollars in filings with the SEC may continue to do so for fiscal years prior to 2011[;]" however, "[b]eginning with fiscal year 2011, a Canadian company that is not a foreign private issuer must use U.S. GAAP in filings with the SEC. The financial statements and selected financial data should be recast into U.S. GAAP for all periods presented in the financial statements." *See* SEC, Division of Corporation Finance, Financial Reporting Manual, Topic 6120.5 (Mar. 17, 2016 Ed.). *See also infra*, Note 10.

4 Outside the offering and exchange context, the SEC has appeared more open toward mutual recognition regimes. In 2008, the SEC entered into a mutual recognition arrangement with the Australian government and the Australian Securities and Investments Commission, permitting U.S. and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions without the need in certain respects for separate regulation in both countries. *See* Press Release, SEC, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008). Similarly, the SEC and the Chairmen of four Canadian securities regulators announced in 2008 a schedule for completing a U.S.-Canadian mutual recognition process agreement, which was to lay out the process for discussion of an eventual U.S.-Canada stock exchange and broker-dealer mutual recognition agreement. *See* Press Release, SEC, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement (May 29, 2008). No process agreement, however, has yet been signed. The financial crisis and the departure of then-SEC Chairman Christopher Cox, a supporter of mutual recognition regimes, drew resources and attention away from the mutual recognition process, which appears to be on hold.

5 *See* SEC Release No. 33-7745 (Sept. 28, 1999) (revised 20-F); SEC Release No. 33-8879 (Dec. 21, 2007) (acceptance of IFRS); *see also* the discussions of Form 20-F in §§ 3.03[1][b] and 4.04 and of the SEC's acceptance of IFRS from foreign private issuers in § 4.05[1]. The acceptance of IFRS also contributed to the elimination of Form F-9. *See* text accompanying *infra* Note 21.

6 *See* SEC Release No. 33-7606 (Nov. 3, 1998), amended by SEC Release No. 33-7606A (Nov. 13, 1998). The Aircraft Carrier Release was largely withdrawn. *See* § 1.01. Portions of the proposal, however, have been pursued individually (*see*, *e.g.*, SEC Release No. 33-7943 (Jan. 26, 2001) (discussing mixed public/private offerings and Rule 155, dealing with integration concerns)), and in 2005 the SEC adopted new rules that implemented significant reforms to the U.S. public securities offering process. *See* § 3.02.

7 *See U.S. SEC Urged to Reconsider Plan to End Expedited Prospectus Approval*, WORLD SECURITIES LAW REPORT (Oct. 1999).

U.S. Regulation of the International Securities and Derivatives Markets, § 13.02, U.S. OFFERINGS BY "SUBSTANTIAL" CANADIAN ISSUERS

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 § 13.02 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The centerpiece of the MJDS is its provision for "substantial" Canadian issuers (*i.e*., those meeting certain Canadian reporting history and "size" tests) to offer securities in the United States by means of a prospectus prepared in accordance with Canadian disclosure requirements (with certain U.S. additions). [8] Such offerings may be made in conjunction with a contemporaneous Canadian offering or on a "U.S.-only" basis. For Canadian issuers eligible to use Canada's short-form system, the Canadian prospectus may be a "short-form" prospectus. [9]

With the adoption of IFRS by Canadian public companies on January 1, 2011, [10] which generally eliminated the need for U.S. GAAP reconciliations, very little additional information is required to be included in MJDS prospectuses. Other than the home country prospectus, Canadian issuers need only include a

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few informational legends and similar technical disclosures. [11] Significantly, however, MJDS prospectuses are required to include all "material" information (within the meaning of the U.S. securities laws), [12] and issuers and underwriters (as well as other statutorily responsible parties) are subject to liability under the U.S. civil liability and antifraud provisions if the MJDS filing contains a material misstatement or omission.

The application of the U.S. antifraud rules to MJDS offerings particularly needs to be borne in mind in light of the additional disclosures mandated by the Sarbanes-Oxley and Dodd-Frank Acts and the related SEC rules and proposals, [13] particularly in circumstances in which responsive disclosures in annual reports on Form 40-F may need to be updated in MJDS registration statements even when not literally required by those acts and rules, as they may be considered indicia of complete and accurate disclosure.

[1] Eligibility for MJDS "Substantial Issuer" Forms

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To be eligible to use the SEC "substantial issuer" Form F-10 [14] to register a public offering of securities in the United States under the MJDS, an issuer must:

- be incorporated or organized in Canada;
- be a "foreign private issuer"; [15]
- have a 12-month reporting history with one or more of the provincial securities authorities in Canada; [16]

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- be in compliance with its Canadian reporting obligations; and
- not be an "investment company" registered or required to be registered under the U.S. Investment Company Act.

Where a Canadian foreign private issuer that does not satisfy one or more of these criteria is required to file a Securities Act registration statement or Exchange Act report with the SEC, it must use the forms prescribed for foreign private issuers generally. [17]

MJDS offerings by "substantial issuers" are registered with the SEC by filing the Canadian prospectus under cover of a "wrap-around" registration statement on Form F-10. The "wrap-around" registration statement consists of a cover page, the Canadian prospectus, a signature page, [18] required U.S. disclosure regarding indemnification and certain specified exhibits. [19] The MJDS is not

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available if no Canadian offering document is prepared because the issuer is relying on an exemption from prospectus requirements in Canada. [20]

In 2011, the SEC released a final rule relating to the use of security ratings by credit rating agencies in SEC rules and forms, pursuant to the requirements of § 939A of the Dodd-Frank Act. [21] Among other items, the rule "rescind[ed] Form F-9 and adopt[ed] amendments to the Securities Act and Exchange Act forms and rules that refer to Form F-9 to eliminate those references." The elimination of Form F-9 primarily reflected the transition among Canadian public companies from Canadian GAAP to IFRS effective January 1, 2011 and took effect on December 31, 2012, by which time all Canadian public companies had transitioned to IFRS. The primary difference in disclosure requirements between Form F-9 and Form F-10 is that Form F-9 did not require a U.S. GAAP reconciliation of financial statements prepared using Canadian GAAP. The transition to IFRS, however, means that issuers on Form F-10 are also no longer required to provide a U.S. GAAP reconciliation. As the disclosure requirements would have been the same under each form, the SEC viewed Form F-9 as "unnecessary."

Although the disclosure requirements between Forms F-9 and F-10 converged, different eligibility standards between the two forms means that not all issuers that were eligible to use Form F-9 are able to use Form F-10 for their offerings. In particular, investment grade majority-owned subsidiaries may lack the U.S. $75 million public float or parent guarantee required by Form F-10, which was not required for offerings of nonconvertible securities under Form F-9. [22]

Form F-10 is used for all "substantial issuer" offerings under the MJDS, including offerings of (i) common shares, (ii) noninvestment grade debt or preferred shares (iii) convertible debt or preferred shares that may be converted

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within one year of issuance and (iv) “A/B” exchange offers. [22.1] Issuers wishing to use Form F-10 must have a public float of U.S. $75 million or more. [23]

Form F-10 may not be used for offerings of derivative securities except for (i) warrants, options and rights where such securities and the underlying securities are issued by the registrant, its parent or an affiliate of either and (ii) convertible securities that are convertible into securities of the registrant, its parent or an affiliate of either. Accordingly, securities such as currency warrants, stock index warrants and debt securities paying interest based on the performance of a stock index may not be offered on Form F-10.

A majority-owned, Canadian-incorporated subsidiary of a parent that meets all of the applicable eligibility tests for Form F-10 may use such form to offer debt securities or preferred shares even though the subsidiary does not have a 12-month Canadian reporting history or does not meet the public float test (if applicable), provided that the parent fully and unconditionally guarantees the securities being registered and the securities, if convertible or exchangeable, are convertible or exchangeable only into securities of the parent.

The Canadian shelf and post-receipt pricing ("PREP") rules [24] may be used in the United States as well as in Canada in the context of MJDS offerings. Eligible Canadian issuers may establish a single "cross-border shelf," based on Canadian disclosures and shelf rules that may be used for takedowns in either jurisdiction as market conditions warrant. [25] Cross-border medium-term note programs can be established in this manner. [26] The PREP rules are available to all issuers and are not restricted to short-form system issuers (generally issuers

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whose equity securities are listed on certain recognized Canadian stock exchanges). [27] Offering procedures under the Canadian shelf rules are generally comparable to the procedures that have developed under the SEC's Rule 415, which served as the model for the Canadian rules. [28] SEC Rules 415 and 430B do not apply to MJDS offerings by Canadian issuers. [29]

[2] SEC Review

As adopted, the MJDS provides that, absent special circumstances, the SEC staff will not review MJDS registration statements, but will instead rely on review procedures applied in Canada. [30] Where the MJDS is used for the U.S. portion of an offering being made simultaneously in Canada and the United States, the registration statement on Form F-10 is effective upon filing with the SEC (unless designated as preliminary material on the form, *e.g.*, where the Canadian preliminary prospectus will be used for marketing in the United States). Accordingly, the U.S. offering can proceed immediately after the final prospectus has been cleared in Canada without any special notice or certification to the SEC. [31] The virtual elimination of SEC review was one of the most important aspects of the MJDS as adopted and has to date solved, in most cases, what had previously been a difficult coordination problem for offerings made simultaneously in both jurisdictions (*i.e.*, the fact that SEC review generally takes substantially longer than review in Canada).

For U.S.-only offerings, the issuer is required to designate a review jurisdiction in Canada and file a copy of the registration statement and prospectus

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with the review jurisdiction concurrently with the SEC filing. [32] The issuer may designate on the cover page of the registration statement a date and time for the registration statement to become effective that is not earlier than seven calendar days after the date of filing with the SEC, and the registration statement will become effective in accordance with the designation, unless (i) the filing is selected for review by the review jurisdiction, in which case effectiveness may be delayed, or (ii) the review jurisdiction issues a receipt or notification of clearance prior to the designated date, in which case effectiveness may be accelerated by order of the SEC. [33] MJDS offerings are subject to the SEC's "stop order" authority to stop an offering for the public interest and for the protection of investors.

Footnotes

8 *See* Rule 467 under the Securities Act and § 13.02[2]. Although the SEC reserves the right to review any MJDS registration statement, MJDS filings are automatically effective in the United States (unless designated as preliminary material), so any review would generally be after effectiveness (absent the issuance of a stop order pursuant to § 8(d) of the Securities Act).

9 The short-form system, available to Canadian issuers meeting specified eligibility tests, provides for the qualification of offerings of securities by means of a "short-form" prospectus that incorporates by reference the issuer's Canadian continuous disclosure filings. The short-form system provides for an expedited regulatory review period of three business days in the principal review jurisdiction. It essentially parallels the provisions for Form S-3 issuers in the SEC's integrated disclosure system.

The MJDS is particularly attractive to Canadian short-form system issuers that have not previously had access to the U.S. markets. Without the MJDS, such issuers, although qualifying for a short-form prospectus in Canada, would be required to prepare a long-form prospectus (generally, Form F-1) to offer securities in the United States. By allowing Canadian short-form prospectuses to be used in the United States under the MJDS, the SEC recognized the Canadian integrated disclosure system, even though many eligible Canadian issuers have no substantial market following in the United States.

10 Calendar year-end reporting issuers began reporting using IFRS as of January 1, 2011, followed by noncalendar year-end reporting issuers at the start of their next fiscal year thereafter. *See* CSA National Instrument 52-107, Acceptable Accounting Principles and Auditing Standards. In connection with Canada's transition to IFRS, the SEC determined that "[a] Canadian company that is not a foreign private issuer must

use U.S. GAAP in filings with the SEC. The financial statements and selected financial data should be recast into U.S. GAAP for all periods presented in the financial statements." *See* SEC, Division of Corporation Finance, Financial Reporting Manual, Topic 6120.5 (Mar. 17, 2016 Ed.)

11 MJDS prospectuses must include four SEC-mandated legends addressing, respectively, use of foreign disclosures, tax consequences, enforcement of U.S. civil liabilities and absence of SEC approval of the prospectus. Any legends required under state securities laws must also be included. The SEC's "red herring" legend (which states that the information is subject to completion or amendment and that offers and sales may not be made until the related registration statement becomes effective) must be included in all preliminary prospectuses under the MJDS. MJDS prospectuses must include a list of all documents filed with the SEC as part of the MJDS registration statement, including all documents incorporated by reference in the prospectus. Incorporated documents need not be delivered to offerees together with the prospectus unless required under the laws of the principal jurisdiction in Canada. If the prospectus is in the French language only, it must be translated into English.

Certain required Canadian disclosures applicable solely to Canadian offerees or purchasers (and not material to offerees or purchasers in the United States) may be omitted from MJDS prospectuses. These items include: (i) the "red herring" legend used in Canada, (ii) any discussion of Canadian tax considerations not material to U.S. offerees or purchasers, (iii) the names of any Canadian underwriters not acting as underwriters in the United States and a description of the Canadian plan of distribution (except to the extent necessary to describe the material facts of the U.S. plan of distribution), (iv) any description of purchasers' statutory rights under applicable Canadian, provincial or territorial securities laws (except where such rights are available to U.S. purchasers), and (v) issuer's and underwriters' prospectus certificates. These omissions are permitted in order to allow MJDS prospectuses to have a "U.S. look."

Companies should also take into consideration other cross-border harmonizing issues, including coordination on the content of "road show" presentations and other marketing materials. These marketing materials may be required to be filed with the OSC in Canada, but are customarily not filed with the SEC in the United States. *See* § 3.02[3][c][iii][B] for more information about road shows.

12 *See, e.g.*, Form F-10, General Instruction II.C.; Adopting Release, 56 Fed. Reg. 30,036, 30,087 (June 21, 1991); *see also* Chapter 11. In addition to the supplemental prospectus information required by the MJDS rules, certain additional disclosures (*e.g.*, a discussion of U.S. tax consequences, disclosure of exchange rates, *etc.*) historically have been provided because of their relevance to U.S. purchasers. Marketing considerations and investor expectations in the United States increasingly have led issuers also to include certain supplemental disclosures not required in Canada but normally included in U.S. disclosure documents (*e.g.*, capitalization tables and summary financial information).

13 *See* §§ 4.07 and 4.08.

14 Pursuant to the requirements of the Dodd-Frank Act, the SEC rescinded Form F-9, effective December 31, 2012, in a release relating to the use of security ratings by credit agencies in SEC rules and forms. SEC Release No. 33-9245 (July 27, 2011). This release is further discussed later in this chapter.

15 *See* § 3.01, Note 1 for a discussion of the "foreign private issuer" definition. Issuers are required to test their foreign private issuer status annually on the last day of their second fiscal quarter. *See* SEC Release No. 33-8959 (Sept. 23, 2008).

Prior to December 31, 2012, a "crown corporation" was also eligible to use a "substantial issuer" form. A "crown corporation" is a corporation all of whose common shares or comparable equity shares are owned directly or indirectly by the government of Canada or a province or territory of Canada. Because the MJDS relies on Canadian disclosure requirements and Canadian regulatory review as a replacement for the SEC's disclosure rules and review procedures, only those crown corporations that file prospectuses with Canadian securities regulators are able to use the MJDS for U.S. financings. Relatively few Canadian crown corporations are subject to prospectus requirements in Canada, as they generally finance through exempt transactions with government guarantees. Moreover, because crown corporations, by definition, do not have a "public float," their use of the MJDS was effectively limited to offering nonconvertible investment grade debt or preferred shares on Form F-9, due to there being no public float eligibility test for such offerings. Following the rescission of Form F-9 effective December 31, 2012, crown corporations are no longer eligible to use the MJDS for these offerings.

16 A special reporting history test is provided under Form F-10 (and other MJDS forms that include a reporting history eligibility requirement) for successor issuers (*i.e.*, issuers subsisting after a business combination) that do not themselves have the requisite reporting history. An alternative test is important in these circumstances because under corporate statutes in Canada, the surviving corporation in a business combination is generally viewed as a new entity (as in a consolidation in the United States). The test is satisfied if each company participating in the business combination other than the successor issuer has been a reporting company for at least 12 calendar months. A predecessor company may be disregarded for purposes of the test if the assets and gross revenues from continuing operations of the remaining predecessor(s) account for at least 80% of the successor issuer's *pro forma* combined assets and gross revenues from continuing operations, as measured based on *pro forma* combination of the participating companies' most recently completed fiscal years. A similar test applies to successor issuers subject to a listing history eligibility requirement (*e.g.*, for use of Form F-7 in connection with a rights offering, *see* § 13.03, or Form F-8 or F-80 in connection with a business combination, *see* § 13.04, or exchange offer, *see* § 13.05) that do not themselves have the requisite listing history.

17 For a discussion of forms prescribed for foreign private issuers generally, *see* §§ 3.03[1][b], 4.04 and 4.02[3][c]. In addition, some Canadian issuers do not satisfy one or more of the criteria for foreign private issuer status. When any such issuer is required to file a Securities Act registration statement or Exchange Act report, it must use the forms prescribed for U.S. domestic issuers.

18 The MJDS Securities Act registration forms specifically exempt Canadian issuers from complying with Regulation C under the Securities Act, which sets forth requirements for preparing and filing registration statements and prospectuses. Each such registration form states that "[t]he rules comprising Regulation C under the Securities Act shall not apply to filings on this form unless specifically referred to in the form." Thus, among other requirements, the plain English requirements are not applicable to the MJDS Securities Act registration forms. Similarly, Form 40-F, the Exchange Act annual report form available to MJDS issuers, states that "Rules 12b-2, 12b-5, 12b-10, 12b-11, 12b-12, 12b-13, 12b-14, 12b-21, 12b-22, 12b-23, 12b-25, 12b-33 and 12b-37 under the Exchange Act," which govern the form and method of preparation of Exchange Act reports, "shall not apply to filings on this [f]orm." Each of the MJDS Securities Act registration forms and Form 40-F specify that, instead, "the rules and regulations applicable in the home jurisdiction regarding the form and method of preparation of disclosure documents shall apply." As of November 4, 2002, all foreign private issuers, including MJDS filers, are required to make filings with the SEC electronically using the EDGAR system. SEC Release No. 33-8099 (May 14, 2002). The SEC's rule requiring interactive data reporting using XBRL applies to Forms F-10 and 40-F, but did not require or permit the filing of interactive data related to these forms when the financial statements are prepared in accordance with Canadian GAAP or as a U.S. GAAP reconciliation. SEC Release No. 33-9002 (Jan. 30, 2009), as amended by SEC Release No. 33-9002A (Apr. 1, 2009). As Canadian MJDS filers transitioned to reporting under IFRS by January 1, 2011, they were required to comply with the interactive data requirements applicable to those filings. The SEC, however, has issued a no-action letter relieving foreign private issuers of their obligation to submit interactive data files with their IFRS financial statements until the SEC has specified a taxonomy for preparing such information. *The Center for Audit Quality* (avail. Apr. 8, 2011). The SEC staff is continuing to review taxonomies for use by foreign private issuers. The IFRS Foundation periodically publishes versions of the IFRS taxonomy for public comment.

19 Required exhibits include (i) all publicly available documents filed concurrently with the prospectus in Canada, (ii) copies of all documents incorporated by reference and (iii) consents of experts named in the filing. These documents must be filed electronically using the SEC's EDGAR system. *See* SEC Release No. 33-8099 (May 14, 2002).

20 In the case of U.S.-only offerings on Form F-10, the MJDS may be used despite the availability of an exemption from the Canadian prospectus requirements as long as a Canadian offering document is

prepared and filed with the Canadian securities regulator in the review jurisdiction. *See* § 13.02[2].

21 SEC Release No. 33-9245 (July 27, 2011). Section 939A of the Dodd-Frank Act required that the SEC "review any regulation issued by the SEC that requires the use of an assessment of credit-worthiness of a security or money market instrument and any references to or requirements in such regulations regarding credit ratings." Following this review, the Dodd-Frank Act required the SEC to modify its regulations to "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness" as the SEC determined to be appropriate.

22 To address this issue, the SEC introduced a temporary "grandfather" provision for Form F-9 filers. This provision, which expired on December 31, 2015, allowed any issuer that disclosed in its registration statement that it had a reasonable belief that it would have been eligible to make an offering of investment grade, nonconvertible securities on Form F-9 as of December 31, 2012, and disclosed the basis for that belief, to file a final prospectus for an offering on Form F-10. *See* SEC Release No. 33-9245 (July 27, 2011).

22.1 For more information about "A/B" exchange offers, *see* SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Forms, Question 109.06 (Feb. 27, 2009) and § 7.05[2].

23 *See* § 4.05[1]. Filings on Form F-10 must include a full U.S. GAAP reconciliation of all financial statements in the Canadian prospectus to the extent that the required financial statements have not been prepared in accordance with IFRS. Given that all Canadian issuers must present their financial statements in accordance with IFRS, however, this requirement is moot. Historically, the U.S. GAAP reconciliation requirement imposed substantial costs and was, for some Canadian issuers, an impediment to their use of MJDS.

24 *See* National Instrument 44-102, Shelf Distributions, 23 O.S.C.B. (Supp) 985 (Dec. 22, 2000) (amended by 28 O.S.C.B. 10449 (Dec. 30, 2005)) and Companion Policy 44-102, 23 O.S.C.B. (Supp) 1005 (Dec. 22, 2000) (amended by 28 O.S.C.B. 10456) (Dec. 23, 2005), and by National Instrument 44-103, Post-Receipt Pricing, 23 O.S.C.B. (Supp) 1013 (Dec. 22, 2000) (amended by 28 O.S.C.B. 10458) and Companion Policy 44-103CP, 23 O.S.C.B. (Supp) 1025 (amended by 28 O.S.C.B. 10460).

25 A number of large Canadian issuers eligible to use the short-form registration statement for U.S. domestic issuers (Form S-3) currently have shelf debt programs in the United States. Without the MJDS, Canadian issuers would need, among other things, to establish a 12-month U.S. reporting history in order to be eligible to use the U.S. shelf procedures.

26 Interest income paid to U.S. residents on certain Canadian issuer debt securities previously may have been subject to Canadian withholding tax. However, since January 1, 2008, Canadian tax legislation eliminated Canadian withholding tax on interest paid or credited on all arm's-length and nonparticipating debt to non-Canadian lenders.

27 Short-form eligible exchanges include the Toronto Stock Exchange, Tier 1 and Tier 2 of the TSX Venture Exchange, Aequitas NEO Exchange Inc., and the Canadian Securities Exchange.

28 Like the U.S. shelf rules, the Canadian shelf procedures permit offerings to be made on a continuous or delayed basis after a "base" prospectus has been cleared by the Canadian securities regulatory authorities as evidenced by the issuance of a final receipt. Once the terms of a particular tranche are determined, the specific terms are provided by a supplement to the prospectus that is not subject to advance clearance by the Canadian securities regulatory authorities.

29 Allowing the U.S. rules to apply in place of the Canadian rules would put home jurisdiction regulators in Canada (who have the responsibility for reviewing MJDS filings) in the difficult position of having to evaluate disclosures prepared under U.S. rules (*e.g.*, the content and format of the "base" prospectus used for a shelf program).

30 The Adopting Release states the SEC's review standard as follows: "[E]xcept in the unusual case where the [SEC] staff has reason to believe there is a problem with the filing or the offering, the documents generally will be given a ‘no review’ status.…" Adopting Release, 56 Fed. Reg. 30,036, 30,046 (June 21, 1991).

31 Note, however, that FINRA review may still be required in certain circumstances. For example, FINRA Rule

5110(b)(7)(C)(ii) exempts F-10 filings from FINRA review only if the securities are offered pursuant to Canadian shelf prospectus offering procedures.

32 A jurisdiction designated to act as the review jurisdiction must agree to act in that capacity. The securities regulatory authorities of New Brunswick, Prince Edward Island, Newfoundland, the Yukon Territory and the Northwest Territories have indicated that they will not act as the review jurisdiction in connection with U.S.-only offerings. As a practical matter, based on the home jurisdictions of Canadian companies, most U.S.-only offerings are cleared through Ontario, Quebec, Alberta or British Columbia.

33 The SEC's effective no-review policy with respect to MJDS filings has continued despite concerns expressed regarding compliance by certain filings with MJDS requirements. In 1996, a member of the SEC accounting staff publicly indicated that the staff had conducted an informal review of selected filings under the MJDS, which review had revealed instances of noncompliance with, or significant inaccuracies with respect to, the U.S. GAAP reconciliation requirement, as well as noncompliance with certain other technical requirements of the MJDS. As a result of these shortcomings, and in particular the inadequate compliance with the U.S. GAAP reconciliation requirement, the SEC staff member indicated at that time that MJDS filings, especially annual reports on Form 40-F but also potentially filings to register securities for offering in the United States (in particular Form F-10, which requires a U.S. GAAP reconciliation for financial statements not prepared in accordance with IFRS), might be subject to review by the SEC, either in conjunction with that of the securities regulatory authority in the Canadian review jurisdiction or in lieu of a review by such regulatory authority. Having in effect placed issuers and others on notice as to the possibility of SEC review (perhaps in an effort to bring about voluntary compliance without undermining a key aspect of the MJDS), the SEC has continued its MJDS no-review practice other than to the extent review is required under the Sarbanes-Oxley Act. (The fact that financial statements of Canadian filers are now prepared in accordance with IFRS as a practical matter may further reduce the likelihood of SEC review.) *See supra* Note 30.

U.S. Regulation of the International Securities and Derivatives Markets, § 13.03, 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 § 13.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Because many Canadian companies, including those that have not financed in the United States or established a U.S. trading market for their securities, have U.S. shareholders, U.S. regulatory requirements are frequently implicated in Canadian rights offerings. Prior to adoption of the MJDS, U.S. shareholders of Canadian companies were frequently excluded from rights offerings or "cashed out" to avoid the need for the issuer to comply with the U.S. securities laws. As a result, U.S. shareholders lost the opportunity to participate in the offering on

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an equal basis with Canadian and other non-U.S. holders. The rights offering provisions of the MJDS (as well as the provisions governing business combinations, exchange offers and tender offers discussed below) are intended to encourage equal treatment of U.S. shareholders by reducing the burdens on Canadian issuers extending such offers into the United States. [34]

Eligible Canadian issuers may use the MJDS to extend rights offerings to U.S. shareholders by means of a Canadian prospectus or rights offering circular. The Canadian disclosure document is filed with the SEC under cover of a "wrap-around" registration statement on Form F-7. [35] To be eligible to use Form F-7, an issuer must:

- be incorporated or organized in Canada;
- be a foreign private issuer;
- have had a class of its securities listed on the Toronto Stock Exchange ("TSX") or the TSX Venture Exchange [36] for the 12 calendar months immediately preceding the filing;
- have a three-year reporting history with one or more of the provincial securities authorities in Canada;
- be in compliance with its Canadian listing and reporting obligations; and
- not be an "investment company" registered or required to be registered under the U.S. Investment Company Act.

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Canadian issuers need not meet any "size" tests to use the MJDS for rights offerings, and no U.S. GAAP reconciliation is required for financial statements included in the Canadian offering document using IFRS. Thus, a broad class of Canadian issuers is eligible for the rights offering component of the MJDS, which is appropriate because rights offerings were included in the system to encourage equal treatment of U.S. shareholders. The MJDS contains other special accommodations intended to encourage rights offerings. [37]

Form F-7 requires that the rights granted to securityholders in the United States be granted on terms and conditions not less favorable than those extended to any other holder of the same class of security. The rights granted to U.S. holders [38] may not be transferred except outside the United States in accordance with Regulation S under the Securities Act. [39] Securities purchased by U.S. holders upon exercise of rights are, however, not restricted and therefore are freely transferable in the United States. Unlike Rule 801 rights offerings by foreign private issuers, [40] Form F-7 is available without regard to the percentage of the class of securities being issued that is held by U.S. holders.

Registration statements on Form F-7 are effective upon filing with the SEC. Accordingly, the rights may be issued in the United States as soon as the Canadian securities regulators have completed their review of the Canadian prospectus or rights offering circular and have cleared the issuance of the rights in Canada.

Although the MJDS rules are intended to make it as easy as possible for Canadian issuers to extend their rights offerings to U.S. shareholders, the system does not eliminate all the potential burdens for Canadian issuers. Many Canadian rights offerings are made pursuant to an exemption from Canadian prospectus requirements that permits the rights to be offered by means of a rights offering circular, a brief disclosure document that is not required to contain

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Canadian "prospectus-level" disclosure and typically includes very little information about the issuer. Although the MJDS expressly contemplates the use of rights offering circulars, the fact that the disclosure is less complete than Canadian prospectus disclosures can, in certain circumstances, raise concerns under the U.S. civil liability and antifraud rules. This result may lead issuers to involve U.S. lawyers in the preparation of the disclosure document, which increases the costs of the offering. [41]

State securities laws [42] can also increase the difficulty and costs of MJDS rights offerings. For Canadian issuers that cannot rely on the federal preemption of state securities registration requirements provided by the National Securities Markets Improvement Act of 1996 (the "NSMIA") [43] applicable to certain "covered securities" (*e.g.*, based on an NYSE or Nasdaq listing), a number of states will subject the rights offering to their "merit review" procedures, potentially delaying the offering or making it impossible to extend the rights offering to shareholders in those states. Determining and complying with applicable state law requirements demands specialized U.S. lawyers, raising offering costs.

Footnotes

34 In 2000, the SEC adopted rules that facilitate cross-border tender and exchange offers, business combinations and rights offerings of equity securities by all foreign private issuers (including Canadian issuers) by, among other things, extending the MJDS principle of recognition of home country disclosures. *See* text accompanying *supra* Note 2 and text accompanying *infra* Notes 52 and 60; *see also* §§ 10.05[2] and 9.05. Consistent with the approach taken in the MJDS, rights offerings under Rule 801 under the Securities Act generally must be extended to U.S. holders on terms and conditions not less favorable than those extended to any other holder of such securities, and issuers using Rule 801 remain subject to the civil liability and antifraud provisions of the U.S. securities laws. *See* § 10.05[2].

35 The securities registered on Form F-7 are those issued upon exercise of the rights. The rights themselves generally are not required to be registered based on a "no-sale" theory. It does not appear that Form F-7 (or the documents used for rights offered to existing Canadian shareholders pursuant to a prospectus exemption under National Instrument 45-101) allows for rights to be offered to persons who do not hold the securities in respect of which the rights were issued. Any offering of a "rump" would have to be qualified by another prospectus or pursuant to an exemption from registration in Canada and not pursuant to Form F-7 in the United States. One possible option would be to rely on the private placement rules of both regimes.

36 Form F-7 also references the Montreal Exchange and the Senior Board of the Vancouver Stock Exchange. Both of these exchanges have since been merged into the TSX and the TSX Venture Exchange.

37 For example, the SEC's auditor independence rules, discussed in § 13.07[4], do not apply to MJDS rights offerings, and Form F-X, which provides, among other things, for the appointment of an agent for service of process, is not required in connection with MJDS rights offerings (*but see infra* Note 68). Although the special MJDS exemption from the reporting requirements of § 15(d) of the Exchange Act contained in Rule 12g3-2(b) under the Exchange Act has been eliminated, MJDS filers can qualify for the exemption on the same basis as other foreign private issuers. *See* § 13.10.

38 "U.S. holder" is defined to include "any person whose address appears on the records of the registrant, any

voting trustee, any depositary, any share transfer agent or any person acting on behalf of the registrant as being located in the United States." 17 C.F.R. § 239.37(d).

39 Regulation S under the Securities Act provides a safe harbor from SEC registration for persons (other than the issuer, a distributor, their respective affiliates and any person acting on behalf of any of the foregoing) reselling securities in an offshore transaction (including offers and sales on the TSX and the TSX Venture Exchange not prearranged with a U.S. buyer) and without directed selling efforts in the United States. *See* § 8.02.

40 *See* § 10.05[2].

41 Despite potential concerns as to the U.S. civil liability and antifraud rules, many rights offerings circulars filed under Form F-7 have been prepared following the standard Canadian approach to rights offerings with little or no modification to conform to U.S. disclosure practices.

42 *See* § 13.07[7].

43 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

U.S. Regulation of the International Securities and Derivatives Markets, § 13.04, BUSINESS COMBINATIONS

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 § 13.04 (11th and 12th Editions 2014-2017)
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The MJDS permits the registration in the United States of securities issued by Canadian corporations in connection with a statutory amalgamation, merger, arrangement or other reorganization requiring the vote of shareholders of the participating companies (a "business combination"). [44] Eligible Canadian issuers may register these securities with the SEC by filing the information circular prepared in accordance with applicable proxy solicitation rules in Canada [45] under cover of a "wrap-around" registration statement on SEC Forms F-8 or F-80

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(or Form F-10 if the applicable eligibility tests are satisfied). Forms F-8 and F-80 do not require a U.S. GAAP reconciliation of the financial statements included in the Canadian information circular. The MJDS is not available if no information circular is prepared because of the availability of an exemption from such requirements. [46]

To be eligible to use the MJDS in connection with a business combination, each corporation participating in the business combination (other than the successor registrant) must satisfy the eligibility criteria identified above for use of the MJDS in connection with a rights offering and must also have a public float of at least U.S. $75 million. [47] However, a participating company is not required to satisfy the public float or the reporting and listing eligibility criteria if other participating companies that do satisfy these criteria have assets and gross revenues from continuing operations that in the aggregate would contribute, on a *pro forma* basis for the most recently completed fiscal year, at least 80% of the successor registrant's total assets and gross revenues from continuing operations. In addition, the successor registrant must be a foreign private issuer that is incorporated or organized in Canada.

The securities being registered under the MJDS in connection with a business combination must be issued to U.S. holders on terms and conditions not less favorable than those extended to any other holder of the same class of security. For Form F-8, less than 25%, and for Form F-80, less than 40%, of the class of securities being offered by the successor registrant in connection with the business combination must be held by U.S. holders [48] measured on a *pro forma* basis as of immediately after completion of the business combination. The disclosure

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requirements under Forms F-8 and F-80 are the same. [49] Registration statements on Forms F-8 and F-80 are effective upon filing with the SEC.

Registrants participating in business combinations that are ineligible to use Forms F-8 or F-80 because, for example, the limitation on securities issued to U.S. holders is not satisfied (*i.e.*, if more than 40% of the class of securities being offered by the successor registrant will be held by U.S. holders) may use Form F-10 if participating companies accounting for at least 80% of the total assets and gross revenues from continuing operations of the successor registrant meet the eligibility criteria for Form F-10.

The business combination (and exchange offer) provisions of the MJDS are limited to transactions in which all of the participating companies are Canadian. Thus, although Form F-10-eligible Canadian companies can use Canadian disclosures under the MJDS to make a traditional common share offering in the United States and to list common shares on a U.S. stock exchange, these companies, even after a longstanding U.S. presence, will be required to use the FPI System forms or U.S. domestic issuer forms (with the attendant costs and delays) [50] to register securities offered in business combinations or exchange offers involving U.S. companies.

Canadian issuers are also eligible to use the rules adopted by the SEC in January 2000 and October 2008 [51] for cross-border tender and exchange offers, business combinations and rights offerings. These rules include Rule 802 under the Securities Act, under which exchange offers for a foreign private issuer's securities and securities issued in business combinations involving foreign private issuers are exempt from the registration requirements of the Securities Act if U.S. securityholders hold 10% or less of the subject class of securities. [52]

Footnotes

44 Many Canadian business combinations can be structured so that they are effected with the approval of a Canadian court, in which case the securities being offered are generally exempt from Securities Act registration requirements pursuant to § 3(a)(10) of the Securities Act. For a discussion of issues that frequently arise in connection with this exemption, *see* SEC, Division of Corporation Finance, Staff Legal Bulletin No. 3A, Fed. Sec. L. Rep. (CCH) ¶60,003 (June 18, 2008).

45 Provincial securities laws generally exempt securities issued in a business combination from prospectus requirements on the theory that the information circular required under the proxy rules provides sufficient disclosure to shareholders. Canadian securities regulators have taken action to require prospectus-level disclosure in information circulars prepared in connection with business combinations, which enabled the SEC to determine that such circulars are adequate for purposes of the MJDS. *See* OSC Rule 51-801, Implementing National Instrument 51-102, Continuous Disclosure Obligations (the "Implementing Rule"), 27 O.S.C.B. 3555 (Mar. 30, 2004) (amended by 28 O.S.C.B. 4559 (May 16, 2005), amended by 29 O.S.C.B. (Supp-2) (Dec. 29, 2006), a local Ontario rule implementing National Instrument 51-102, Continuous Disclosure Obligations, 27 O.S.C.B. 3439 (in force on Mar. 30, 2004) (amended by 28 O.S.C.B. 10384 (June 1, 2005), amended by 28 O.S.C.B. 10463 (Dec. 30, 2005), amended by 30 O.S.C.B. (Supp-1) 1 (Dec. 29, 2006) ("NI 51-102"), in Ontario. NI 51-102 requires prospectus-level disclosure, including updated financial statements, for information circulars prepared in connection with a business combination.

46 *See supra* Note 23.

47 For second-step business combinations occurring within 12 months after the termination of an exchange offer or cash tender offer that was or could have been extended into the United States under the MJDS, public float may be measured as of the date immediately prior to the commencement of the exchange offer or cash tender offer (and therefore prior to any reduction in a participating company's public float resulting from the offer).

48 For purposes of applying the U.S. holder tests under Forms F-8 and F-80 (used in connection with business combinations and exchange offers) and Schedules 14D-1F and 13E-4F (used in connection with third-party and issuer tender offers), except as described in § 13.06 in certain cases involving competing tender offer bids, the calculation of U.S. holders is made as of the end of the participating companies' (in business combinations) or subject issuer's (in exchange offers) last quarter (or, if such quarter terminated within 60 days of the filing date, as of the end of the preceding quarter).

49 The distinction between Forms F-8 and F-80 is limited to the permissible percentage ownership of the subject securities by U.S. holders (25% for Form F-8 and 40% for Form F-80). The SEC provided separate forms as an accommodation to state securities regulators, who have not been willing to recognize a threshold above 25% for purposes of the application of four model rules (discussed in § 13.07[7]) that provide for, *inter alia*, expedited review of MJDS registration statements by the state securities regulators. Offers for which the 25% threshold is exceeded are filed on Form F-80 so that they may be readily identified by the states for review purposes.

50 Canadian companies meeting certain specified eligibility requirements and having previously filed annual reports on Form 40-F will be entitled, however, to incorporate by reference such reports into a registration statement on Form F-4, the form under the FPI System used to register securities in the case of business

combinations, to satisfy the disclosure requirements concerning the acquiror, thereby limiting certain of the additional costs and delays. In the case of a Canadian company that does not meet these requirements, the company would be required to provide in the Form F-4 the information required by the long-form foreign private issuer registration form (*i.e.*, Form F-1).

51 *See* SEC Release No. 33-8957 (Sept. 19, 2008).

52 *See* text accompanying *supra* Notes 2 and 34 and text accompanying *infra* Note 60; *see also* § 9.05[9].

U.S. Regulation of the International Securities and Derivatives Markets, § 13.05, EXCHANGE OFFERS

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 § 13.05 (11th and 12th Editions 2014-2017)
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Exchange offers for a Canadian issuer's securities may be extended into the United States under the MJDS through use of Forms F-8 or F-80 (or Form F-10 if the applicable eligibility tests are satisfied), which "wrap-around" the Canadian securities exchange takeover bid circular or issuer bid circular. [53] The MJDS is not available if no takeover or issuer bid circular is prepared due to the availability of an exemption from such requirements.

The eligibility criteria applicable to registrants for the use of Forms F-8 or F-80 in an exchange offer are the same as identified above for use of the MJDS in connection with a rights offering, except that, for third-party exchange offers, the registrant must also have a public float of at least U.S. $75 million. [54] The target must be a foreign private issuer that is incorporated or organized in Canada and must not be an "investment company" registered or required to be registered under the U.S. Investment Company Act. The registrant must offer its securities to U.S. holders on terms and conditions not less favorable than those offered to any other holder of the same class of securities subject to the exchange offer.

For Form F-8, less than 25%, and for Form F-80, less than 40%, of the class of subject securities outstanding may be held by U.S. holders. For third-party exchange offers, the registrant may rely on a conclusive presumption [55] that the target is a foreign private issuer and that less than 25% (for Form F-8) or 40% (for Form F-80) of the subject securities is held by U.S. holders, unless (i) published data on trading volumes indicates that the aggregate trading volume of the subject securities in the United States exceeds the aggregate trading volume in Canada, (ii) the most recent annual report filed in Canada or the United States by the target indicates that the applicable threshold is exceeded or (iii) the registrant has actual knowledge to the contrary. As discussed with respect to business combinations and tender offers, Canadian issuers are also eligible to use the rules adopted by the SEC for certain foreign private issuer cross-border tender and exchange offers, business combinations and rights offerings, including Rule 802 under the Securities Act. [56]

Footnotes

53 Exchange offers made in the United States are generally subject to the requirements of the Williams Act in addition to the registration requirements of the Securities Act. The MJDS relief from Williams Act requirements is discussed in § 13.06.

54 There is an additional eligibility requirement for third-party exchange offers because, unlike in a rights offering or issuer exchange offer, the investor has not made a prior investment decision with respect to the issuer.

55 There is no presumption (either in Form F-8 or F-80 or in the tender offer provisions of the MJDS) regarding the target's investment company status.

56 *See* text accompanying *supra* Notes 2, 34 and 52 and text accompanying *infra* Note 60; *see also* § 9.05[9].

U.S. Regulation of the International Securities and Derivatives Markets, § 13.06, TENDER OFFERS

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 § 13.06 (11th and 12th Editions 2014-2017)
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Under the MJDS, eligible third-party and issuer cash tender offers or exchange offers for a class of securities of a Canadian issuer may be extended to U.S. securityholders, without regard to the application of the Williams Act and the SEC rules thereunder governing such offers, by using a Canadian takeover or issuer bid circular and complying with Canadian procedural rules governing the offers, provided that the transaction is subject to and not exempt from the substantive provisions of Canadian law governing the terms and conditions of the offer. [57] SEC Schedules 14D-1F (for third-party offers) and 13E-4F (for issuer offers), which "wrap-around" the Canadian takeover or issuer bid circular, are filed with the SEC concurrently with filing in Canada.

The target must be a foreign private issuer incorporated or organized in Canada, must not be an "investment company" registered or required to be registered under the U.S. Investment Company Act and less than 40% of the Canadian target's securities that are subject to the tender offer may be held by U.S. holders (including affiliates of the target). [58] There are no eligibility requirements for bidders in third-party cash tender offers and such bidders accordingly may include U.S. entities. The bidder must extend the cash tender offer to U.S. holders on terms and conditions not less favorable than those extended to any other holder of such securities.

Third-party bidders in a tender offer may rely on a conclusive presumption that the target is a foreign private issuer and that less than 40% of the subject securities are held by U.S. holders on the same basis as described above for exchange offers. There are no market value or public float tests for tender offers under the MJDS. However, if securities form part of the consideration, the MJDS

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requirements discussed above for registering the exchange offer under the Securities Act are applicable. [59] As a result, a U.S. bidder may follow Canadian bid rules if the MJDS eligibility requirements are met and the offer is limited to cash, but must comply with the normal U.S. registration requirements if securities are offered as part of the consideration, which could put a U.S. bidder at a disadvantage.

In addition, Canadian issuers are eligible to use rules adopted by the SEC to facilitate certain foreign private issuer cross-border tender and exchange offers, business combinations and rights offerings, extending the MJDS principle of recognition of home country disclosure and bid rules. [60] In the case of tender offers, these rules establish a two-tier system. The "Tier I exemption" provides that where 10% or less of the subject securities is held by U.S. holders, [61] third-party and issuer tender offers for a foreign private issuer may be conducted in the United States in accordance with the procedural and disclosure requirements of the target's home jurisdiction and without compliance with the Williams Act. Under the Tier I exemption, offering materials required by the target's home jurisdiction are to be submitted to the SEC under cover of Form CB. The "all-holders" and "best price" rules of Rule 14d-10 under the Exchange Act, as well as the "going private" disclosure and procedural requirements of Rule 13e-3 and Rule 14e-5 under the Exchange Act (which restricts purchases of securities outside a tender or exchange offer), are inapplicable to Tier I exempt offers.

The "Tier II exemption" provides more limited relief from the U.S. tender offer rules and applies where 40% or less of the subject securities is held by U.S. holders. [62] Under the Tier II exemption, the offeror has a right to divide a bid into two separate offers, one for U.S. and the other for non-U.S. holders, to offer "loan notes" or similar securities to non-U.S. holders only and to announce extensions of an offer in accordance with home jurisdiction practice rather than under U.S. rules. Furthermore, the Tier II exemption permits relaxation of the prompt payment rules to permit an offeror to pay for securities in accordance with requirements of the subject company's home jurisdiction and allows an offeror to reduce or waive the minimum tender condition without extending the offer if certain disclosure procedures and timing requirements are met. Offerors relying on the Tier II exemption are subject to the SEC's disclosure and filing obligations, certain other procedural obligations and the "going private" requirements of Rule 13e-3 under the Exchange Act. In addition, Rule 14e-5 under the Exchange Act continues to apply to bids made under the Tier II exemption, with limited exceptions. With respect to the Securities Act registration requirements

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for cross-border exchange offers, the rules establish an exemption from registration under Rule 802 where the Tier I exemption is available. Consistent with the approach taken in the MJDS, under the rules the offeror generally must extend the cash tender or exchange offer to U.S. holders on terms and conditions not less favorable than those extended to any other holder of such securities, and issuers and bidders remain subject to the civil liability and antifraud provisions of the U.S. securities laws.

Footnotes

57 Certain tender offers are exempt from provincial or territorial securities regulation, including, for example, issuer bids conducted on a recognized Canadian stock exchange such as the TSX, provided that the bid is conducted in accordance with the rules and policies of such exchange. The MJDS is available if the tender offer remains fully subject to at least one set of bid rules in Canada.

An issuer that has obtained a limited grant of exemptive relief from the application of bid regulations in Canada, which relief implicates protections corresponding to certain Williams Act protections, must seek an SEC order for the offer to proceed under the MJDS. The order may be conditioned on compliance with the relevant Williams Act provisions with respect to U.S. holders or without conditions. The SEC has indicated that it will respond to requests for such orders on an expedited basis.

58 If a Schedule 14D-1F or 13E-4F is filed while another cash tender or exchange offer for the same class of securities is ongoing and the earlier offer was commenced or was eligible to be commenced under the MJDS, the calculation of U.S. holders for purposes of the 40% limit is made as of the date applicable to the initial bid. Although the MJDS treatment of tender offers is intended by the SEC to encourage Canadian issuers to extend predominantly Canadian offers into the United States by removing the costs associated with complying with applicable U.S. securities regulations, the SEC has indicated that its adoption of a U.S. ownership threshold is not indicative of any belief that it may lack the jurisdiction to compel extension into the United States of a predominantly Canadian offer.

59 *See* § 13.05.

60 *See* § 9.05[9].

61 *See* § 9.05[9][a].

62 *See* § 9.05[9][b].

U.S. Regulation of the International Securities and Derivatives Markets, § 13.07, OTHER RELEVANT U.S. LEGAL CONSIDERATIONS

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 § 13.07 (11th and 12th Editions 2014-2017)
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The SEC's accommodations for MJDS securities offerings consist principally of the acceptance of Canadian disclosure documents and waiver of SEC review (although both accommodations are now directly or indirectly affected by the additional requirements of the Sarbanes-Oxley and Dodd-Frank Acts—namely, substantive disclosure requirements and mandate for SEC review of company disclosures once every three years [63]). MJDS securities offerings generally are subject to all other customary requirements for U.S. public offerings (*e.g.*, broker-dealer registration requirements for underwriters, prospectus delivery obligations, [64] limitations on publicity during the offering period, [65] *etc.*). The continued application of certain U.S. requirements, discussed below, may offset some of the benefits of the MJDS for Canadian issuers.

[1] U.S. Liability Rules

As noted above, the MJDS does not affect the applicability of U.S. civil liability and antifraud rules. Thus, Canadian issuers using the MJDS are subject to potential liability under U.S. law if their registration statements, prospectuses, circulars, Exchange Act disclosure filings or other communications contain material misstatements or omissions, with "materiality" and other elements of claims determined under U.S. law. [66] Although the relevant U.S. liability provisions for registration statements and prospectuses are phrased much like their Canadian counterparts, [67] Canadian issuers generally have been concerned that their potential exposure to civil liabilities is greater in the United States due to, among other things, differences in certain procedural rules (*e.g.*, the wider availability of class

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actions and contingency fee arrangements in the United States) and the generally higher incidence of securities litigation in the United States. [68]

The SEC clarified in the Adopting Release that, by adopting the MJDS, it in essence was adopting as its own requirements the disclosure requirements of the applicable Canadian forms, with the same effect as if such requirements were specifically spelled out in the MJDS forms. Accordingly, "good faith compliance with the disclosure requirements of the home jurisdiction, as construed by Canadian regulatory authorities, will constitute compliance with the applicable U.S. federal securities disclosure requirements, even if such compliance results in the omission of information which might otherwise have been required as a line item in registration statements filed by U.S. issuers on the [SEC's] other registration forms." [69] As to certain specified disclosures, however, the Sarbanes-Oxley and Dodd-Frank Acts have in effect modified the MJDS to impose such disclosure requirements on Form 40-F filers.

Although the clarification in the Adopting Release confirmed that the SEC did not expect Canadian issuers using the MJDS to comply with the line-item disclosure requirements of other U.S. disclosure forms, the requirement that MJDS disclosure documents contain all "material information" necessary to make the required statements "not misleading" (within the meaning of the U.S. securities laws) and the applicability of the U.S. civil liability and antifraud rules effectively require Canadian issuers to consider general U.S. disclosure principles and practices in preparing their MJDS filings. [70] Moreover, to help establish their "due diligence" defense under § 11 of the Securities Act, U.S. underwriters in MJDS offerings generally request Canadian issuers to provide,

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among other things, customary representations, and, under certain circumstances, a legal opinion or negative comfort letter from U.S. counsel, [71] as to the adequacy of the disclosure (from the perspective of the U.S. liability rules) in MJDS registration statements and prospectuses.

[2] Investment Companies

The restrictions of the U.S. Investment Company Act apply to MJDS offerings. Accordingly, Canadian issuers that are registered or required to register as an "investment company" under the U.S. Investment Company Act may not make securities offerings under the MJDS. The definition of "investment company" under the U.S. Investment Company Act is very broad, [72] and Canadian issuers whose assets include a substantial proportion of securities may constitute "investment companies." Thus, absent an exemption, such issuers may not use the MJDS for U.S. securities offerings.

Rule 3a-6 under the U.S. Investment Company Act excludes from the definition of "investment company" foreign banks and insurance companies and specifically extends the exclusion to Canadian trust and loan companies, which otherwise might not satisfy the rule's definition of "foreign bank." [73] Entities within the scope of the rule are not subject to regulation under the act and are therefore able to use the MJDS for offerings of any type, including common share offerings. In addition, by operation of the rule, finance subsidiaries of those entities (and of their holding companies) that make U.S. offerings of guaranteed debt or nonvoting preferred stock are eligible for an exemption from the U.S. Investment Company Act pursuant to Rule 3a-5 thereunder. Similarly, because

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foreign banks and insurance companies are effectively treated as operating companies by virtue of Rule 3a-6, the exceptions from investment company status available to holding companies of operating entities [74] are also available to foreign bank and insurance holding companies. [75]

Other Canadian issuers that are caught by the broad "investment company" definition (*e.g.*, holding companies with substantial nonmajority or noncontrolling investments) and cannot rely on Rule 3a-1, Rule 3a-5 or Rule 3a-6 or another exemption must seek individual discretionary exemptive orders from the SEC pursuant to § 6(c) of the U.S. Investment Company Act (which can be time-consuming) in order to use the MJDS for public offerings.

[3] Market Regulation Rules

Regulation M under the Exchange Act generally prohibits, during a distribution of securities, bids for or purchases of those securities (and certain "reference securities") by distribution participants (*e.g.*, issuers, underwriters and members of the dealer group and certain of their affiliates), and governs stabilization and certain post-offering activities. [76] Where any part of a distribution is being made in the United States, the SEC staff generally applies these rules to the conduct of both U.S. and non-U.S. distribution participants outside the United States, which can have the effect of disrupting normal market practices in the home jurisdiction. [77]

[4] Auditor Independence

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Audited financial statements included in MJDS registration statements (other than registration statements on Form F-7 in respect of rights offerings) and in certain other MJDS filings are subject to the SEC's auditor independence requirements commencing with the most recent fiscal year for which audited financial statements are presented. For prior periods, compliance with Canadian independence standards is sufficient. Accordingly, where the auditor for a Canadian issuer does not meet the U.S. independence requirements on a current basis and cannot obtain discretionary relief from the SEC staff, the issuer will not be able to effect such an MJDS offering without undertaking one of the following steps: (i) engaging an independent accounting firm to audit at least the most recent fiscal year or (ii) adopting the SEC's auditor independence requirements and allowing at least one year to pass so that the report of an independent accounting firm would cover the then most recently completed fiscal year.

[5] "Bought Deals"

Securities laws in Canada allow short-form system issuers to sell securities in "bought deals" in which the underwriters that have committed to purchase an issue are permitted to solicit indications of interest during a four-day window period after an underwriting agreement is signed but before the preliminary

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prospectus is filed. [78] Bought deals are an important distribution technique in Canada, both for common stock and debt offerings.

The MJDS does not change the basic Securities Act prohibition against public offers prior to the filing of a registration statement. Accordingly, if the normal Canadian bought deal timing is followed and the MJDS registration statement is not filed until the Canadian preliminary prospectus is filed four business days after the underwriting agreement is signed, U.S. underwriters and dealers will not be permitted to engage in any solicitation activities during the four-business day window period. In a successful bought deal, however, Canadian underwriters generally would expect to have obtained indications of interest from prospective investors covering the entire amount of securities being offered well before the end of the window period. Therefore, to the extent that marketing efforts for the U.S. offering can begin only after the end of the window period, the U.S. offering would serve the function only of a delayed "safety valve" for the Canadian underwriters—that is, the U.S. market would be tapped only if marketing efforts in Canada during the window period did not produce sufficient indications of interest from Canadian investors.

To address this issue and permit the U.S. and Canadian markets to be accessed simultaneously on a public basis, an "accelerated filing" bought deal technique has been used in a number of transactions. [79] Under this approach, the filings of the preliminary prospectus in Canada and the MJDS registration statement in the United States are accelerated and made either concurrently with the signing of the underwriting agreement, if the agreement is signed in the morning, or at the open of business the following morning if the agreement is signed in the evening after the close of the Canadian stock exchanges. This approach makes it possible for U.S. marketing efforts to begin as soon as solicitation activity begins in Canada. As bought deals are often commenced with little prior

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notice, this approach is a practicable alternative only if the issuer has a form of Canadian bought deal prospectus (and MJDS registration statement) prepared in advance of a bought deal proposal. [80]

In circumstances where a public offering in the United States is either not desired by the issuer or is impracticable because the preliminary prospectus cannot be made available on an accelerated basis, Canadian underwriters may resell securities purchased in bought deals in the U.S. private market through their U.S.-registered broker-dealer affiliates (including resales under Rule 144A under the Securities Act where available or on a § 4(1 ½) basis) [81] because private offers and sales can be effected on the same timetable as offers and sales in Canada. In circumstances where the resale safe harbor under Regulation S under the Securities Act does not provide sufficient liquidity for U.S. private purchasers, the Canadian prospectus, once available and with appropriate additions, could be used under the MJDS in conjunction with the Canadian shelf rules to register the securities sold privately in the United States so that they may be resold freely from time to time by U.S. purchasers. [82]

[6] "At-the-Market" or "Dribble-Out" Offerings

At-the-Market ("ATM" or "dribble-out") offerings are an alternative to traditional follow-on public offerings and bought deals. ATM offerings allow an issuer to sell equity securities into the market from time to time at the market price.

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MJDS issuers that conduct ATM offerings must file a base shelf prospectus in Canada, which may be reviewed by the Canadian securities regulators and a corresponding registration statement on Form F-10 in the United States, which (absent unusual circumstances) is not reviewed by the SEC. [83] If selected for review by the Canadian securities regulators, the review process generally takes one to two weeks to complete. Upon completion of the Canadian review process, a final base prospectus and an amended registration statement must be filed in Canada and the United States, respectively.

The placement agent or agents and the issuer enter into a distribution agreement for the ATM offering that typically includes customary representations, warranties, covenants and closing conditions. The execution of the distribution agreement in an ATM offering triggers the requirement to file a prospectus supplement disclosing the terms of the ATM offering and a requirement to issue a press release. The prospectus supplement must disclose the identity of the placement agent or agents, the commissions payable to the placement agent or agents and the maximum number of shares to be sold in the offering or the aggregate offering size. [84] Because equity issuances may occur frequently under an ATM program, disclosure of equity issuances off of an ATM shelf is often effected through disclosure in quarterly and annual reports in Canada and the United States.

Generally, Canadian securities laws require a broker-dealer to deliver a prospectus to purchasers of securities. [85] However, because an ATM offering is usually executed anonymously over a securities exchange, it is generally impracticable to physically deliver a prospectus to purchasers in an ATM offering. Therefore, to conduct an ATM offering in Canada, an MJDS issuer must obtain exemptive relief from the requirement to physically deliver a prospectus to each purchaser in an ATM offering and from certain form requirements, including the requirement to include therein a statement regarding the purchasers' statutory rights and a certificate of the issuer, each in the prescribed form. Exemptive relief is typically granted by Canadian securities regulators, subject to a cap on the number of shares sold on the TSX of 25% of the trading volume of shares on the TSX on the trade date. [86] Exemptive relief is not required if the ATM offering

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is conducted solely on a U.S. securities exchange. [87] An MJDS issuer must also consider whether conducting an ATM offering requires additional disclosure or raises considerations under Regulation M, [88] FINRA rules or securities exchange rules.

[7] State Securities Laws

In addition to the registration requirements of the SEC at the federal regulatory level, state securities or "blue sky" laws are also applicable to MJDS offerings. [89] However, the NSMIA amended the Securities Act to create a number of general exemptions from certain state securities law requirements. As a result, the need to register securities at the state level has been eliminated in connection with virtually all significant securities offerings in the United States by non-U.S. issuers.

As amended by the NSMIA, § 18 of the Securities Act provides exemptions for several categories of "covered securities" (or any security that will be a "covered security" upon completion of a transaction), including:

- securities that are listed on the NYSE or any national securities exchange that the SEC determines has substantially similar listing standards, [90] or securities of the same issuer that are equal or senior in rank to a security that is so listed; and
- securities offered or sold in certain transactions exempt from registration under the Securities Act, including ordinary secondary market transactions (provided the issuer of the security is a reporting issuer under the Exchange Act). [91]

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A "covered security" is exempt from all state requirements with respect to (i) registration and qualification of securities or securities transactions, (ii) prohibitions, limits or conditions on the use of any offering document "prepared by or on behalf of the issuer" of the security, [92] and (iii) prohibitions, limits or conditions on offers or sales of the security based on the merits of the offering or the issuer. [93] The NSMIA generally does, however, preserve each state's authority to maintain and enforce its own antifraud laws and notice filing requirements. [94]

In circumstances where state law registration requirements do apply, however, absent an available state exemption from registration, the MJDS issuer must register the securities under the applicable state securities statutes (which can involve a filing, comment and clearance process similar in some respects to SEC registration [95]). Because the majority of states have adopted the Uniform Securities Act, the states' securities laws are similar to a substantial degree.

The state securities regulators were consulted extensively during the process of drafting the MJDS. Although state regulators would not agree to recommend a general exemption from state securities laws' registration requirements for MJDS offerings, the North American Securities Administrators Association ("NASAA"), which represents all state securities regulators, endorsed the MJDS and, in 1990, recommended model rules designed to facilitate MJDS offerings in the various states. The rules, as updated in 2005, are designed to accommodate registration of MJDS offerings with the states by, among other things: (i) harmonizing the state review period with Canadian review periods, (ii) providing for state acceptance of financial information presented in the registration statement in accordance with the requirements of the registration statement, and (iii) providing an exemption to facilitate secondary trading in the securities offered under the MJDS. [96]

Adoption of the model rules does not, however, alter the substantive standards of review that may be applied by a state to MJDS offerings subject to state registration. Accordingly, the "merit review" states may continue to apply their

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standards of fairness to any MJDS offering required to be registered. [97] As a result, certain Canadian issuers wishing to use the MJDS that are unable to rely on federal preemption of a "covered security" or an exemption from blue sky registration may have difficulty obtaining clearance in the merit review states. This difficulty is likely to arise most frequently in MJDS offerings by smaller Canadian companies, such as those electing to use the MJDS for rights offerings. Such issuers may have difficulties clearing their rights offerings in those merit review states (including California) that do not have an exemption for sales of securities to the issuer's existing shareholders.

It therefore remains important for MJDS offerings of securities not subject to the federal preemption under the NSMIA to fall within exemptions from state registration requirements to the extent possible. Where exemptions are not available, the need to obtain state clearances can result in additional costs and delays, and, in certain circumstances, state clearances may be impossible to obtain.

[8] Oil, Gas and Mining Disclosure

The SEC adopted revisions to its oil and gas reporting disclosures that became effective as of January 1, 2010. The revisions are intended to provide investors with a more meaningful and comprehensive understanding of oil and gas reserves to facilitate their assessment of the relative value of oil and gas companies. In its adopting release, the SEC clarified that the new disclosure requirements do not apply to MJDS issuers that file annual reports on Form 40-F so long as they comply with the disclosure requirements of Canadian National Instrument 51-101, Standards of Disclosure for Oil and Gas Activities ("National Instrument 51-101"). [98] In the past, some Canadian issuers obtained exemptions in Canada permitting them to estimate reserves and disclose related oil and gas activities in accordance with SEC oil and gas disclosure requirements instead of complying with National Instrument 51-101. In July 2015, National Instrument 51-101 was amended to significantly alter its disclosure requirements as well as allow Canadian reporting issuers to provide oil and gas disclosure and reserve estimates in accordance with alternative standards, including SEC rules, without the need for a specific exemption. However, reserve estimates must still be prepared and audited by a qualified reserve evaluator or auditor.

In 2016, the SEC proposed changes to its mining disclosure policies, which are designed to modernize its requirements and more closely align them with industry standards, including Canadian National Instrument 43-101, Standards of

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Disclosure for Mineral Projects ("National Instrument 43-101"). [99] The proposed changes would rescind Industry Guide 7 and update Section 102 of Regulation S -K (for domestic issuers) and Item 4.D of Form 20-F (for foreign private issuers). These changes would apply to Canadian issuers that file as foreign private issuers and prepare annual reports on Form 20-F. However, Canadian issuers that file under MJDS would be exempt and could continue to provide disclosure pursuant to National Instrument 43-101. [100]

Footnotes

63 *See*, *e.g.*, *supra* Note 30.

64 *See* § 3.02[4].

65 *See* § 3.02[3].

66 Although liability for material misstatements or omissions can arise under various federal and state law provisions, the principal provisions under which civil liability can be asserted are §§ 11 and 12(a)(2) of the Securities Act and §§ 18 and 10(b) of, and Rule 10b-5 under, the Exchange Act. *See also* § 11.03[1] and [2].

67 *See*, *e.g.*, § 130 of the Securities Act (Ontario).

68 The provisions of the MJDS relating to consent to service of process may raise related concerns. At the time of filing a registration statement under the MJDS (other than on Form F-7, which separately imposes a requirement to appoint an agent for service of process), as well as certain other MJDS filings, Canadian issuers must file with the SEC a Form F-X containing an irrevocable consent to service of process in SEC proceedings or civil actions arising out of or relating to the offering or the securities being offered, an appointment of a U.S. person as agent for service of process, a consent to service of an administrative subpoena and an undertaking to assist the SEC with an administrative investigation. If the agent for service of process resigns, is dismissed or is unable to continue serving as agent, the issuer generally must appoint a successor agent unless the issuer has ceased filing reports under the Exchange Act for a period of more than six years. The agent for service designated in Form F-X is authorized to accept service of process on the issuer's behalf in connection with any investigations or administrative proceedings conducted by the SEC and any civil suits relating to the offering or the offered securities brought against the issuer in any federal or state court in the United States.

69 Adopting Release, 56 Fed. Reg. 30,036, 30,049 (June 21, 1991).

70 In transactions where there is a high risk of litigation, such as hostile tender or exchange offers, Canadian issuers using the MJDS may elect voluntarily to comply with certain line-item disclosure requirements of the U.S. disclosure forms in an effort to minimize their risk of liability under the U.S. liability rules.

71 In U.S.-only offerings underwritten by U.S. investment banking firms, negative comfort letters generally have been obtained from U.S. counsel to the issuer. Negative comfort letters generally have not been provided by U.S. counsel to the issuer in the context of dual offerings in Canada and the United States that are underwritten on a "bought deal" basis by Canadian investment banking firms (as more fully discussed in § 13.07[5] below) with sales in the United States of a portion of the securities typically effected by the U.S. affiliates of the Canadian underwriters. Negative comfort letters of U.S. counsel to the issuer generally have not been provided in these offerings because of (i) the extra cost being viewed as unwarranted given the relatively small size of the U.S. component of the offering compared to the Canadian component, (ii) insufficient time in the bought deal context for U.S. counsel to undertake the necessary due diligence in

order to deliver such letters and (iii) the fact that generally only the U.S. affiliates of the Canadian underwriters of such offerings have participated in the sales in the United States.

72 *See* § 3(a)(1) of the U.S. Investment Company Act. *See* Chapter 15, for a discussion of U.S. regulation of foreign investment companies.

73 Rule 3a-6 was adopted in SEC Release No. IC-18381 (Oct. 29, 1991) and replaced Rule 6c-9 under the U.S. Investment Company Act, which provided a more limited exemption from the Act for U.S. offerings of debt securities and nonvoting preferred stock by foreign banks and their finance subsidiaries, but did not extend to Canadian trust and loan companies. *See* § 15.05[2].

74 § 3(a)(1)(C) of the U.S. Investment Company Act and Rule 3a-1 thereunder. *See* § 15.05[2].

75 Foreign banks and insurance companies seeking to rely on Rule 3a-6 to make a U.S. registered public offering of their securities, as well as their holding companies and finance subsidiaries relying on Rules 3a-1 and 3a-5, respectively, must file Form F-N under the Securities Act. The Form, which replaced Form N-6C9, calls for certain information about the proposed offering and also includes an appointment of a U.S. agent for receipt of service of process. *See* Rule 489 under the Securities Act. Canadian entities that have filed a Form F-X (*see supra* Note 68) or that are filing a registration statement relating to debt securities or nonvoting preferred stock and have a "currently accurate" Form N-6C9 on file with the SEC are, however, excepted from this requirement. *See* Rule 489(b) under the Securities Act.

76 *See* § 3.02[9].

77 As a result of the SEC's extra-territorial approach and because the applicable rules in the United States and in Canada differ in some respects, problems may arise with respect to market stabilization activities conducted in both jurisdictions. OSC Rule 48-501, Trading During Distributions, Formal Bids and Share Exchange Transactions ("Rule 48-501"), regulates, among other things, trading by issuers and underwriters during a distribution by prospectus of TSX-listed securities. Issuers and underwriters are prohibited, throughout the period of distribution, from bidding for or purchasing the class of securities being distributed by an underwriter or dealer. The period of distribution commences on the later of two trading days prior to fixing the offering price and the date on which the underwriter agrees to participate in the prospectus offering and continues through the period of distribution that is deemed to end when the underwriter has distributed its participation and the stabilization arrangements have terminated. The foregoing restrictions do not apply in connection with market stabilization or market balancing activities that occur at or below the distribution price or last independent sale price for the restricted security for the purpose of maintaining a fair and orderly market by reducing price volatility. Also, the restrictions do not apply to a "highly-liquid security," which is defined as a listed security with an average of at least 100 trades per trading day during a 60-day period and with an average trading value of at least Cdn $1 million per trading day, or a security that is an "actively traded security" under Regulation M. The Universal Market Integrity Rules governing trading on all of Canada's major stock exchanges have been amended to ensure consistency with Rule 48-501.

In connection with the adoption of Regulation M, which became effective in 1997 and replaced the SEC's former market regulation rules set forth in Rules 10b-6, 10b-6A, 10b-7, 10b-8 and 10b-21 under the Exchange Act (the "Prior Trading Rules"), the SEC withdrew its prior exemptive and no-action positions taken with respect to the Prior Trading Rules. As a consequence, the limited exemptive relief granted by the SEC in 1991 with respect to the Prior Trading Rules (the "1991 MJDS Relief") for certain Canadian and other non-U.S. market activities in connection with certain U.S. offerings by Canadian issuers (predicated on the adoption in Canada of certain market regulation rules) is no longer applicable and can no longer be relied on in connection with those market activities. *See* Letter from William H. Heyman, Director, SEC Division of Market Regulation, to Pamela S. Hughes, Director of International Markets Branch, Ontario Securities Commission, and Daniel Laurion, Chief of Registration, *Commission des valeurs mobiliéres du Quebec* (Aug. 22, 1991).

78 An alternative approach often used in practice is for the issuer and the underwriters to sign a binding "bought deal agreement" committing (i) the parties to execute an underwriting agreement within four days, (ii) the issuer to print the preliminary prospectus within four days and (iii) the issuer to issue a press release

announcing the offering upon the signature of the bought deal agreement, among other things. The "bought deal agreement" is a written agreement (i) under which one or more underwriters has agreed to purchase all of the securities to be offered under the short form prospectus on a firm commitment basis (other than any over-allotment option), (ii) does not have a "market-out" clause, (iii) that, other than in the case of an over-allotment option, does not provide an option for any party to increase the number of securities to be purchased and (iv) that, other than in prescribed circumstances, is not conditional on one or more additional underwriters agreeing to purchase any of the securities offered.

79 Some recent examples of MJDS bought deals include Platinum Group Metals, Prospectus Supplement (Oct. 24, 2016), Cordiorne Pharma Corp., Short Form .Prospectus (July 28, 2016), Suncor Energy Inc., Short Form Prospectus (June 8, 2016), Enbridge Inc., Prospectus Supplement (June 19, 2014), Rubicon Minerals Corporation, Short Form Prospectus (Mar. 3, 2014), Novadaq Technologies Inc., Prospectus Supplement (May 1, 20l3).

80 Historically, the U.S. GAAP reconciliation requirement was a particular problem under the quick timetable of bought deals, where the time delay occasioned by the need to prepare a U.S. GAAP reconciliation effectively precluded use of the MJDS unless the issuer had done the necessary work in advance of the offering. For Form F-10 filings, this required advance preparation of a U.S. GAAP reconciliation in accordance with Item 18 of Form 20-F of all the relevant financial statements, which could be time-consuming for issuers that had not previously developed a "long-form" reconciliation. In practice, the U.S. GAAP reconciliation requirement effectively limited use of the MJDS for bought deal offerings to Canadian issuers that were Exchange Act-reporting companies (and thus at a minimum had financial statements that were reconciled to U.S. GAAP in accordance with Item 17 of Form 20-F). The transition to IFRS in Canada has eliminated the need for a U.S. GAAP reconciliation.

81 *See* § 7.04.

82 The registration of the privately placed securities under the MJDS in conjunction with the Canadian shelf rules would, however, impose upon the issuer the costs of having to maintain an "evergreen" registration statement. In addition, the selling shareholders may have statutory underwriters' liability in the United States and may need to be named in the MJDS prospectus. The possibility of incurring such liability in connection with subsequent resales may be significant enough to dissuade certain institutional investors from purchasing in the private placement.

Form F-10 may also be used to register "A/B" exchange offers where the issuer of securities that have been sold in a private placement offers to exchange those securities that are otherwise identical in all respects. SEC, Division of Corporation Finance, Compliance and Disclosure Interpretations, Securities Act Forms, Question 109.06 (Feb. 27, 2009). For further information on “A/B” exchange offers, *see* § 7.05[2].

83 *See* § 13.02[2].

84 Under National Instrument 44-102, the market value of shares distributed in an ATM offering pursuant to a prospectus supplement may not exceed 10% of the aggregate market value of the Canadian issuer's outstanding shares measured at the last trading day of the month before the month in which the first trade under the ATM distribution is made.

85 An ATM offering in Canada may be made pursuant to Part 9 of National Instrument 44-102.

86 For recent examples of exemptive relief granted for ATM offerings, *see* Oncolytics Biotech Inc. and Canaccord Genuity Corp., 39 O.S.C.B. 3612 (Jan. 27, 2016) and Mongolia Growth Group Ltd. and Cantor Fitzgerald Canada Corporation, 37 O.S.C.B. 9913 (June 6, 2014).

87 Although the United States has similar prospectus delivery requirements, under Rule 172 of the Securities Act, access is deemed to equal delivery and ATM offerings require no SEC exemptive relief to be conducted in the United States. *See* SEC Release No. 33-8591 (July 19, 2005). *See* text accompanying *supra* Note 29.

88 *See* § 13.03 and § 3.02[9].

89 *See* § 3.02[8].

90 Rule 146(b)(1) under the Securities Act contains a list of U.S. securities exchanges the SEC has determined

have listing standards substantially similar to those of the NYSE.

91 The practical result of this provision of the NSMIA is to preempt blue sky laws with respect to secondary market trading in securities issued by an SEC-reporting issuer, in addition to all transactions in any security of an issuer with common stock listed on a major U.S. securities exchange. This preemption would not extend to secondary trades in all types of securities; for example, state registration requirements with respect to unlisted securities of a foreign issuer that satisfies the requirements of Rule 12g3-2(b) under the Exchange Act are not preempted.

92 The SEC has adopted Rule 146 under the Securities Act, which defines the phrase "prepared by or on behalf of the issuer" to include an offering document if the issuer or an agent or representative (i) authorizes its production and (ii) approves the document before its use. SEC Release No. 33-7418 (May 6, 1997).

93 *See infra* Note 96.

94 Generally, state notice filings (and corresponding payment of a filing fee) are required in connection with certain private placements of securities and not for offerings registered under the Securities Act or secondary market transactions. However, U.S. sales to qualified institutional buyers, including those made under Rule 144A, and to other institutional investors, as defined by each state, are exempt from state notice filings and filing fee requirements.

95 *But see infra* Note 96.

96 The Adopting Release indicated that NASAA anticipated that substantially all the states would adopt the model rules. Adopting Release, 56 Fed. Reg. 30,036, 30,051 (June 21, 1991). To date, more than 40 states have adopted one of the two versions of the NASAA model rules.

97 "Merit review" states apply a fairness standard of review that differs from the SEC's "full disclosure" requirements. In these states, the securities administrator may deny registration if the offering is determined to be unfair, unjust or inequitable from the individual investor's perspective. *See* § 3.02[8][a].

98 *See* SEC Release No. 33-8995 (Dec. 31, 2008), 74 Fed. Reg. 2157, 2179 (Jan. 14, 2009).

99 *See* SEC Release No. 33-10098 (June 16, 2016).

100 In the proposing release, the SEC clarified that the new regulations would apply the same standards to domestic and foreign private issuers, as the SEC stated that it "[B]elieve[s] that the proposed rules should apply equally to foreign private issuers and domestic registrants."

U.S. Regulation of the International Securities and Derivatives Markets, § 13.08, LISTING OF SECURITIES ON A U.S. NATIONAL SECURITIES EXCHANGE

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 § 13.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

Canadian issuers eligible to use Form F-10 may use Canadian disclosures to list their securities on a U.S. stock exchange and to effect the required registration of such securities under the Exchange Act. [101] The Canadian disclosures filed under the Exchange Act for this purpose are filed under cover of Form 40-F and consist of all information material to an investment decision that the registrant, since the beginning of its last full fiscal year, (i) made or was required to make public pursuant to the law of any Canadian jurisdiction, (ii) filed or was required to file with a stock exchange on which its securities are traded and which was made public by such exchange or (iii) distributed or was required to distribute to its securityholders. The registrant also must provide the portion of its home jurisdiction reports, forms or listing applications that contain a description of the securities to be registered.

Canadian issuers using Form 40-F to register their securities under the Exchange Act also must file a consent to service of process on Form F-X. The SEC's approach of not reviewing MJDS Securities Act registration statements absent unusual circumstances is also applied to Form 40-F registration statements. [102]

Rules adopted by the SEC under § 301 of the Sarbanes-Oxley Act, however, require U.S. national securities exchanges and national securities associations to prohibit the listing of any issuer, including an MJDS issuer, that among other things does not comply with specified requirements concerning the independence of the issuer's audit committee. [103]

Footnotes

101 Section 12(a) of the Exchange Act requires all issuers listing on a U.S. stock exchange to register the listed securities under the Exchange Act.

102 *See* § 13.02[2].

103 *See* Rule 2-01 of Regulation S -X.

U.S. Regulation of the International Securities and Derivatives Markets, § 13.09, EXCHANGE ACT REPORTING REQUIREMENTS

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 § 13.09 (11th and 12th Editions 2014-2017)
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The MJDS provides the broadest relief for Canadian issuers that become subject to the Exchange Act reporting requirements solely as a result of one or more MJDS offerings (*i.e.*, issuers that do not publicly offer securities in the United States on non-MJDS forms, do not obtain a U.S. stock exchange listing for their securities and do not otherwise register their securities under § 12(g) of the Exchange Act). These issuers may use Canadian disclosures (filed on Forms 40-F and 6-K), together with the additional disclosures mandated by the Sarbanes-Oxley Act [104] and Dodd-Frank Act [105] and reflected in Form 40-F, to satisfy their ongoing Exchange Act reporting requirements (which would arise under § 15(d) of the Exchange Act) regardless of whether they continue to satisfy the eligibility requirements of the MJDS Securities Act registration forms subsequent to the offering. If these issuers use only Forms F-7, F-8 or F-80 (relating to rights offerings, business combinations and exchange offers), they may be entitled to a complete exemption from the § 15(d) reporting requirements provided that they comply with the requirements of Rule 12g3-2(b) under the Exchange Act. [106]

The MJDS accommodations for other Canadian issuers are more limited. Canadian issuers that use (or have used) non-MJDS registration forms for U.S. public offerings or that list their securities on a U.S. stock exchange (or otherwise register their securities under § 12(g) of the Exchange Act) must meet the "substantial issuer" eligibility tests (*i.e.*, the eligibility tests for Form F-10, depending on the type of securities to which the reporting obligation relates) [107] in order to use Canadian disclosures (as supplemented by Form 40-F) to satisfy their Exchange Act reporting obligations. [108] These issuers must continue to meet

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the "substantial issuer" tests in order to remain eligible to use Canadian disclosures in the United States, which raises a potential problem for issuers that do not exceed the relevant eligibility tests by a significant amount. [109]

Canadian issuers using the MJDS for Exchange Act reporting are required to file their Canadian annual information form, audited annual financial statements and management's discussion and analysis, together with the additional disclosures mandated by the Sarbanes-Oxley and Dodd-Frank Acts and reflected in Form 40-F, as an MJDS annual report under cover of Form 40-F, with such annual report certified by the CEO and CFO as required by § 302 and § 906 of the Sarbanes-Oxley Act. Form 6-K is used as a cover form for the issuer's quarterly reports, material change reports and all other material disclosure documents made public in Canada, filed with Canadian stock exchanges or distributed to securityholders. [110]

Footnotes

104 The Sarbanes-Oxley Act generally applies to issuers that file periodic reports under the Exchange Act or registration statements under the Securities Act with the SEC and does not expressly authorize the SEC, in adopting rules thereunder, to draw distinctions between U.S. domestic issuers and foreign private issuers (including MJDS-eligible issuers). As a result, with limited exceptions, all provisions of the Sarbanes-Oxley Act and the rules thereunder that the SEC has adopted apply to MJDS issuers. *See* § 4.02 for a more complete discussion of the Sarbanes-Oxley Act.

105 The Dodd-Frank Act also requires all issuers who file reports with the SEC, including Canadian issuers who

file under the MJDS system, to furnish information to the SEC on Form SD about "conflict minerals" used in their business, as well as payments made to government officials to further the commercial development of oil, natural gas or minerals. *See* § 4.07[4] and [5].

106 *See* SEC Release No. 34-58465 (Sept. 5, 2008). For a discussion of Rule 12g3-2(b) under the Exchange Act, *see* §§ 4.02[3][iv] and 13.10.

107 *See* § 13.02[1] for a discussion of the eligibility requirements for use of Forms F-10 (and, therefore, Form 40-F).

108 These obligations may arise under § 15(d) of the Exchange Act (as the result of a public offering), §§ 12(b) and 13(a) of the Exchange Act (as the result of a stock exchange listing) or §§ 12(g) and 13(a) of the Exchange Act (as the result of an OTC Bulletin Board quotation, exceeding a specified threshold of U.S. shareholders or a voluntary registration under § 12(g)). *See* § 4.02[3].

109 The Adopting Release clarifies that if the "substantial issuer" tests are met as of the end of a fiscal year, the issuer will be presumed to continue to meet such tests until the end of the next fiscal year. *See* Adopting Release, 56 Fed. Reg. 30,036, 30,050 (June 21, 1991).

110 Canadian issuers are required to submit to the SEC, under cover of Form 6-K, information concerning specified matters of relevance to securityholders that is material with respect to the issuer and its subsidiaries and that the issuer (i) makes or is required to make public pursuant to the law of the jurisdiction of its domicile or in which it is incorporated or organized, (ii) files or is required to file with a stock exchange on which its securities are traded and which was made public by that exchange or (iii) distributes or is required to distribute to its securityholders. The certification requirements of §§ 302 and 906 of the Sarbanes-Oxley Act do not apply to reports submitted on Form 6-K. *See* § 5.04[4].

U.S. Regulation of the International Securities and Derivatives Markets, § 13.10, EFFECTS OF SEC DEREGISTRATION RULES AND AMENDMENTS TO EXCHANGE ACT RULE 12g3-2 ON MJDS ISSUERS

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 § 13.10 (11th and 12th Editions 2014-2017)
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In March 2007, the SEC adopted Rule 12h-6 under the Exchange Act to liberalize Exchange Act deregistration rules for foreign private issuers, as well as amendments to Rule 12g3-2 under the Exchange Act, which provides an exemption from Exchange Act registration. [111] The impact of Rule 12h-6 on MJDS issuers has been limited. The SEC stated that it did not expect Rule 12h-6 to have as great an effect on MJDS filers as on other reporting foreign private issuers because, typically, the percentage of an MJDS filer's shares held by U.S. residents and the U.S. trading volume relating to those shares is significant, facts that would disqualify an MJDS filer from meeting the conditions that are necessary for a foreign private issuer to delist under Rule 12h-6 under the Exchange Act. In addition, the SEC expected that due to the close proximity of MJDS filers to the U.S. capital markets, these filers would be less likely to seek to terminate

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their Exchange Act registration, and related U.S. listing, than other foreign private issuers. [112]

Similarly, the March 2007 amendments to Rule 12g3-2 under the Exchange Act have had a limited impact on MJDS issuers. Prior to adoption of those amendments, the Rule 12g3-2(b) exemption from Exchange Act registration requirements generally was not available to foreign private issuers that had an active or suspended reporting obligation under § 15(d) of the Exchange Act as a result of having filed a Securities Act registration statement. The amendments to Rule 12g3-2 made the Rule 12g3-2(b) exemption available to foreign private issuers that terminate § 15(d) reporting obligations pursuant to Rule 12h-6. Even prior to adoption of the amendments, however, the Rule 12g3-2(b) exemption was available to foreign private issuers that had an active or suspended § 15(d) reporting obligation arising from the filing of an MJDS registration statement (*e.g.*, Form F-7, F-8, F-9, F-10 or F-80). In effect, therefore, the amendments simply extended to non-MJDS foreign private issuers a benefit that MJDS issuers had already enjoyed.

In September 2008, the SEC further amended Rule 12g3-2(b), among other things, to eliminate the reporting exemption for MJDS filers. [113] Historically, this rarely used exemption allowed MJDS filers to avoid registration of a class of equity securities under § 12(g) of the Exchange Act based on the submission to the SEC of certain information provided by the issuer in its home country. As a result, the MJDS exemption enabled MJDS filers to claim the Rule 12g3-2(b) exemption in respect of a class of equity securities while simultaneously having Exchange Act reporting obligations regarding a class of debt securities. With the elimination of this special exemption, MJDS issuers are now afforded the 12g3-2(b) reporting exemption on the same basis as other foreign private issuers. As this exemption was, according to the SEC, "rarely used, if at all," the amendment has had minimal impact on MJDS filers. [114]

Footnotes

111 For a discussion of Rule 12h-6 and the amendments to Rule 12g3-2(b), *see* § 4.11[2].

112 SEC Release No. 34-55005 (Dec. 22, 2006), 72 Fed. Reg. 1384, 1404 n.144 (Jan. 11, 2007).

113 *See* SEC Release No. 34-58465 (Sept. 5, 2008).

114 SEC Release No. 34-58465 (Sept. 5, 2008), 73 Fed. Reg. 52,752, 52,761 (Sept. 10, 2008).

U.S. Regulation of the International Securities and Derivatives Markets, § 13.11, PROXY AND INSIDER RULES

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 § 13.11 (11th and 12th Editions 2014-2017)
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All Canadian foreign private issuers have a complete exemption from the U.S. proxy requirements and U.S. insider reporting/short-swing profit recovery rules because Canadian issuers are treated on an equal basis with other foreign private issuers under the FPI System. [115] Canadian issuers had traditionally viewed these rules as substantial deterrents to U.S. equity financings. The

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exemption is available whether or not the issuer uses the MJDS or the FPI System. Thus, a Canadian foreign private issuer that files Form 40-F, 20-F or 10-K annual reports is nevertheless exempt from such proxy requirements and insiders are exempt from insider reporting/short-swing profit recovery rules. [116]

Footnotes

115 Like other foreign private issuers, however, holders of voting equity securities of Canadian issuers remain subject to the beneficial ownership reporting requirements of §§ 13(d) and 13(g) of the Exchange Act. *See* §§ 6.04[1] and 6.04[2][a] for a discussion of such requirements.

116 It should be emphasized, however, that Canadian foreign private issuers that choose to file Form 10-K annual reports remain subject to those substantive disclosure requirements of the U.S. proxy requirements that are also required to be included in a Form 10-K filing, specifically in Part III thereof, as to executive compensation, related party transactions and security ownership by management. The SEC staff has accepted an approach whereby a Canadian reporting company incorporates this information by reference from its proxy circular that it attaches as an exhibit to its annual report on Form 10-K. *See also* § 13.13 for a discussion of the Exchange Act reports that are available to Canadian issuers.

U.S. Regulation of the International Securities and Derivatives Markets, § 13.12, TRUST INDENTURE ACT

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 § 13.12 (11th and 12th Editions 2014-2017)
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In connection with the MJDS, the SEC adopted exemptive rules under the U.S. Trust Indenture Act intended to facilitate MJDS debt offerings. Rule 10a-5 under the U.S. Trust Indenture Act generally permits eligible Canadian trust companies (*i.e.*, those subject to supervision or examination under the Trust Companies Act (Canada) or the Canada Deposit Insurance Act) [117] to act as sole trustees under indentures used for MJDS debt offerings, avoiding the need to appoint a U.S. co-trustee. The exemption provided by Rule 10a-5 is self-executing, so that eligible Canadian trustees are not required to file any application or statement of eligibility and qualification on Form T-1. [118] Canadian trustees are required, however, to file a consent to service of process on Form F-X together with the MJDS registration statement.

Rule 4d-9 under the U.S. Trust Indenture Act exempts trust indentures used for MJDS debt offerings from virtually all substantive requirements of the U.S. Trust Indenture Act, provided that the indenture is subject to regulation in Canada under the Canada Business Corporations Act, the Business Corporations Act (Ontario) or the Bank Act (Canada). Section 316(b) of the U.S. Trust

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Indenture Act, which provides that the right of each securityholder to receive principal and interest when due and to institute suit therefor shall not be impaired without the consent of such holder, continues to apply to MJDS offerings because Canadian law does not contain corresponding protections. [119] Rule 4d-9 requires that the Canadian trust indenture be filed with the SEC together with the MJDS registration statement and, for debt offerings with a Canadian trustee, the consent to service of process on Form F-X.

Footnotes

117 Canadian trust companies subject to such Regulation M ay not necessarily be eligible to act as sole trustees under indentures used for MJDS debt offerings. Rules 4d-9 and 10a-5 under the U.S. Trust Indenture Act exempt such trust companies from all but two of the eligibility requirements set forth in § 310(a) of the U.S. Trust Indenture Act: the minimum capital requirement (§ 310(a)(2)) and the requirement that the trustee not be an affiliate of the obligor (§ 310(a)(5)). Although the SEC apparently construed the Canadian trustee eligibility rules as disqualifying affiliates of the obligor from acting as trustees under the obligor's indenture in all cases, this appears to be a fact-specific determination under Canadian law, and affiliation alone may not be deemed to give rise to an impermissible conflict. Consideration, therefore, must be given as to whether, in cases where the trustee and the obligor are affiliates, it is necessary to appoint an eligible co-trustee under an indenture used in connection with MJDS debt offerings.

118 Form T-1 is filed by the trustee in public debt offerings to demonstrate the trustee's compliance with the eligibility requirements under the U.S. Trust Indenture Act.

119 Section 316(b) is intended to protect minority holders from debt restructuring plans that are not supervised by a bankruptcy court.

U.S. Regulation of the International Securities and Derivatives Markets, § 13.13, FOREIGN PRIVATE ISSUER INTEGRATED DISCLOSURE SYSTEM

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 § 13.13 (11th and 12th Editions 2014-2017)
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Canadian issuers have equal access to the FPI System, which provides special reduced disclosure forms for public offerings and less burdensome periodic reporting requirements for foreign private issuers (Forms F-1, F-3, F-4, 20-F and 6-K). [120] This availability is most beneficial for smaller Canadian issuers that do not meet the MJDS eligibility tests or for any Canadian company seeking to effect an initial public offering. [121] Historically, before the extension of the FPI System, Canadian issuers were, in many cases, required to file full U.S. domestic issuer Securities Act and Exchange Act forms (*e.g.*, Form S-1 registration statements and Form 10-K annual reports). [122]

The Securities Act registration forms that allow for incorporation by reference of Exchange Act reports (Forms F-1 (to a limited extent), F-3 and F-4) also may be used by Canadian issuers. Canadian issuers are able to incorporate filings on Forms 10-K, 10-Q and 8-K (in addition to Forms 20-F and 6-K) into such registration forms. Thus, eligible Canadian issuers that have used the U.S. domestic issuer forms are able to switch at any time to the FPI System registration forms.

In addition, Canadian issuers are able to incorporate into such registration statements Canadian annual information forms filed under the MJDS under cover of Form 40-F, provided that the issuer is eligible to use Form F-10. [123] Thus, the core "company" disclosures in certain FPI System registration statements filed by "substantial" Canadian issuers can be provided by Canadian continuous disclosure documents filed under the MJDS. Although this accommodation is

significant (and may be particularly useful in the context of acquisitions and related issuances of securities under Form F-4), customary SEC review procedures do apply to FPI System registration statements incorporating Canadian continuous disclosures.

Canadian issuers are not required to use the MJDS or the FPI System and may, at their option, use the Securities Act registration forms for U.S. domestic issuers provided that the issuer files the same Exchange Act reporting forms as U.S. domestic issuers (*i.e.*, Forms 10-K, 10-Q and 8-K). [124] The SEC has not modified such registration forms to permit incorporation of MJDS filings on Forms 40-F and 6-K.

Canadian issuers meeting the "substantial issuer" eligibility criteria have three U.S. disclosure systems from which to choose: (i) Canadian disclosures under the MJDS, (ii) reduced U.S. disclosures under the FPI System, and (iii) full U.S. disclosures of the type filed by domestic U.S. issuers. The determination of which system is most advantageous depends on the particular situation and needs of the issuer. On the one hand, Canadian issuers that are not eligible to use a short-form prospectus under the FPI System or the U.S. domestic issuer regime (and would thus be forced to prepare a long-form prospectus under those systems and would face a high probability of SEC review) may find the MJDS to be the best alternative because it will, among other things, allow U.S. offerings to proceed on the basis of a short-form system prospectus and, absent special circumstances, without SEC review. On the other hand, certain Canadian issuers that have regularly accessed the U.S. markets using the U.S. domestic issuer short-form prospectus (Form S-3) may find it attractive to continue to do so under the U.S. domestic issuer regime based on U.S. investor relations and other considerations. Although the FPI System generally appears to offer "substantial" Canadian issuers few, if any, benefits over the MJDS, the FPI System benefits Canadian issuers that do not meet the "substantiality" tests under the MJDS and do not wish to use the U.S. domestic issuer system.

Footnotes

120 *See* §§ 3.03[1][b], 3.02[1][b], 4.04 and 4.04[3][c].

121 No matter how large, a Canadian company that has not publicly offered or listed its securities will not meet the reporting history requirements of the MJDS.

122 *See supra* Note 3.

123 Form S-8, which may be used to register securities offered in connection with certain employee compensation arrangements, also permits incorporation of Form 40-F and 6-K filings by "substantial" Canadian issuers.

124 *See* § 13.02[1].

U.S. Regulation of the International Securities and Derivatives Markets, § 13.14, USE OF MJDS BY U.S. ISSUERS FOR FINANCINGS IN CANADA

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The Canadian MJDS is essentially reciprocal to the MJDS adopted by the SEC. Eligible U.S. issuers may use prospectuses prepared in accordance with SEC requirements to offer securities in Canada, generally without Canadian regulatory review. The U.S. shelf rules may be used by eligible U.S. issuers for MJDS shelf offerings in Canada. The relatively small size of the Canadian capital markets and the ability with relative ease for U.S. issuers and their underwriters to access the Canadian capital markets in connection with registered U.S.

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offerings on a Canadian private placement basis, however, has resulted in very limited use of the Canadian MJDS by eligible U.S. issuers. [124.1]

The "northbound" MJDS has been used in recent years by several U.S. mining companies, which have taken advantage of the Canadian capital markets' strength in the resource sector. [125] Such offerings are typically made by filing a shelf prospectus and a supplement or supplements to that shelf. Section 11.3 of National Instrument 71-101, The Multijurisdictional Disclosure System ("National Instrument 71-101") exempts U.S. issuers from having to comply with the Canadian disclosure regime as it relates to mineral exploration and development and mining properties, [126] thus allowing U.S. standards to be incorporated into northbound MJDS prospectuses. [127]

Another noteworthy use of the northbound MJDS involved the offering of common shares into Canada by newly organized General Motors Company ("New GM") as part of its global initial public offering (the "New GM IPO")

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subsequent to the bankruptcy proceedings involving General Motors Corporation. [128] As a general rule, a company that has not publicly offered or listed its securities will not be MJDS-eligible (northbound or southbound) in light of the reporting history requirements of the MJDS. [129] New GM succeeded in effecting a northbound MJDS offering by obtaining exemptive relief from the certain northbound MJDS requirements, including waiver of the twelve-month reporting history, U.S. $75 million public float and Canadian GAAP reconciliation requirements. [130]

Footnotes

124.1 In 2016, the CSA adopted amendments to the exempt distribution trade requirements in Canada that significantly changed the reporting requirements for issuers, including the United States and other non-Canadian issuers, that sell securities into Canada by way of private placements and rely on a Canadian "wrapper" or Canadian wrapper exemption. The United States and other non-Canadian issuers are still able to take advantage of the use of a Canadian wrapper and wrapper exemption, but the form of post-trade reporting to be filed in provinces where the securities are sold has been amended. The amended form requires additional information about the purchasers and the issuer, which may, in some cases, be difficult or time-consuming to obtain. For example, the new form requires disclosure of information about the specific basis on which the purchaser is relying to qualify as an accredited investor. The form also requires disclosure as to whether the purchaser is a "registrant" or an "insider" of the issuer; the CSA has, however, scaled back these disclosure requirements for non-Canadian issuers provided they meet the criteria of the relief. In addition, the new form requires specific information about the issuer that may not traditionally be included in an offering document. The new form must also be signed by an officer or director of the issuer or the underwriter. All provinces and territories require disclosure of the same information, but they may have different requirements on how and where to submit the form.

125 *See, e.g.*, Royal Gold, Inc., Prospectus (Mar. 12, 2009). Some more recent examples include Royal Gold, Inc., Prospectus Supplements (June 22, 2010, Dec. 22, 2011, Jan. 10, 2012, June 14 and 2012, Oct. 10, 2012), Uranerz Energy Corp., Prospectus Supplements (Nov. 30, 2010, Aug. 27, 2013 and July 17, 2014), Mercer International Inc., Prospectus Supplements (Dec. 14, 2012, July 17, 2013 and Mar. 27, 2014) and Prospectus (Sept. 26, 2016), Allied Nevada Gold Corp., Prospectus (June 14, 2013), General Moly, Inc., Prospectus (Apr. 24, 2014) and Uranium Energy Corp., Prospectus Supplement (Jan. 10, 2014). The "northbound" MJDS has also recently been used in other industries including, pharmaceuticals (Delmar Pharmaceuticals, Inc., Prospectus (Oct. 6, 2016)), oil and gas (Gran Tierra Energy Inc., Prospectus Supplements (Aug. 5, 2016 and Nov. 21, 2016)) and power (Pattern Energy Group Inc., Prospectus (Aug. 8, 2016)).

126 National Instrument 43-101, 34 O.S.C.B. 7043 (June 30, 2011).

127 It is worth noting that Section 11.3 of National Instrument 71-101 does not exempt U.S. oil and gas issuers from the disclosure required by National Instrument 51-101, 26 O.S.C.B 6615 (amended by 28 O.S.C.B 7181, 28 O.S.C.B 10461, 31 O.S.C.B 419 and 33 O.S.C.B 11945). *See also* §§ 4.07 and 4.08 for a discussion of oil and gas issuers in the southbound context.

128 General Motors Company, Prospectus (Nov. 17, 2010).

129 *See supra* Note 122.

130 In the Matter of General Motors Company (Aug. 11, 2010). Canada and the Province of Ontario were each major stockholders in New GM, owning prior to the New GM IPO approximately 11.7% of the common shares of the company through Canada GEN Investment Corporation, a crown corporation. The U.S. Department of the Treasury owned, prior to the New GM IPO, approximately 61% of the common shares of the company. However, given these specific facts and circumstances, this precedent may be of limited applicability in other contexts.

U.S. Regulation of the International Securities and Derivatives Markets, § 14.01, 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 § 14.01 (11th and 12th Editions 2014-2017)
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Securities brokers and dealers (commonly collectively referred to as "broker-dealers") that are required by the Exchange Act to register with the SEC are subject to a comprehensive U.S. federal regulatory scheme that includes stringent financial, recordkeeping, customer protection and other substantive requirements. SEC-registered broker-dealers are also required to become members in one or more securities industry self-regulatory organizations ("SROs") and to comply with the SROs' additional detailed rules. [1]

The regulatory reach of both the SEC and the SROs extends in many respects to all activities of an SEC-registered broker-dealer, not only to its U.S. personnel and activities or to its securities activities. Consequently, the first line of consideration for non-U.S. financial institutions contemplating U.S. activities is whether SEC registration as a broker-dealer is required. If the proposed U.S. activities would require registration, an international financial organization should generally seek to arrange its U.S. securities activities so that they may be conducted in a separate SEC-registered broker-dealer without subjecting the organization's non-U.S. activities or nonsecurities activities to SEC registration and regulation.

Entities that effect transactions in futures contracts or swaps also may be subject to regulation under the Commodity Exchange Act ("CEA") as futures commission merchants ("FCMs"). [2] Entities that deal in security-based swaps may also be subject to regulation by the SEC as security-based swap dealers ("SBSDs") and entities that deal in other types of swaps may be subject to regulation by the U.S. Commodity Futures Trading Commission ("CFTC").

Footnotes

1 In addition, broker-dealers may be subject to registration and regulation in the states where they have offices or customers. Under the National Securities Markets Improvement Act of 1996 (hereinafter the "NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996), however, a state may not generally impose regulatory requirements (other than the requirement to register with and pay filing fees to the state securities administrator) that differ from or add to those established by the SEC. *See* § 14.12.

2 Entities that effect transactions in security futures products are subject to registration both as broker-dealers under the Exchange Act and FCMs (or introducing brokers) under the CEA, although intermediaries registered as an FCM (or an introducing broker) under the CEA or as a broker-dealer under the Exchange Act, but not both, may avail themselves of a notice registration procedure to register in the other capacity for the limited purpose of trading security futures products. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4. Security futures products generally are defined as futures contracts on individual nonexempt securities or narrow-based groups or indices of nonexempt securities. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5][c].

U.S. Regulation of the International Securities and Derivatives Markets, § 14.02, SEC JURISDICTION

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Section 15(a)(1) of the Exchange Act makes it "unlawful for any broker or dealer … to make use of the mails or any means or instrumentality of interstate commerce [3] to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security … unless such broker or dealer is registered … [with the SEC]." [4] The literal meaning of this language is to require SEC registration by any non-U.S. broker-dealer that telephones or sends documents into the United States (commonly referred to as using "jurisdictional means") to contact U.S. investors. The SEC endorses this interpretation, stating that a "broker-dealer operating outside the physical boundaries of the United States, but using the U.S. mails, wires, or telephone lines to trade securities with U.S. persons located in this country, would not be… transact[ing] a business in securities without the jurisdiction of the United States." [5] Indeed, the SEC has stated that § 15 of the Exchange Act could require registration by a non-U.S. broker-dealer whose only U.S. contacts are the execution of unsolicited orders from U.S. customers. [6]

The SEC has also claimed authority to require registration in several circumstances that go beyond the literal language of § 15, stating that it could require the registration of any non-U.S. broker-dealer that (i) effected a transaction, even from outside the United States, in a security registered in the United States or listed on a U.S. exchange [7] or (ii) specifically targeted

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identifiable groups of foreign-based U.S. citizens (*e.g.*, military and embassy personnel). [8]

As discussed below, the SEC has not required broker-dealer registration in all circumstances where its view of the scope of its jurisdiction would permit.

Footnotes

3 Interstate commerce includes any "trade, commerce, transportation, or communication… between any foreign country and any State … [and] any [use of a] facility of a national securities exchange or of a telephone." § 3(a)(17) of the Exchange Act.

4 *See also* §§ 15B(a) and 15C(a) of the Exchange Act (requiring registration of certain dealers in municipal securities and certain brokers and dealers in government securities).

5 SEC Release No. 34-27017 (July 11, 1989) (hereinafter the "Rule 15a-6 Adopting Release"), 54 Fed. Reg. 30,013, 30,016 n.41 (July 18, 1989).

6 *See* Rule 15a-6 Adopting Release at 54 Fed. Reg. 30013, 30017 (July 18, 1989) ("the requirements of section 15(a) do not distinguish between solicited and unsolicited transactions").

7 To illustrate the extent of the SEC's asserted authority to require broker-dealer registration under § 15, the Rule 15a-6 Adopting Release cites, among other cases, *Schoenbaum v. Firstbrook*, 405 F.2d 200, 208 (2d Cir.), *rev'd in part on other grounds*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Manley v. Schoenbaum*, 395 U.S. 906 (1969). Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,016 n.41 (July 18, 1989). That case held that U.S. courts have jurisdiction under the Exchange Act over an antifraud claim relating to a foreign security registered with the SEC and traded on a U.S. exchange. There is some

indication that U.S. courts are more likely to extend U.S. jurisdiction to non-U.S. activities in the context of asserted fraud or manipulation than in matters involving registration or filings. In 2010, in *Morrison v. National Australian Bank Ltd.*, 561 U.S. 247 (2010), the Supreme Court limited the extraterritorial reach of the antifraud provisions of the Exchange Act by providing that § 10(b) of the Exchange Act applied only to securities transactions in the United States or securities listed on U.S. exchanges. A month later, the Dodd-Frank Act restored SEC and Department of Justice (the "DOJ") extraterritorial power (*see* §§ 929P(b) and 929Y of the Dodd-Frank Act), but the *Morrison* transactional test still applies for private rights of action. In 2012, the SEC released a study "on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act," which did not take a position on whether Congress should override the *Morrison* transactional test for private rights of action. *See* SEC, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 AS REQUIRED BY SECTION 929Y OF THE [DODD-FRANK ACT] (Apr. 11, 2012). While the SEC's view is that anyone who facilitates any stock transaction through conduct in the United States must register with the SEC under § 15(a), one federal district court has applied *Morrison* to interpret the Exchange Act more narrowly to exclude certain entities that operate in the United States but where the ultimate and intended purchase and sale is foreign and does not occur on a national securities exchange. *See SEC v. Benger*, 934 F. Supp. 2d 1008, 1013 (C.D. Ill. 2013) ("[A] broker's failure to register under Section 15(a) of the [Exchange] Act is not actionable in those cases where the ultimate and intended purchase and sale was foreign and thus, itself, outside the scope of the Act."). For additional discussion on *Morrison*, *see* § 11.10[3].

8 *See SEC v. Siamerican Securities, Ltd.*, SEC Litigation Release No. 6937 (June 17, 1975) (charging a broker-dealer that solicited securities transactions from U.S. servicemen stationed abroad for execution primarily in U.S. markets with failure to register); *see also* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,017 (July 18, 1989).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.03, SEC REGISTRATION AS A BROKER-DEALER

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Notwithstanding the broad jurisdictional reach of § 15 of the Exchange Act, there are circumstances in which non-U.S. (and U.S.) financial institutions engaged in securities activities using jurisdictional means are not subject to SEC registration. [9] Broadly speaking, a conclusion that SEC registration is not required can follow from any one of three determinations: the financial institution is not a "broker" or "dealer"; the financial institution, although a "broker" or "dealer," engages only in activities that do not require registration under § 15; or the financial institution is not based in the United States and engages only in those U.S. activities that the SEC permits (often subject to various conditions) to foreign broker-dealers. [10]

[1] Definition of Broker and Dealer

The registration requirement under § 15 of the Exchange Act is applicable only to "brokers" and "dealers" in "securities."

[a] Broker

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Prior to the enactment of the Gramm-Leach-Bliley Act (the "GLB Act") in 1999, the term "broker" was defined in § 3(a)(4) of the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others, but … not … a bank." [11] The GLB Act modified the Exchange Act definition of "broker" by replacing the blanket bank exclusion with a number of specified exceptions. [12] In September 2007, the SEC and the Board of Governors of the Federal Reserve System (the "Board") jointly adopted Regulation R implementing the broker exceptions and setting forth related exemptions and definitional clarifications. [13]

To be "engaged in the business" of effecting securities transactions for others generally requires a regularity of securities activity, but not that such activity be an entity's principal business or source of income. An entity may be a "broker" even though its securities transactions are a small part of its business activities or its income. [14]

In the SEC's view, the term "broker" includes two types of entities that might not ordinarily be considered to be engaged in the business of effecting securities transactions for others. First, an entity or individual that engages in activities related to corporate mergers and acquisitions may be deemed a "broker." [15] Entities that do nothing more than bring merger-and acquisition-minded companies or investors and companies together (*i.e.*, "finders"), who do not participate in negotiations or in the distribution of securities and who are paid on an hourly or flat fee basis generally are not deemed to be brokers. [16] On the other

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hand, entities that negotiate merger or acquisition transactions involving securities (*e.g.*, all of the stock of a target company), as opposed to assets, engage in other activities to consummate the transactions, advise whether to enter into transactions and receive fees that are contingent upon the completion, or proportional to the size, of the transactions are more likely to be considered brokers. [17]

In 2014, the SEC issued no-action relief to "M&A Brokers" in connection with the transfer of ownership of a privately-held company without registering as a broker or dealer. [18] For purposes of the relief, an M&A Broker was defined as "a person engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company." [19] To avail itself of the relief, the M&A Broker cannot bind any party to the relevant transaction, cannot provide financing (directly or indirectly through an affiliate) for the transaction, cannot handle or control

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funds or securities in connection with the transaction for the account of others, cannot assist in the formation of the group of buyers and must abide by certain other restrictions contained in the letter. [20]

Second, the term "broker" may include employees of an issuer who participate in the sale of the issuer's securities. Generally, however, an issuer's employees would not be considered brokers where they are not employed solely or primarily to market securities, their compensation is not tied to the sale of securities and certain other requirements are satisfied. [21]

The SEC has had the opportunity to consider broker-dealer registration issues in connection with the provision of access to financial services on the Internet. For instance, the SEC has granted no-action relief allowing an online service provider, such as America Online or CompuServe, to provide subscribers access to the services of a broker-dealer without the online service itself having to register as a broker-dealer. [22] The SEC has also permitted an online research center to provide subscribers with direct communication links to registered broker-dealers as well as access to financial and business information such as market quotations, economic indicators, annual and quarterly reports for listed companies, new offering filings and press releases without the research center itself having to register as a broker-dealer. [23] The SEC has also granted no-action relief to a company that provides a computerized platform linking registered broker-dealers to one another, permitting broker-dealers to send electronic messages that communicate buy and sell orders to other broker-dealers participating on the platform with whom a sending broker has a pre-existing brokerage relationship. [24] In all three instances, the relief granted is subject to several assumptions and conditions, one of the more prominent being that the compensation to the service provider from the broker-dealer will be a flat fee on a per order or per usage basis and will not vary with the number or value of the shares in any order placed through the service or depend on whether such an order results in an executed trade.

In 2000, however, the SEC refused to grant a no-action request submitted by MuniAuction Inc., a web-based municipal bond auction site, in which

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MuniAuction stated that it did not "(1) actively solicit investors, (2) advise investors as to the merit of an investment, (3) act with ‘certain regularity of participation in securities transactions' [or] (4) receive commissions or transaction-based compensation." [25] In its response letter to MuniAuction (the "MuniAuction Letter"), the SEC staff described the key elements it uses to determine "broker" status. First, the SEC noted that "[a] person effects transactions in securities if he or she participates in such transactions ‘at key points in the chain of distribution.’" Such participation includes, among other activities:

- assisting an issuer to structure prospective securities transactions;
- helping an issuer to identify potential purchasers of securities;
- soliciting securities transactions; and
- participating in the order-taking or order-routing process. [26]

The MuniAuction Letter stated that "[f]actors indicating that a person is ‘engaged in the business' include, among others: receiving transaction-related compensation; holding one's self out as a broker, as executing trades, or as assisting others in settling securities transactions; and participating in the securities business with some degree of regularity. In addition to indicating that a person is ‘effecting transactions,’ soliciting securities transactions is also evidence of being 'engaged in the business.'" [27]

Noting, among other factors, that "MuniAuction brings buyers and sellers of securities together for a fee … solicits issuers and other securities holders to use its auction services to sell securities through its site … [and] participates in the order-taking process through purchasers' submission of their bids on issuers' and other holders' securities through its website," the staff stated its belief that MuniAuction was acting (and should register) as a "broker" within the meaning

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of § 3(a)(4) of the Exchange Act and further cautioned that, given its activities, MuniAuction may also be required to register as an exchange or satisfy the exemption from exchange registration provided for so-called "alternative trading systems" by Regulation ATS. [28]

In November 2015, the SEC adopted Regulation Crowdfunding, a set of new rules permitting the limited offering and sale of securities through Internet crowdfunding without the registration of such securities. [29] Regulation Crowdfunding is intended to provide a balance between protecting investors and enabling small businesses to raise capital through small investments from ordinary investors without overburdening them with regulation. The new rules, which took effect in May 2016, require that crowdfunding transactions be conducted exclusively through an intermediary that is registered as a broker or a "funding portal," a new form of SEC registrant subject to strict limitations on its activities. [30] A maximum of $1 million can be raised by an issuer through crowdfunding in a twelve-month period, and only certain categories of issuers are eligible to take advantage of Regulation Crowdfunding. [31] In addition, the securities purchased by investors in a crowdfunded offering are subject to restrictions on resale and generally cannot be transferred for at least a year. [32] The rules require that all filings use a new Form C, which generally demands less extensive disclosure than that required in registered offerings.

For the new funding portals, Regulation Crowdfunding finalized a new form for funding portal registration ("Form Funding Portal"), which requires similar, but less extensive and costly, information as that required by Form BD. [33] For funding portals that register with the SEC, the rules provide a non-exclusive, conditional safe-harbor from the broker-dealer registration requirements of the Exchange Act. [34] In addition to SEC registration, funding portals are required to become members of FINRA. [35] The activities in which a funding portal may engage are far more limited than those of a registered broker-dealer and include: (1) limited offerings on the funding portal platform; (2) highlighting and displaying offerings on the platform; (3) providing communication channels for potential investors and issuers; (4) providing search functions on the platform; (5) advising issuers on the structure or content of offerings; (6) compensating

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others for referring persons to the funding portal and for other services; and (7) advertising the funding portal's existence. [36] Funding portals are prohibited from most other broker-dealer activities, including offering investment advice or soliciting purchases and sales.

Because of the low offering limit and still substantial disclosure requirements, it is unlikely that, outside of small Internet startups, most issuers will take advantage of Regulation Crowdfunding.

[b] Dealer

Prior to the enactment of the GLB Act, the term "dealer" was defined in § 3(a)(5) of the Exchange Act as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise," but not a bank, or any person insofar as he "buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business." [37] The GLB Act modified the Exchange Act definition of "dealer" by replacing the blanket bank exclusion with a number of specified exceptions. [38] Banks have been required to comply with the revised definition of "dealer" and related rules adopted by the SEC since September 30, 2003. [39]

Title VII of the Dodd-Frank Act further modified the Exchange Act definition of "dealer" by specifically excluding persons engaged in the business of buying and selling security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants. [40]

To be a "dealer," one must be "engaged in the business" of buying and selling securities for one's own account. However, the term does not include a person whose buying and selling are "not … part of a regular business." [41]

"Dealer" status is generally a more complicated matter than "broker" status. There are numerous entities and individuals (*e.g.*, insurance companies, hedge funds and other private investment partnerships and individual investors) that engage as principals in securities transactions to an extent that might, for other purposes, be regarded as "engaged in business" or in a "regular business." Moreover, interposition of a "broker" in a principal's trading activities does not exclude the principal from "dealer" status, since the term "dealer" includes principals who trade "through a broker or otherwise." The SEC has, however,

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interpreted the definition of "dealer" to exclude "investors," including those whose activity is large and frequent enough to make them "active traders." [42] On the other hand, the SEC has indicated that a low volume of securities activity by itself does not establish that an entity is not a dealer. [43]

It is often the case that no single factor will determine whether an entity is an "investor" or "trader" as opposed to a "dealer." A conclusion must be reached that takes into account each of the entity's securities-related activities. In the SEC's view, the following activities would ordinarily be engaged in by a dealer, but not by an investor or trader:

- issuing or originating securities; [44]
- participating in a selling group or underwriting securities; [45]
- purchasing or selling securities as principal from or to customers rather than from or to only brokers or dealers; [46]
- carrying a dealer inventory; [47]
- quoting a market in securities or publishing any quotations on or through any quotation system used by dealers, brokers or institutional investors or otherwise quoting prices other than on a limited basis through a retail screen broker; [48]
- holding oneself out as a dealer or market-maker or as otherwise willing to buy or sell particular securities on a continuous basis; [49]

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- rendering incidental investment advice; [50]
- handling other people's money or securities or executing securities transactions on other people's behalf; [51]
- extending or arranging for the extension of credit to others in connection with securities; [52]
- conducting processing or clearing activities; [53]
- obtaining a regular clientele; [54] and
- engaging in trading transactions for the benefit of others, rather than consistently with one's own judgment, investment and liquidity objectives. [55]

[c] Banks

Unlike a broker or dealer, which may be a person of any nationality, the term "bank" as defined in the Exchange Act is limited to U.S. federal and state organized and regulated banks and savings associations with deposits insured by the Federal Deposit Insurance Corporation ("FDIC"). [56] A foreign bank is thus

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not a "bank" for purposes of the Exchange Act, although a U.S. branch of a foreign bank is generally considered to be a "bank" for purposes of the Exchange Act. [57] A bank holding company or nonbank subsidiary or affiliate of a bank is likewise not a "bank" for Exchange Act purposes.

As discussed above, prior to the enactment of the GLB Act, U.S. banks enjoyed a blanket exclusion from the Exchange Act definitions of both "broker" and "dealer." [58] However, the GLB Act eliminated these blanket exclusions and replaced them with more limited exceptions, effectively requiring banks to "push out" into registered broker-dealers activities that do not come within the exceptions. [59]

Under the GLB Act amendments to the definition of "broker," a bank is not considered to be a broker merely because it engages in the following activities:

- so-called "networking" or "kiosking" arrangements with third-party brokers or dealers (subject to restrictions on advertising and restrictions on incentive compensation);
- trust and fiduciary activities (subject to restrictions on advertising and restrictions on incentive compensation);
- transactions in commercial paper, bankers' acceptances, commercial bills, exempt U.S. or Canadian federal, state, provincial or municipal government or agency securities ("specified exempt securities") or "Brady bonds";
- transactions for employee benefit, dividend reinvestment and shareholder plans (subject to certain conditions);
- sweep account transactions into money market mutual funds registered with the SEC;
- transactions for the account of an affiliate (other than a U.S. broker-dealer or merchant banking affiliate);
- private placements (subject to certain limits); however, the private placement exception is not available if, at any time after November 11, 2000, the bank is affiliated with a broker-dealer that has been registered for more than one year in accordance with the Exchange Act and engages in dealing, market-making or underwriting activities (other than with respect to specified exempt securities);

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- safekeeping and custody services (subject to certain conditions);
- transactions in "identified banking products"; [60]
- transactions in municipal securities; or
- transactions pursuant to a *de minimis* exception (up to 500 transactions per year, [61] which may not be effected by staff shared with a broker-dealer affiliate). [62]

The Financial Services Regulatory Relief Act of 2006 (the "FSRRA") [63] required the SEC and the Board to issue joint rules implementing the broker push-out exceptions. In 2007, the SEC and the Board jointly adopted new Regulation R, which implements four of the exceptions from the definition of "broker" available to banks: "networking" arrangements, trust and fiduciary activities, sweep accounts, and safekeeping and custody activities. [64] In addition, Regulation R also provides several conditional exemptions for activities in which a bank may engage without being deemed a "broker" under the Exchange Act, including exemptions permitting banks to engage in:

- certain transactions effected in securities issued pursuant to Regulation S ;
- certain securities lending transactions;

- certain transactions in mutual funds and variable insurance contracts; and
- certain transactions in a company's securities for its employee benefit plans. [65]

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Regulation R also provides banks with a limited "good faith" exemption from contract rescission liability under § 29(b) of the Exchange Act for violation of the broker-dealer registration requirements. [66]

Under the GLB Act amendments to the definition of "dealer," a bank is not considered to be a dealer merely because it:

- buys or sells commercial paper, bankers' acceptances, commercial bills, specified exempt securities or "Brady bonds";
- buys or sells securities for investment, trust or fiduciary purposes;
- engages in the issuance or sale of asset-backed securities, if the underlying assets are predominantly originated [67] by the bank, an affiliate that is not a broker-dealer or (if the asset-backed securities are mortgage or consumer-related) a syndicate of banks [68] of which it is a member; or

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- buys or sells "identified banking products." [69]

In addition to clarifying these statutory exceptions, the SEC adopted, in the Dealer Release, an exemption from the definition of "dealer" for banks engaging in certain securities lending transactions in which the bank is acting as a conduit lender or agent and is conducting such transactions with or on behalf of (i) a qualified investor (as defined in § 3(a)(54) of the Exchange Act), or (ii) any employee benefit plan that owns and invests on a discretionary basis not less than $25,000,000 in investments. [70] The SEC has also adopted an exemption permitting banks to engage in certain riskless principal transactions in Regulation S securities with non-U.S. persons. [71]

[d] U.S. Branches and Agencies of Foreign Banks

The Exchange Act definition of "bank" includes "any other banking institution … doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising a fiduciary power." [72] It has long been understood that U.S. branches of foreign banks were entitled to the benefits of the Exchange Act "bank" exclusion from broker-dealer registration. [73] However, with the elimination of the bank exclusion by the GLB Act, those U.S. branches of foreign banks that continue to qualify as "banks" for purposes of the Exchange Act are, like U.S. domestic banks, subject to potential registration and regulation as "brokers" or "dealers."

Whether a U.S. agency of a foreign bank can qualify as a "bank" for purposes of the Exchange Act depends on the particular agency's activities, which may in turn depend on the particular regulatory scheme to which it is subject. Historically, a key distinction between foreign banks' U.S. branches and their

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agencies was that branches could take deposits while agencies could not. [74] Currently, however, agencies in a number of states can take deposits from nonresidents. For example, New York agencies can issue deposit-type obligations to institutions in denominations of $100,000 or more; [75] New York law also permits agencies (like branches) to exercise fiduciary powers with special authorization from the New York Superintendent of Financial Services. [76] Federal agencies, on the other hand, cannot accept deposits or exercise fiduciary powers. [77]

[e] Business in Securities

A broker or dealer is only required to register with the SEC if it conducts a business in "securities." The term "security" is defined in § 3(a)(10) of the Exchange Act (and discussed in Chapter 12). [78] An entity engaged in activities involving exclusively nonsecurities is therefore not required to register as a broker or a dealer. [79] However, both the securities and nonsecurities activities of an entity that is required to register are subject to regulation. As a result, most financial institutions that provide financial services with respect to both securities and nonsecurities conduct their securities activities in a registered broker-dealer and have established one or more separate affiliates to carry out wholly nonsecurities activities in areas such as real estate, currencies, lending and certain derivative instruments. [80]

[2] Exclusions

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There are a number of additional explicit exclusions from the registration requirement under § 15 of the Exchange Act. [81]

[a] Business Exclusively Intrastate

Section 15 of the Exchange Act does not require registration of a broker or dealer "whose business is exclusively intrastate." As any communication from outside the United States into a state is "interstate" rather than "intrastate," a foreign broker-dealer using jurisdictional means cannot make use of this exclusion. [82] Even for U.S.-based broker-dealers, the scope of the intrastate exemption is so limited that it is of little utility. [83]

[b] Business Exclusively in Certain Instruments

A broker or dealer whose business is exclusively in "commercial paper," bankers' acceptances, commercial bills or "exempted securities" [84] is also not required by § 15(a) of the Exchange Act to register with the SEC.

[i] *Commercial Paper*

The term "commercial paper" is not defined in the Exchange Act. By current practice, however, it is understood that this term is coextensive with the exemption from registration provided under the Securities Act for notes used to

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finance current transactions and having a maturity of less than nine months. [85] The general Securities Act requirements for establishing that a note is of the type commonly referred to as "commercial paper" are that it: (i) is of prime quality and negotiable, (ii) is of a type not ordinarily purchased by the general public, (iii) has a maturity of less than nine months, and (iv) is issued solely to derive proceeds that fund "current transactions." [86]

[ii] *U.S. Government Securities*

U.S. government securities are "exempted securities" for purposes of § 15(a) of the Exchange Act; accordingly, broker-dealers conducting a securities business exclusively in U.S. government securities need not register under that section. [87] However, § 15C of the Exchange Act requires all U.S. government securities broker-dealers (i) that are not banks or similar financial institutions to register with the SEC or (ii) that are banks or similar financial institutions to give notice of their government securities activities to the "appropriate regulatory agency," [88] generally the agency responsible for regulation of their banking activities.

[3] Exemptions Available to Foreign Broker-Dealers

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[a] Background; Rule 15a-6

In 1989, the SEC adopted a general exemptive rule—Rule 15a-6 under the Exchange Act [89]—which specified a variety of circumstances in which foreign broker-dealers may have contact with U.S. investors and use U.S. jurisdictional means without registering as a broker or dealer with the SEC. [90]

Certain of the registration exemptions provided by Rule 15a-6 are available to all foreign broker-dealers ("general exemptions"). The remaining Rule 15a-6 exemptions from registration are available only to those foreign broker-dealers that comply with certain additional conditions specified in the rule ("conditional exemptions"). A precondition to both types of exemptions is that, except as specifically permitted by the rule (or subsequent liberalizing interpretations

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discussed below), the foreign broker-dealer has no physical presence conducting securities activities in the United States. [91]

[b] General Exemptions

The general exemptions provided in Rule 15a-6 under the Exchange Act fall into three categories. All foreign broker-dealers may: (i) effect "unsolicited" securities transactions with U.S. persons, (ii) solicit and effect securities transactions for specified categories of counterparties, and (iii) provide research to "major U.S. institutional investors." The Rule 15a-6 Adopting Release also recognizes additional mechanisms by which all foreign broker-dealers may distribute research reports generally in the United States, provide quotations to U.S. investors and execute trades through linkages with U.S. securities exchanges.

[i] *Unsolicited Transactions*

Rule 15a-6 provides that all foreign broker-dealers may effect "unsolicited" transactions with U.S. persons. [92] Rule 15a-6 itself does not define "solicitation," and the Rule 15a-6 Adopting Release states that the SEC will determine the term's meaning on a case-by-case basis, taking into account SEC precedents.

The Rule 15a-6 proposing release defines "solicitation" generally as "including any affirmative effort by a broker or dealer intended to induce transactional business for the broker-dealer or its affiliates.…[It] includes efforts to induce a single transaction or to develop an ongoing securities business relationship." [93] "Solicitation" has also been interpreted as including the following activities:

- telephone calls from a broker-dealer to a customer encouraging the use of the broker-dealer to effect transactions;
- transmission of a market-maker's bid/ask quotations into the United States;
- any attempt by a broker-dealer to make its business known in the United States, whether through an individual introductory meeting with a potential customer or through advertisement of its services on a television or radio

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  broadcast into the United States or in a publication of "general circulation" [94] in the United States;
- the conduct by a foreign broker-dealer of investment seminars for U.S. investors, even though the seminar is hosted by a registered broker-dealer and the subject of the seminar is not specific securities but a general explanation of regulation in an overseas securities market in which the foreign broker-dealer is active; [95]
- the making of any recommendation of a security in an instance in which the recommendation is likely to lead to a transaction with the recommending broker-dealer;

- the provision by a broker-dealer of research to investors, even to investors who have actively sought out and requested the research; [96] and
- a series of frequent transactions or a significant number of transactions between a foreign broker-dealer and a U.S. investor. [97]

The distribution of research to U.S. investors is such a strong indicator of solicitation that, in the SEC's view, a foreign broker-dealer should establish "adequate procedures to avoid transmission of research reports into U.S. markets," except as permitted by Rule 15a-6, in order to avoid the conclusion that the broker-dealer is using the research to induce U.S. customer transactions. [98]

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In sum, the SEC views "solicitation" as including any action by a broker-dealer intended to induce transactions, to develop customer goodwill or to make itself known. A good illustration of the breadth of the concept in the SEC's view is its statement that a foreign broker-dealer could be deemed to have solicited a U.S. investor who on his own initiative opened an account with the foreign broker-dealer and became a "regular customer." [99]

In 2013, the staff of the SEC's Division of Trading and Markets clarified that a foreign broker-dealer that administers or seeks to administer an employee stock option plan or other employee benefit plan established and administered in accordance with foreign law for a foreign issuer that is organized outside the United States and whose principal office and place of business are located outside the United States would not, solely because of that activity, be considered to have solicited the U.S. employees or U.S. subsidiary, provided that the foreign broker-dealer deals exclusively with management and employee benefit representatives from the foreign issuer (located outside the United States) in administering the plan and limits its activities with respect to U.S. persons to certain activities. [100] Permitted activities include facilitating the transfer of the foreign issuer's securities to a U.S. person employed for the foreign issuer or its U.S. subsidiary; sending required plan documents, account statements, confirmations, privacy notices, prospectuses, proxy statements or other legally required documents to the employee; and selling, transferring or otherwise disposing of the foreign issuer's securities, so long as the activities relate solely to foreign securities acquired by U.S. persons pursuant to the applicable employee benefit plan. [101]

[ii] *Activities with Selected Counterparties*

Rule 15a-6 specifies categories of counterparties who all unregistered foreign broker-dealers may solicit and with whom they may engage in transactions. These counterparties are: SEC-registered broker-dealers, banks acting in a broker or dealer capacity, certain supranational organizations, certain foreign persons temporarily visiting the United States and U.S. persons resident outside the United States.

[A] Registered Broker-Dealers and Banks Acting Under a Broker or Dealer Exception

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All foreign broker-dealers may solicit and engage in transactions with "a registered broker-dealer, whether … acting as principal for its own account or as agent for others, or a bank acting pursuant to certain exceptions from the Exchange Act definition of 'broker' or 'dealer.'" [102] This exemption, which predates the adoption of Rule 15a-6, [103] recognizes that, if investors are to be able to buy securities traded in markets outside their home countries, broker-dealers must be able to do business with each other across national borders. [104] It also recognizes that U.S. banks (including U.S. branches and agencies of foreign banks) engage in broker and, to a more limited extent, dealer activity, though these activities have been curtailed by the full implementation of the push-out provisions of the GLB Act. [105] Although Rule 15a-6 is not explicit on this point, it seems clear that the exempted transactions in which registered broker-dealers or U.S. banks purchase securities as principal include purchases for investment purposes as well as those for dealing inventory.

Certain members of the SEC staff have expressed the view, on an informal basis, that the exemption for transactions between foreign broker-dealers and U.S. broker-dealers pursuant to Rule 15a-6(a)(4)(i) in which the U.S. broker-dealer acts as agent for a U.S. customer may not be available for certain over-the-counter ("OTC") derivative transactions involving the purchase and sale of a security where there is contractual privity between the foreign broker-dealer and the U.S. customer and the obligations of the counterparties are ongoing. However, there has been no published authority explicitly addressing this informal staff position and this interpretation does not appear to be consistent with either

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the structure of Rule 15a-6 or the policy considerations articulated by the SEC in connection with the rule's adoption. [106]

[B] Supranational Organizations

Rule 15a-6 contains a list of supranational organizations that foreign broker-dealers may solicit and with which they may engage in transactions in the United States. [107] The listed supranational organizations are the African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development (commonly referred to as the "World Bank"), the International Monetary Fund, the United Nations, and their respective agencies, affiliates and pension funds.

[C] Foreign Persons Temporarily in the United States

Any foreign broker-dealer may solicit and effect transactions for a foreign person temporarily present in the United States with whom the foreign broker-dealer had a "*bona fide*, pre-existing relationship before the foreign person entered the United States." [108] For this purpose, a non-U.S. citizen can be treated

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as "temporarily present" in the United States so long as such person has not become a lawful permanent resident of the United States (*i.e.*, a "Green Card holder"). [109]

This exemption evidences the SEC's greater willingness than in the past to avoid application of U.S. regulatory schemes to situations involving only foreign investors, [110] as well as a willingness to apply pragmatically the SEC's traditional territorial approach to securities law jurisdiction. [111]

U.S. advisers acting for non-U.S. persons are specifically treated as non-U.S. persons for purposes of Regulation S under the Securities Act. [112] However, Rule 15a-6 under the Exchange Act does not contain a similar provision. Accordingly, technical compliance with Rule 15a-6 requires that an SEC-registered broker-dealer be interposed in transactions with U.S.-based advisers for non-U.S. persons, which can result in greater restrictions on such U.S.-based advisers and place them at a competitive disadvantage *vis-á-vis* their non-U.S.-based counterparts. In an effort to alleviate these competitive disadvantages, the SEC issued in 1996 a no-action letter that grants relief from broker-dealer registration requirements to certain foreign broker-dealers affiliated with U.S.-registered

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broker-dealers that directly contact and effect transactions with certain U.S.-resident professional fiduciaries that act for "offshore clients" in connection with transactions in "foreign securities." [113]

[D] U.S. Persons Abroad

Foreign broker-dealers may solicit (i) an agency or branch of a U.S.-organized entity permanently located outside the United States and (ii) a U.S. citizen resident outside the United States, provided in each case that the resulting securities transactions "occur outside the United States." [114] However, in the case of U.S. citizens resident abroad, foreign broker-dealers may not direct their selling efforts to "identifiable groups" of U.S. citizens, [115] *e.g.*, military and embassy personnel. [116] This treatment of U.S. persons abroad under Rule 15a-6 is

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generally consistent with their treatment for purposes of Regulation S under the Securities Act. [117]

[iii] *Provision of Research Reports*

[A] To Major U.S. Institutional Investors

Rule 15a-6(a)(2) provides that all foreign broker-dealers may provide research reports, without involvement by a U.S. broker-dealer in the review, approval or distribution of the reports, to "major U.S. institutional investors" and effect any resulting transactions. [118] Major U.S. institutional investors are certain "U.S. institutional investors" that have, or have under management, total assets exceeding $100 million. [119] Under the definitions set forth in Rule 15a-6, however, a corporation or partnership generally will not qualify as a "major U.S. institutional investor," even if it owns or manages $100 million in assets and is, for example, a "qualified institutional buyer" within the meaning of Rule 144A under the Securities Act. [120] This limitation, which significantly reduced the utility of, and reliance on, the rule, has been largely eliminated by SEC no-action

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relief granted in 1997 to the effect that qualifying foreign broker-dealers may provide research reports to, and under the conditional exemption discussed below, may enter into transactions with, institutional entities (including corporations and partnerships) that own or control (or, in the case of registered or unregistered investment advisers, have under management) in excess of $100 million in aggregate financial assets ("$100 Million Entities"). [121] The SEC staff's expanded view of the term "major U.S. institutional investor" applies to all provisions of Rule 15a-6 in which that term is used. [122]

This exemption is subject to the following conditions:

- the research reports do not recommend the use of the foreign broker-dealer to effect trades in any security;
- the foreign broker-dealer does not initiate contact to follow up on the research reports and does not otherwise attempt to induce securities transactions by those investors;
- the foreign broker-dealer does not provide research pursuant to any express or implied understanding that those U.S. investors will direct commission income to the foreign broker-dealer (*i.e.*, there may not be any "soft dollar" arrangements between the U.S. investors and the foreign broker dealer); [123] and
- if the foreign broker-dealer enters into a so-called "chaperoning" arrangement with an SEC-registered broker-dealer (as described in § 14.03[3][c][ii] below), any trades with the recipient of the research in securities that were discussed in the research reports must be effected "through" such registered broker-dealer. [124]

[B] To Other Investors

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The Rule 15a-6 Adopting Release specifies conditions under which all foreign broker-dealers may distribute research to any U.S. investor. These conditions are that: (i) a registered broker-dealer "accepts responsibility" for the research and the research report states this prominently, [125] (ii) the research report prominently indicates that any U.S. persons wishing to effect transactions in the securities discussed in the research do so through the registered broker-dealer, and (iii) all resulting transactions are in fact effected by the registered broker-dealer. [126] One consequence of these conditions has been to make this exemption of practical utility primarily to those foreign broker-dealers that have an affiliated registered broker-dealer. [127]

[iv] *Participation in Third-Party Quotation Systems*

A non-U.S. broker-dealer's provision of bid/ask quotations into the United States is a form of "solicitation" that, in the view of the SEC, generally requires the broker-dealer's registration. However, the provision of quotations to registered broker-dealers and to banks excepted or exempt from the Exchange Act definitions of "broker" or "dealer" is an exempted activity under Rule 15a-6. [128]

Prior to 1997, the SEC position, as stated in the Rule 15a-6 Adopting Release, was that the SEC also would grant interpretive relief from broker-dealer registration to permit the use of certain "third-party" quotation systems (that is, systems not controlled by an individual broker-dealer). Specifically, relief would be granted for distribution of quotations on "systems operated by foreign marketplaces or by private vendors, that distributed these quotations primarily in foreign countries … [and only to those] third-party systems that did not allow securities transactions to be executed [directly online]." [129] However, the Rule 15a-6 Adopting Release indicated that the SEC would not approve a "direct dissemination" quotation system (that is, a system controlled by an individual foreign broker-dealer) [130] and that the SEC would have "reservations" concerning any "specialized" quotation system, such as a system that disseminated quotes only for large block trades. [131]

Under the 1997 Cleary Letter, the SEC reconsidered its prior position on electronic quotation systems in light of increasing globalization and technological changes in the securities markets. First, the SEC eliminated the qualification for relief that quotations are distributed "primarily in foreign countries." Furthermore, providing U.S. investors with access to proprietary and third-party screen-based quotation systems that supply quotations, prices and other trade-reporting information input directly by foreign broker-dealers will not constitute an impermissible "contact" with a foreign broker-dealer, so long as any transactions between the U.S. investor and the foreign broker-dealer are effected in accordance with the requirements (including, to the extent required, the intermediation requirements) of Rule 15a-6. The SEC has indicated that it would also be willing to provide individual firms with additional guidance regarding the execution of such intermediated transactions through an automated trading system operated by the registered U.S. broker-dealer intermediary. [132]

[v] *Trades Through Stock-Exchange Linkages*

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The SEC has stated that it "generally views agreements between U.S. and foreign securities exchanges [permitting the transfer of orders between the exchanges] as positive developments." [133] The SEC has approved three linkages between Canadian and U.S. exchanges: the Montreal Stock Exchange with the Boston Stock Exchange, [134] and the Toronto Stock Exchange with each of the AMEX [135] and the Chicago Stock Exchange (formerly, the Midwest Stock Exchange). [136] In all three cases, the linkage was limited to dual-listed stocks. In addition, in 2000, the NYSE announced its intention to establish a 24-hour "Global Equity Market," linking the NYSE to nine other foreign exchanges, [137] but none of the linkages between the NYSE and the foreign exchanges is currently in operation. [138]

[vi] *Participation in Exempt Exchanges*

In 1999, the SEC granted exemptive relief to Tradepoint Financial Networks plc ("Tradepoint") permitting it to operate the Tradepoint Stock Exchange (a screen-based electronic market regulated as a recognized investment exchange

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in the United Kingdom) in the United States without registering as a national securities exchange. [139] Under the terms of the exemptive relief and later no-action relief, certain U.S. institutions and brokers are permitted to become members of Tradepoint and to trade on Tradepoint certain stocks eligible to be traded on the London

Stock Exchange directly from terminals located in the United States (subject to certain limitations on the trading of "restricted securities" under the Securities Act). [140] There are currently no other non-U.S. securities exchanges permitted to place electronic trading terminals in the United States.

[c] Conditional Exemptions

Rule 15a-6(a)(3) under the Exchange Act permits unregistered foreign broker-dealers, acting from outside the United States (except to the limited extent that the rule permits U.S. visits), to solicit and take orders for securities transactions from "U.S. institutional investors" and "major U.S. institutional investors," [141]

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provided that certain conditions are met. [142] These conditions are briefly summarized as follows:

- the foreign broker-dealer must enter into an arrangement (a "Rule 15a-6 arrangement") with an SEC-registered broker-dealer, pursuant to which the SEC-registered broker-dealer must agree to effect all securities transactions resulting from contacts undertaken in reliance on the conditional exemptions and take on certain other responsibilities with respect to securities-related contacts and transactions between the foreign broker-dealer and U.S. investors (such SEC-registered broker-dealer is hereinafter referred to as a "chaperoning broker-dealer"); and
- the foreign broker-dealer and those of its personnel involved in transactions pursuant to the exemptions must consent to the service of process in the United States and comply with certain additional conditions specified in the rule (a foreign broker-dealer that has entered into such an arrangement and has complied with such additional conditions is hereinafter referred to as a "qualifying foreign broker-dealer").

[i] *Qualifying Foreign Broker-Dealer*

A foreign broker-dealer seeking to rely on the conditional exemptions set forth in Rule 15a-6(a)(3) must enter into a Rule 15a-6 arrangement with a chaperoning broker-dealer. [143] The chaperoning broker-dealer may, but need not, be an affiliate of the qualifying foreign broker-dealer, and may (so long as it is properly registered with the SEC) be located in a jurisdiction (including the foreign broker-dealer's home country) outside the United States. [144] A qualifying foreign broker-dealer may enter into Rule 15a-6 arrangements with any number of chaperoning broker-dealers. [145]

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As part of the Rule 15a-6 arrangement, a qualifying foreign broker-dealer must consent to service of process for any civil action brought by, or proceeding before, the SEC or an SRO, and this consent must be maintained by the chaperoning broker-dealer as part of its books and records. Once this consent has been executed and submitted to the chaperoning broker-dealer, there appears to be no limit as to the purposes for which process may be served. In other words, the SEC apparently takes the view that its jurisdiction under the rule over a qualifying foreign broker-dealer is as extensive as if the foreign broker-dealer were registered with the SEC, and thus it is not restricted to taking action concerning only those transactions which the qualifying foreign broker-dealer effects under Rule 15a-6, through the chaperoning broker-dealer or even with U.S. persons. [146]

In addition to consenting to service of process, a qualifying foreign broker-dealer also must provide the SEC "with any information or documents within [its]… possession, custody, or control … any testimony of foreign associated persons, and any assistance in taking the evidence of other persons, wherever located, that the [SEC] requests and that relates to transactions [effected pursuant to the conditional exemptions]." [147]

[A] Associated Persons of Qualifying Foreign Broker-Dealers

Each employee or other "associated person" of a qualifying foreign broker-dealer who proposes to solicit or otherwise engage in contacts with U.S. investors pursuant to the conditional exemptions must consent to service of process in the same manner as the qualifying foreign broker-dealer and provide certain employment and other background information to the chaperoning broker-dealer so that the chaperoning broker-dealer can determine whether to approve the associated person's participation in the Rule 15a-6 arrangement (each such approved associated person is hereinafter referred to as a "qualifying foreign associated person"). [148]

[B] Oral Communications from Outside the United States

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Qualifying foreign associated persons may engage in oral communications (*e.g.*, by telephone), from outside the United States, with U.S. institutional investors, major U.S. institutional investors and, pursuant to the 1997 Cleary Letter, $100 Million Entities, provided that, in the case of oral communications with U.S. institutional investors that are not major U.S. institutional investors or $100 Million Entities, either (i) a duly licensed employee of the chaperoning broker-dealer participates in such communication, or (ii) in accordance with the 1997 Cleary Letter, such communication takes place outside NYSE trading hours and no orders to effect transactions other than those involving foreign securities (as defined in the 1996 Cleary Letter) are accepted. [149]

[C] Visits to the United States

Under Rule 15a-6, qualifying foreign associated persons may visit U.S. institutional investors and major U.S. institutional investors in the United States provided that a duly licensed employee of the chaperoning broker-dealer chaperones these visits. [150] The chaperone must be familiar with any research reports discussed during these visits, must conduct a prior review of any written materials that are to be distributed and of any summaries or outlines of the qualifying foreign associated person's oral presentation and must know whether the qualifying foreign associated person's statements are consistent with the qualifying foreign broker-dealer's current recommendations. The Rule 15a-6 Adopting Release states that the responsibility imposed on the chaperoning broker-dealer and its employees for these visits is the same as if the chaperoning broker-dealer were acting directly on its own behalf. [151] In addition, pursuant to the 1997 Cleary Letter, a qualifying foreign associated person may also have in-person, unchaperoned contacts during visits to the United States with major U.S. institutional investors and $100 Million Entities so long as the number of days on which such contacts occur does not exceed 30 per year and the qualifying foreign associated

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person does not accept orders to effect any securities transactions (whether involving U.S. or foreign securities) while in the United States. [152]

[D] Manner of Effecting Transactions

All transactions entered into pursuant to the Rule 15a-6 arrangement must be "effected" by the chaperoning broker-dealer. [153] This condition will be deemed fulfilled if the chaperoning broker-dealer performs each of the following activities: [154]

- effecting the transactions (other than negotiating their terms);
- issuing all required confirmations and statements to U.S. investors; [155]
- as between the qualifying foreign broker-dealer and the chaperoning broker-dealer, extending or arranging for the extension of any credit to U.S. investors in connection with the transactions; [156]
- maintaining Exchange Act-required books and records relating to the transactions; [157]

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- complying with the SEC's net capital and customer protection rules; [158] and

- receiving, delivering and safeguarding funds and securities in connection with the transactions.

The requirement that the chaperoning broker-dealer actually "effect" the transactions entered into between the qualifying foreign broker-dealer and U.S. counterparties would still be met even if the chaperoning broker-dealer were to delegate to the qualifying foreign broker-dealer the task of physically executing foreign securities trades in foreign markets or on foreign exchanges. [159] Further, the qualifying foreign broker-dealer may be appointed to process all records related to the transaction, as long as the records comply with applicable requirements under U.S. law and the chaperoning broker-dealer retains responsibility for, and maintains the originals or copies of, the records. [160]

[ii] *Chaperoning Broker-Dealer*

In addition to being responsible for the mechanics of effecting securities transactions between qualifying foreign broker-dealers and U.S. institutional investors, major U.S. institutional investors and $100 Million Entities, a chaperoning broker-dealer should treat the investor as its customer for purposes of

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applicable sales practice and other requirements. [161] The Rule 15a-6 Proposing Release would have required the chaperoning broker-dealer to be responsible for taking steps to assure itself that there was a reasonable basis for all recommendations made by a qualifying foreign broker-dealer. [162] While the Rule 15a-6 Adopting Release did not adopt such a requirement, it does state that the chaperoning broker-dealer has "a responsibility to review … [Rule 15a-6] trades for indications of possible violations of the federal securities laws … [and] an obligation, as it has for all customer accounts, to review any Rule 15a-6 account for indications of potential problems." [163] For example, it can be expected that the SEC would take the position that such reviews require monitoring likely instances of insider trading or fraud by the qualifying foreign broker-dealer where the chaperoning broker-dealer arguably should know of such activities. [164] These reviews should include periodic examination of the accounts, any transactions, related correspondence and lending activity.

[d] Government Securities Activities

After the SEC's adoption of Rule 15a-6 under the Exchange Act, the U.S. Treasury department adopted an exemptive rule under § 15C of the Exchange Act covering government securities activities that essentially parallels Rule 15a-6. [165] Moreover, the Treasury staff has indicated that the relief provided in the 1997 Cleary Letter applies equally to those entities subject to § 15C. [166] Treasury's exemptive rule (as modified by the 1997 Cleary Letter), like Rule 15a-6, permits execution of unsolicited transactions, transactions with the selected counterparties described in Rule 15a-6 and the 1997 Cleary Letter, the distribution of research reports to major U.S. institutional investors and $100 Million Entities and the limited solicitation of major U.S. institutional investors, U.S.

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institutional investors and $100 Million Entities by qualifying foreign broker-dealers. [167]

[e] Violations of U.S. Law

The Rule 15a-6 Adopting Release provides that the SEC would not view isolated violations of § 15 of the Exchange Act by virtue of a foreign broker-dealer's failing to comply with the exemptions provided by Rule 15a-6 under the Exchange Act as preventing the foreign broker-dealer's reliance on the rule with respect to its other activities. However, if a foreign broker-dealer "repeatedly engaged in nonexempt … activities intermittently with exempt … activities," the SEC could conclude that all the foreign broker-dealer's U.S. activities had been conducted in violation of the § 15 registration requirement. [168]

A foreign broker-dealer's violation of the Exchange Act registration requirement would be deemed to have concluded when it had "completely ceased to conduct U.S. securities activities … not exempt under the Rule" or registered with the SEC. [169] The foreign broker-dealer would, however, remain liable for the violations it had committed, and in particular, could be liable to private investors with whom the foreign broker-dealer had wrongfully effected transactions. [170] In addition, even foreign broker-dealers that conduct their U.S. activities in compliance with Rule 15a-6 remain subject to the various antifraud provisions of the U.S. securities laws. [171]

[f] The Recognition Concept Release

At the time it adopted Rule 15a-6 under the Exchange Act, the SEC also issued a concept release on Recognition of Foreign Broker-Dealer Regulation, which proposed and requested comment regarding the concept of a conditional exemption from registration for certain limited categories of foreign broker-dealers located in foreign countries (i) with regulatory schemes "comparable" to

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that provided by the Exchange Act and (ii) whose local securities authority and the SEC have in place a Memorandum of Understanding or treaty providing for "the fullest mutual assistance possible." [172] Although reaction to the proposal was generally negative at the time and it was not pursued, [173] there was a resurgence of interest in 2007 to 2008 in the implementation of a "mutual recognition" approach. This interest has been reflected in numerous articles and speeches by senior SEC staff, commissioners and others and, in June 2007, the SEC sponsored a Roundtable on Selective Mutual Recognition. [174] In August 2008, the SEC announced its entry into a mutual recognition arrangement that provides a framework for the SEC, the Australian government, and the Australian Securities and Investment Commission to consider regulatory exemptions that would permit U.S. and eligible Australian stock exchanges and broker-dealers to operate in both jurisdictions, without the need for these entities (in certain aspects) to be separately regulated in both countries. [175] In addition, in 2008 the SEC staff began working with the Committee of European Securities Regulators and, separately, with four Canadian securities regulators, to define the process to be followed in discussing mutual recognition arrangements. [176] No further progress has been made on these mutual recognition arrangements since that time; however,

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it is possible that the acceptance by other U.S. and non-U.S. regulators of equivalent or comparable foreign regulation would lead the SEC to once again consider accepting equivalent foreign broker-dealer regulation. [177]

[g] Increasing Reliance on Rule 15a-6

There is no publicly available information on the number of foreign broker-dealers that are relying on the conditional exemption provided by Rule 15a-6(a)(3) under the Exchange Act; however, by most accounts the number continues to increase. In the period immediately following the adoption of Rule 15a-6, the benefits of complying with the conditional exemption were viewed as quite limited because, for example, the conditional exemption could not (until the issuance of the 1997 Cleary Letter) be used by foreign broker-dealers to contact U.S. operating companies, no matter how large, even those that satisfied the definition of "qualified institutional buyer" for purposes of Rule 144A under the Securities Act. In addition, the broad consent to SEC jurisdiction required from foreign broker-dealers also appears to have discouraged foreign broker-dealers from relying on the conditional exemption. [178] Accordingly, foreign broker-dealers that had a registered U.S. affiliate generally elected to rely upon that affiliate to contact U.S. investors, including through so-called "dual employees" stationed outside the United States, [179] rather than comply with the terms of the conditional exemption.

Over time, however, a number of countervailing considerations seem to have encouraged more foreign broker-dealers to rely on Rule 15a-6(a)(3). First, as the SEC has increased its own ability to obtain information about foreign

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broker-dealers from foreign securities regulatory authorities, [180] there may seem less disadvantage to foreign broker-dealers in permitting the SEC to obtain information directly from the foreign broker-dealers.

Second, as U.S. investors become increasingly sophisticated about foreign securities, they want the ability to speak directly with foreign research analysts and foreign traders. In theory, the demands of U.S. investors to talk to analysts, traders or other employees of foreign broker-dealers could be accommodated by such employees becoming dual employees of the foreign broker-dealer and a U.S. broker-dealer. In practice, it is difficult, at least on a large scale, for non-U.S. employees of foreign broker-dealers to comply with the testing and other requirements imposed on personnel of U.S. broker-dealers, [181] and the maintenance of dual employees overseas may raise branch office, as well as tax and other, issues for both the U.S. and non-U.S. entities. [182]

Finally, and perhaps most importantly, the 1997 Cleary Letter significantly expanded the utility of the exemption from broker-dealer registration provided by Rule 15a-6(a)(3) by permitting qualifying foreign broker-dealers to rely on the exemption in the context of contacts with $100 Million Entities (rather than just the narrowly defined categories of "major U.S. institutional investors" set forth in the Rule). [183] Furthermore, the 1997 Cleary Letter substantially liberalized the chaperoning requirements of the rule by providing that qualifying foreign associated persons may, without the participation of an employee of the chaperoning broker-dealer, (i) engage in oral communications from outside the United States with U.S. institutional investors if such communications take place outside the trading hours of the NYSE and no orders to effect securities transactions are accepted other than those involving foreign securities [184] and (ii) have in-person contacts during visits to the United States with major U.S. institutional investors and $100 Million Entities so long as the number of days on which such in-person contacts occur does not exceed 30 per year and the foreign associated person does not accept orders to effect any securities transactions while in the United States. [185]

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Nonetheless, even after the issuance of the 1997 Cleary Letter, the limitations of Rule 15a-6 and the complicated mechanics of compliance result in continuing requests by U.S.-registered broker-dealers and their non-U.S. affiliates for further relaxation of the rule's requirements. [186]

[h] Certain M&A Activities

In 2013, the staff of the SEC's Division of Trading and Markets issued a no-action letter to a non-U.S. broker offering strategic consultancy to non-U.S. clients in connection with merger and acquisition ("M&A") transactions. [187] The letter allowed the non-U.S. broker, acting on behalf of a non-U.S. client, to contact buyers or sellers in the United States, or the U.S. parent of a non-U.S. buyer or seller (the "U.S. Target"), without registering as a broker-dealer with the SEC. [188] To rely on the letter, the U.S. Target would have to qualify as a major U.S. institutional investor or $100 Million Entity. [189] In addition, the letter allowed the non-U.S. broker to develop and manage the data room and the information process, conduct negotiations on behalf of the non-U.S. client and advise the non-U.S. client on the terms of the transaction, provided (1) the U.S. Target uses the services of an external advisor, such as a broker-dealer, attorney or other professional with relevant experience, or, (2) if the U.S. Target does not use an external advisor, such U.S. Target uses internal or group level personnel with relevant M&A experience to negotiate the transaction and the non-U.S. broker's personnel engaged in any contacts with the U.S. Target in the United States are limited to persons whom the non-U.S. broker determines satisfy the requirements for "foreign associated persons" in Rule 15a-6(a)(3)(ii)(B). [190] In addition, in order to rely on the relief, the non-U.S. broker should not represent or advise

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any U.S. Target or receive, acquire or hold funds and securities in connection with a transaction it engages in with a U.S. Target. [191]

[i] NAFTA

On January 1, 1994, the North American Free Trade Agreement ("NAFTA") went into effect following formal ratification procedures in Canada, Mexico and the United States. Chapter 14 of NAFTA ("NAFTA Chapter 14"), which governs trade and investment in financial services among the three countries, generally requires each of the party countries to provide investors and financial institutions of the other NAFTA countries with treatment no less favorable than the country provides its own investors and financial institutions under like circumstances. In addition, each party country is required to provide "most favored nation" treatment to investors and financial institutions of the other NAFTA countries, defined as treatment no less favorable than it provides to investors and financial institutions of any other country under like circumstances. [192] A party country also must ensure that the obligations of NAFTA Chapter 14 are observed by any of that country's SROs in which membership or participation is required of any investor or financial institution of another NAFTA country. [193]

As a general matter, the requirements of the Exchange Act imposed upon broker-dealers registered with the SEC are not more favorable to broker-dealers that are organized and physically located in the United States than to those that are not; accordingly, NAFTA has not had any significant effect on U.S. regulation of broker-dealers. However, it is possible that a Canadian or Mexican securities firm could challenge certain SEC requirements imposed solely on nonresident broker-dealers, such as the requirement that nonresidents provide the SEC with a power of attorney designating the SEC as its agent for service of process in certain civil suits. [194] Similarly, an argument could be made that certain rules of the SROs that impose special requirements on nonresident broker-dealers violate NAFTA. [195]

These potential challenges to U.S. regulation may be defeated by two overriding limitations in NAFTA Chapter 14: (i) the "prudential carve-out" and (ii) various reservations to the chapter that have been or may be taken by the parties. The prudential carve-out allows the party countries, notwithstanding the obligations set forth in NAFTA Chapter 14, to adopt and maintain any measure

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that is "reasonable" and adopted or maintained "for prudential reasons," such as the protection of investors or the maintenance of the safety, soundness, integrity or financial responsibility of financial institutions and the financial system. [196]

In addition, the United States has "reserved" the right to enforce certain measures of federal law that are not otherwise consistent with NAFTA Chapter 14. Examples include certain provisions of the Exchange Act, [197] the Primary Dealers Act of 1988 [198] and the Advisers Act. [199]

Measures adopted or maintained by state and provincial governments generally are subject to the same NAFTA Chapter 14 standards that apply to federal measures. [200] Consequently, various states have also "reserved" certain provisions of their securities or "blue sky" laws. For example, among various other types of reservations, many states have reserved certain provisions in their laws that deny U.S. branches or agencies of foreign banks exemptions from state broker-dealer and investment adviser registration requirements (exemptions that are generally available to U.S. banks). [201]

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Certain reservations previously taken by a number of states relating to transactions in securities have since been superseded by the NSMIA, which in general preempts many state registration requirements with respect to securities transactions and certain aspects of state broker-dealer regulation. [202] However, the NSMIA has not preempted those state reservations that effectively subject U.S. branches and agencies of foreign banks to state broker-dealer and investment adviser registration requirements.

NAFTA Chapter 14 also provides that the regulation of cross-border financial services may not be made more restrictive than it was on January 1, 1994, the date that NAFTA entered into force (the so-called "standstill" on cross-border services). [203] Canada has taken a reservation against this obligation with respect to cross-border trade in securities services generally, and the United States in turn has taken a reservation against this obligation with respect to its cross-border securities trade with Canada.

[j] Memoranda of Understanding

Concomitant with the growth in international securities trading over the past decade, the SEC has sought to overcome extraterritorial limitations on its ability to gather information located outside the United States regarding possible violations of U.S. securities laws. [204] Bilateral information gathering and sharing agreements between the SEC and foreign financial regulatory authorities, commonly referred to as Memoranda of Understanding ("MOUs"), have helped in this regard by defining and formalizing procedures to request and provide such information. [205]

Since signing its first MOU with Switzerland in 1982 and as of the date this book went to press, [206] the SEC has entered into MOUs, as well as less comprehensive formal information-sharing agreements and training and technical

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assistance agreements, with foreign authorities in 49 countries. [207] In addition, multilateral organizations, like the Council of Securities Regulators of the Americas and the International Organization of Securities Commissions ("IOSCO"), have adopted resolutions providing for mutual assistance in investigating and gathering information regarding violations of a member nation's securities laws. [208]

The SEC's MOU with the U.K. securities regulatory authorities (the "UK MOU") [209] is one of the most far-reaching of the SEC's MOUs, making assistance available in virtually all types of cases that could arise under the securities and futures laws of the United States and the United Kingdom. [210] Upon request of an authority that is a party to the MOU, it allows each other regulatory authority to provide access to information in its files, to compel testimony and production of information or documents from persons using its subpoena powers, to conduct compliance inspections or examinations of investment businesses and to permit the representatives of the requesting authority to participate in the conduct of the investigations made by the requested authority, all without regard to

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whether the conduct on which information is sought would constitute a violation of the requested authority's laws or regulations. [211]

While the UK MOU is very broad, in the past, there has been some reluctance from certain other foreign authorities to agree to providing open-ended assistance to SEC investigations of domestic financial entities, particularly where local securities disclosure and bank secrecy laws differ markedly from those in the United States. [212] More recently, however, the trend has moved toward broader cooperation. Both Switzerland and Japan, once examples of such reluctance, have since expanded and reconfirmed their commitment toward cooperation and information sharing.

In 1993, Switzerland amended its fairly restrictive 1987 MOU to include violations of law concerning securities, futures, or options, in other than penal proceedings, including cooperation with formal investigations that may lead to such proceedings. [213] The 1993 Swiss MOU, however, still only extends its commitment to information sharing to the "extent feasible."

In 2002, Japan and the United States signed a Statement of Intent that established a framework of cooperation much like the MOUs the United States has with other countries, extending their commitment to provide the "fullest assistance permissible under the laws of the United States and Japan." [214] That MOU represented a significant departure from the previous Japanese MOU, which had no procedures or guidelines for information requests. [215]

In 2003, IOSCO publicly introduced the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of

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Information (the "Multilateral MOU"). [216] The Multilateral MOU is the first global multilateral information sharing arrangement among securities regulators. It specifies the particular types of information a signatory is expected to provide to counterparts upon request, including client identifying records from bank and brokerage accounts, bank and brokerage transaction records, and beneficial ownership information of non-natural persons organized in the jurisdiction of the requested authority. [217] There are now 109 signatories to the Multilateral MOU, including the SEC and the CFTC. [218]

Footnotes

9 This section does not deal with the potential applicability of state registration requirements. *See* § 14.12.

10 Section 15(a)(2) of the Exchange Act gives the SEC the power—exercisable "as it deems consistent with the public interest and the protection of investors," either in individual cases or on a general basis, and conditionally or unconditionally—to exempt broker-dealers from the registration requirement.

11 § 3(a)(4) of the Exchange Act (as amended by the Gramm-Leach-Bliley Act, Pub. L. No. 106–102, § 201, 113 Stat. 1338, 1385 (1999)).

12 § 201 of the GLB Act; *see* § 3(a)(4) of the Exchange Act. For a discussion of related changes the GLB Act made to the application of the definition of "dealer" in § 3(a)(5) of the Exchange Act to banks, *see* § 14.03[1][b]. *See also* § 14.03[1][c] (discussing bank "broker" and "dealer" activities after the GLB Act) and ROBERT L. TORTORIELLO, DEREK M. BUSH AND HUGH C. CONROY, JR., GUIDE TO BANK UNDERWRITING, DEALING AND BROKERAGE ACTIVITIES (21st ed. 2016) (hereinafter the "GUIDE") Part I.C.

13 12 C.F.R. Part 218; 17 C.F.R. Part 247.

14 *See*, *e.g.*, *UFITEC, S.A. v. Carter*, 142 Cal. Rptr. 279 (Cal. 1977) (finding that "engaging in the business" connotes only regularity of participation, not principal business or income source); *InTouch Global, LLC* (avail. Nov. 14, 1995) (finding that a person will be deemed to be "engaged in the business" if the person engages in securities activities for compensation with sufficient recurrence); *SEC v. Helms*, No. A-13-CV-01036ML, 2015 WL 6438872 (W.D. Tex. Oct. 20, 2015) (finding defendant to be a broker based on participation in a single securities transaction).

15 *See*, *e.g.*, *Ruth Quigley* (avail. July 14, 1973) (registration of persons involved in merger and acquisitions activities may be necessary as these activities often involve a distribution or exchange of securities).

16 *See*, *e.g.*, *AngelList LLC and AngelList Advisors LLC* (avail. Mar. 28, 2013) (granting no-action relief to a company that provides a platform to assist investors in identifying companies that seek capital); *FundersClub Inc. and FundersClub Management LLC* (avail. Mar. 26, 2013) (granting no-action relief to a company operating a website through which members may express investment interest in listed private companies); *Country Business, Inc.* (avail. Nov. 8, 2006) (granting no-action relief to a company that represents sellers of small businesses where, among other things, the company advertises only sales of assets (not securities), does not recommend the transfer of the business through a sale of securities and is not compensated differently if the transaction is ultimately effected through the sale of securities); *CommandTRADE, LP* (avail. Dec. 28, 2005); *Paul Anka* (avail. July 24, 1991) (discussion of "introducing" or "finding" activities not requiring broker-dealer registration); *Victoria Bancroft* (avail. Aug. 9, 1987); *International Business Exchange Corp.* (avail. Dec. 12, 1986); *Miller & Co., Inc.* (avail. Aug. 15, 1977); *Ruth Quigley* (avail. July 14, 1973). *See also* American Bar Association, REPORT AND RECOMMENDATIONS OF THE TASK FORCE ON PRIVATE PLACEMENT BROKER-DEALERS (June 7, 2005), which reviews the activities of, and laws applicable to, finders and recommends a new and more simplified registration category for so-called "private placement broker-dealers." *But see SEC v. Kramer*, 778 F. Supp. 2d 1320 (M.D. Fla. 2011) (alleged "finder" held not to be a "broker" despite receiving transaction-based compensation).

17 *See*, *e.g.*, *In re Blackstreet Capital Management, LLC and Murray N. Gunty*, SEC Release No. 34-77959 (June 1, 2016) (finding that a private equity firm acted as an unregistered broker by receiving transaction-based compensation in connection with the purchase and sale of portfolio companies for funds it advised); *In re Ranieri Partners LLC and Donald W. Phillips*, SEC Release No. 34-69091 (Mar. 8, 2013) (finding that a

private equity firm and one of its executives caused an unregistered broker to violate securities laws by soliciting investors for the firm as a hired consultant without being registered as a broker); *Brumberg, Mackey & Wall, P.L.C.* (avail. May 17, 2010) (denying no-action relief to a company that receives transaction-based compensation); *Hallmark Capital Corp.* (avail. June 11, 2007) (denying no-action relief to a company that facilitates mergers and acquisitions and receives a fee based on the outcome of the transaction); *John W. Loofbourrow Assoc., Inc.* (avail. June 29, 2006) (denying no-action relief with respect to a request by a registered broker-dealer to pay a non-registered entity a finder's fee for referring to it a potential investment banking client, where such fee was to be tied to the ultimate size of the securities offering); *Mike Bantuveris* (avail. Oct. 23, 1975); *May-Pac Management Company* (avail. Dec. 20, 1973).

18 *See M&A Brokers* (avail. Jan. 31, 2014).

19 *M&A Brokers* (avail. Jan. 31, 2014).

20 *See M&A Brokers* (avail. Jan. 31, 2014).

21 Rule 3a4-1 under the Exchange Act provides a nonexclusive safe harbor under which employees and other associated persons of an issuer may participate in sales of an issuer's securities without being deemed brokers. *See generally* SEC Release No. 34-22172 (June 27, 1985) (adopting Rule 3a4-1 under the Exchange Act to provide a conditional exemption from broker registration for certain associated persons of issuers).

22 *See Charles Schwab & Co., Inc.* (avail. Nov. 27, 1996).

23 *See Financial Research Center* (avail. Sept. 27, 1996); *see also GlobalTec Solutions, LLP* (avail. Dec. 28, 2005).

24 *See S3 Matching Technologies LP* (avail. July 19, 2012).

25 *MuniAuction Inc.* (avail. Mar. 13, 2000). In particular, MuniAuction stated that its compensation consisted only of fixed auction hosting fees paid by municipal bond issuers, which fees were not tied to the size or success of the transaction.

26 *MuniAuction Inc.* (avail. Mar. 13, 2000).

27 *MuniAuction Inc.* (avail. Mar. 13, 2000); *see also supra* Notes 17 and 21; *In re Ireeco, LLC and Ireeco Limited*, SEC Release No. 34-75268 (June 23, 2015) (finding that two companies acted as unregistered brokers in connection with sales of securities involving the U.S. government's EB-5 Immigrant Investor Program by actively soliciting over 150 foreign investors for which they were paid fees); *BondGlobe, Inc.* (avail. Feb. 6, 2001) (denying no-action relief based, among other factors, on BondGlobe's participation in the communication of customer orders to registered broker-dealers that license the use of the BondGlobe system). *But see Loffa Interactive Corp., Inc.* (avail. Sept. 12, 2003) (granting no-action relief based, among other factors, on the fact that Loffa provides communications services only after all terms of a securities purchase are set, and that it will not solicit participation in any securities transaction or otherwise take part in any of the financial services offered by any broker-dealer).

28 *MuniAuction Inc.* (avail. Mar. 13, 2000). *See* § 14.10[1] for a discussion of alternative trading systems.

29 *See* SEC Release No. 33-9974 (Oct. 30, 2015), 80 Fed. Reg. 71,387 (Nov. 16, 2015) (hereinafter the "Crowdfunding Release").

30 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,389 (Nov. 16, 2015).

31 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,390 (Nov. 16, 2015).

32 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,390 (Nov. 16, 2015).

33 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,456–71,458 (Nov. 16, 2015).

34 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,461 (Nov. 16, 2015).

35 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,480 (Nov. 16, 2015).

36 *See* Crowdfunding Release, 80 Fed. Reg. 71,387, 71,461 (Nov. 16, 2015).

37 § 3(a)(5) of the Exchange Act (as amended by GLB Act § 202).

38 GLB Act § 202; *see* § 3(a)(5) of the Exchange Act. For a discussion of related changes the GLB Act made to the application of the definition of "broker" to banks, *see* § 14.03[1][a]. *See also* § 14.03[1][c] (discussing bank "broker" and "dealer" activities after the GLB Act).

39 *See* SEC Release No. 34-47364 (Feb. 13, 2003) (hereinafter the "Dealer Release").

40 Section 761 of the Dodd-Frank Act, among other things, also added "security-based swaps" to the definition of "security" in § 3(a)(10) of the Exchange Act.

41 § 3(a)(5)(B) of the Exchange Act.

42 *See*, *e.g.*, *Burton Securities* (avail. Dec. 5, 1977); *see also Acqua Wellington North American Equities Fund, Ltd.* (avail. Oct. 11, 2001) (investing in equity lines of credit and agreeing to buy common stock of a company, absent any of enumerated "dealer" activities, does not require registration as a broker-dealer).

43 *See*, *e.g.*, *United Trust Company* (avail. Sept. 6, 1978) (entity that engages in low volume of municipal securities activity but does so in response to customer requests may be a municipal securities dealer).

44 *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Continental Grain Company* (avail. Nov. 6, 1987).

45 *Continental Grain Company* (avail. Nov. 6, 1987).

46 *Continental Grain Company* (avail. Nov. 6, 1987).

47 *Continental Grain Company* (avail. Nov. 6, 1987).

48 *Continental Grain Company* (avail. Nov. 6, 1987); *Burton Securities* (avail. Dec. 5, 1977).

49 *Continental Grain Company* (avail. Nov. 6, 1987); *Burton Securities* (avail. Dec. 5, 1977). In *United Trust Company* (avail. Sept. 6, 1978), the SEC refused to grant a no-action request with respect to an entity's status as a municipal securities dealer based in large part on the company's "apparent willingness … to engage in municipal securities activity when requested to do so by customers." By way of contrast, in each of *Continental Grain Company* (avail. Nov. 6, 1987) and *Louis Dreyfus Corporation* (avail. July 23, 1987), the SEC granted a no-action position in the context of requests emphasizing that the subject entities were "under no obligation" to enter quotes, nor would they "ever do so at the request of another party."

50 *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Robert C. DeFazio* (avail. Dec. 17, 1981); *Burton Securities* (avail. Dec. 5, 1977).

51 *National Council of Savings Institutions* (avail. July 27, 1986); *Robert C. DeFazio* (avail. Dec. 17, 1981); *Burton Securities* (avail. Dec. 5, 1977).

52 *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Continental Grain Company* (avail. Nov. 6, 1987); *Citicorp Homeowner, Inc.* (avail. Oct. 7, 1987); *Burton Securities* (avail. Dec. 5, 1977).

53 *United Mercantile Bank & Trust Company* (avail. Dec. 4, 1986).

54 *National Council of Savings Institutions* (avail. July 27, 1986).

55 *National Council of Savings Institutions* (avail. July 27, 1986); *United Mercantile Bank & Trust Company* (avail. Dec. 4, 1986). With respect to government securities, the following may be added to the list of activities that ordinarily would not be engaged in by an entity other than a broker-dealer: (i) using an interdealer broker or a broker's broker and (ii) running a matched book of repurchases and reverse repurchases of securities. *Fairfield Trading Corp.* (avail. Jan. 10, 1988); *Continental Grain Company* (avail. Nov. 6, 1987); *International Investment Group, Inc.* (avail. July 23, 1987).

56 Section 3(a)(6) of the Exchange Act defines a "bank" as:

> (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act, (B) a member bank of the Federal Reserve System, (C) any other banking institution or savings association, as defined in section 2(4) of the Home Owners' Loan Act, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the

> business of which consists of receiving deposits or exercising a fiduciary power similar to those permitted to national banks under the authority of the Comptroller of the Currency … which is supervised and examined by State or Federal authority having supervision over banks or savings associations.…

57 *See*, *e.g.*, *United States v. Weisscredit Banca, Commerciale E D'Investimenti*, 325 F. Supp. 1384 (S.D.N.Y. 1971); *see also* § 14.03[1][d].

58 *See* § 14.03[1][a] and [b]. For a further discussion of the GLB Act, *see* GUIDE Part IX. B.3.

59 SEC Release No. 34-56501 (Sept. 24, 2007).

60 Under the GLB Act, an "identified banking product" means (i) a deposit account, savings account, certificate of deposit, or other deposit instruments issued by a bank, (ii) a banker's acceptance, (iii) a letter of credit issued or loan made by a bank, (iv) a debit account at a bank arising from a credit card or similar arrangement, (v) a participation in a loan that the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold to "qualified investors" or other sophisticated investors or (vi) any swap agreement, including credit and equity swaps (but only if equity swaps are not sold by the bank directly to any person other than a qualified investor). *See* § 206(a) of the GLB Act.

61 The Dealer Release clarified that this exception would also apply to the definition of "dealer." Furthermore, the SEC stated in the Dealer Release that a riskless principal transaction will count as one transaction toward the annual 500 limit (although the SEC stated that if a "bank acts as an intermediary between one counterparty and multiple counterparties by arranging multiple transactions, the bank must count each of the transactions on the side of the intermediation that involves the largest number of transactions as a separate transaction against the annual 500 transaction-limit"). *See* Dealer Release, 68 Fed. Reg. 8686, 8690 n.38 (Feb. 24, 2003).

62 *See* § 201 of the GLB Act.

63 Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, 120 Stat. 1966 (2006).

64 *See* SEC Release No. 34-56501 (Sept. 24, 2007).

65 12 C.F.R. § 218.

66 The "good faith" exemption is only available if: (i) at the time the contract was created, the bank acted in good faith and had reasonable policies and procedures in place to comply with the definition of "broker" and the related rules and regulations; and (ii) any violation of the broker-dealer registration requirements did not result in "any significant harm, financial loss or cost to the person seeking to void the contract." Regulation R Rule 771, 17 C.F.R. §247.780.

67 As clarified and amended in the Dealer Release, the term "predominantly originated" means that "no less than 85% of the value of the obligations in any pool were originated by: (1) [t]he bank or its affiliates, other than its broker or dealer affiliates; or (2) [b]anks that are members of a syndicate of banks and affiliates of such banks, other than their broker or dealer affiliates, if the obligations or pool of obligations consist of mortgage obligations or consumer-related receivables; (3) [f]or this purpose, the bank and its affiliates include any financial institution with which the bank or its affiliates have merged but does not include the purchase of a pool of obligations or the purchase of a line of business." *See* Dealer Release, 68 Fed. Reg. 8686, 8700-01 (Feb. 24, 2003); Rule 3b-18(g) under the Exchange Act. In addition, the term "originated" means: "(1) [f]unding an obligation at the time that the obligation is created; or (2) [i]nitially approving and underwriting the obligation, or initially agreeing to purchase the obligation, provided that: (i) [t]he obligation conforms to the underwriting standards or is evidenced by the loan documents of the bank or its affiliates, other than its broker or dealer affiliates; and (ii) [t]he bank or its affiliates, other than its broker or dealer affiliates, fund the obligation in a timely manner, not to exceed six months after the obligation is created." *See* Dealer Release, 68 Fed. Reg. 8686, 8700 (Feb. 24, 2003); Rule 3b-18(e) under the Exchange Act.

68 As clarified and amended in the Dealer Release, the term "member of a syndicate of banks" has been

replaced with separate definitions of "member" and "syndicate of banks." The term "member" as it relates to a "syndicate of banks" means "a bank that is a participant in a syndicate of banks and together with its affiliates, other than its broker or dealer affiliates, originates no less than 10% of the value of the obligations in a pool of obligations used to back the securities issued through a grantor trust or other entity." *See* Dealer Release, 68 Fed. Reg. 8686, 8700 (Feb. 24, 2003); Rule 3b-18(c) under the Exchange Act. The term "syndicate of banks" means "a group of banks that acts jointly, on a temporary basis, to issue through a grantor trust or other separate entity, securities backed by obligations originated by each of the individual banks or their affiliates, other than their broker or dealer affiliates." *See* Dealer Release, 68 Fed. Reg. 8686, 8701 (Feb. 24, 2003); Rule 3b-18(h) of the Exchange Act.

69 *See* § 202 of the GLB Act. The Comptroller has taken the position that certain banks may hedge equity derivatives by purchasing, holding and selling the underlying equity securities. *See generally* GUIDE II.E.

70 *See* Dealer Release, 68 Fed. Reg. 8686, 8692 (Feb. 24, 2003) (adopting Rule 15a-11 under the Exchange Act). As originally adopted, Rule 15a-11 under the Exchange Act also provided banks engaging in such activities an exemption from the definition of "broker." In a companion release to the Regulation R adopting release, the SEC redesignated Rule 15a-11 as Rule 3a5-3 and deleted the broker-related provisions of the rule. *See* SEC Release No. 34-56502 (Sept. 24, 2007). The SEC and the Board included the broker exemption for banks engaging in securities lending transactions in Regulation R. *See supra* Note 61.

71 *See* SEC Release No. 34-56502 (Sept. 24, 2007).

72 § 3(a)(6) of the Exchange Act.

73 *See*, *e.g.*, Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,015 n.16 (July 18, 1989) (noting the SEC's treatment of a branch or agency of a foreign bank supervised and examined by a banking authority as a "bank" for purposes of §§ 3(a)(4) and 3(a)(5) of the Exchange Act).

74 N.Y. BANKING LAW § 202-a (McKinney's 2013).

75 N.Y. BANKING LAW § 202-a(1) (McKinney's 2013).

76 N.Y. BANKING LAW § 201-b (McKinney's 2013).

77 *See* 12 U.S.C. § 3102(d).

78 Following enactment of the CFMA in 2000, the definition of "security" in § 3(a)(10) of the Exchange Act was amended to exclude "any non-security based swap agreements." Effective the later of July 6, 2011 or not less than 60 days after adoption of relevant rules or regulations, the Dodd-Frank Act further amended the definition of "security" in § 3(a)(10) of the Exchange Act to include "security-based swaps." § 12.01[1]. The determination of whether certain business activities involve "securities" can raise difficult legal issues. Of course, even entities that effect transactions in financial instruments that are not securities may still be subject to U.S. regulation. For a discussion of the regulation of entities that effect transactions in futures contracts, swaps and other derivatives, *see* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4.

79 An entity that acts as a dealer in security-based swaps will be required to register with the SEC as an SBSD once the rules regulating such registration are effective. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 6.02.

80 *But see* § 14.08[3][b] (regarding reporting requirements imposed with respect to certain unregistered affiliates of registered broker-dealers pursuant to rules adopted by the SEC under § 17(h) of the Exchange Act and for a discussion of the position advanced by the Government Accountability Office (the "GAO") that the SEC use its authority under this provision to determine whether regulation of such affiliates is warranted).

81 The Exchange Act also provides a mechanism for limited purpose registration as broker-dealers for FCMs whose customer-driven securities activities are limited to certain transactions in security futures products. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[2].

82 *See* § 3(a)(17) of the Exchange Act (defining "interstate commerce").

83 *See generally Legacy Motors, Inc.* (avail. July 31, 1991) (rejecting a no-action request with respect to officers, directors and employees of a company due to "absence of a representation that the past securities activities [of the persons] were strictly limited to intrastate transactions"); *Don Chamberlin* (avail. Aug. 10, 1979) (interpreting "exclusively intrastate" to turn principally on the residence of the broker-dealer's customers, including the securities issuer).

84 § 15(a)(1) of the Exchange Act. Broker-dealers that engage in transactions in government securities, however, may have to register under § 15C of the Exchange Act. *See* § 14.03[2][b][ii]. Municipal securities are exempted securities for certain purposes of the Exchange Act, although not for purposes of § 15. Accordingly, nonbank broker-dealers in municipal securities must register under § 15 of the Exchange Act. A bank, or a separately identifiable division or department of a bank, that is engaged in the business of buying or selling municipal securities, otherwise than in a fiduciary capacity, is required to register with the SEC as a "municipal securities dealer" under § 15B of the Exchange Act. *See* §§ 3(a)(30) and 15B(a)(1) of the Exchange Act.

85 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,015 n.21 (July 18, 1989); § 3(a)(3) of the Securities Act. Although the definition of "security" contained in § 3(a)(10) of the Exchange Act by its terms excludes "any note, draft, bill of exchange, or banker's acceptance, which has a maturity at the time of issuance of not exceeding nine months," the SEC staff has on various occasions expressed the view that the additional requirements applicable to the commercial paper exemption in § 3(a)(3) of the Securities Act should be read into the § 3(a)(10) exclusion. *See*, *e.g.*, *Prescient Markets, Inc.* (avail. Apr. 2, 2001) (in which the SEC staff took the position that a commercial paper trading platform did not have to be registered as a broker-dealer if its registered broker-dealer affiliate took full responsibility for the operation of the platform with respect to § 4(a)(2) commercial paper transactions). Several courts have also taken this approach when analyzing whether a short-term note should be viewed as a "security" for purposes of various provisions of the Exchange Act. *See*, *e.g.*, *Zeller v. Bogue Electric Manufacturing Corp.*, 476 F.2d 795 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973) (holding that Rule 10b-5 under the Exchange Act could apply to a note with less than nine months maturity notwithstanding the definition of a security in the Exchange Act); *UBS Asset Management (New York) Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66 (S.D.N.Y. 1996) (exclusion in § 3(a)(10) "applies only to 'prime quality negotiable commercial paper'"); *SEC v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1132 (9th Cir. 1991) ("[T]he presumption that a note is a security applies equally to notes of less than nine months maturity that are not commercial paper.").

86 *See generally* SEC Release No. 33-4412 (Sept. 20, 1961) (discussing § 13(a)(3) of the Exchange Act and the determining factors of "commercial paper"); § 3.05[3].

87 *See* § 3(a)(12) of the Exchange Act (defining "exempted securities").

88 *See* § 3(a)(34) of the Exchange Act (defining "appropriate regulatory agency").

89 *See* Rule 15a-6 Adopting Release; *see also* SEC Release No. 34-25801 (June 14, 1988) (hereinafter the "Rule 15a-6 Proposing Release"). These two releases discuss, or at least cite, virtually all of the prior significant SEC pronouncements on the U.S. activities of foreign broker-dealers. As indicated in the text, in many cases Rule 15a-6 follows from these prior positions. Certain SEC no-action letters that predate Rule 15a-6, and which are arguably broader than Rule 15a-6, *see*, *e.g.*, *Chase Manhattan Corp.* (avail. July 28, 1987), apparently may still be relied upon since the Rule 15a-6 Adopting Release, at Part IV.A.3, provides that such letters remain valid unless expressly modified or withdrawn. 54 Fed. Reg. 30,013, 30,019 (July 18, 1989).

Foreign broker-dealers intending to offer security futures products to U.S. investors in reliance on Rule 15a-6 will also need to consider U.S. commodities law requirements and exemptions applicable to such activity under the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4. Security futures products generally are defined as futures contracts on individual nonexempt securities or narrow-based groups or indices of nonexempt securities. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[c].

90 In 2008, the SEC proposed significant amendments to Rule 15a-6. If adopted, the amendments would have: (i) broadened substantially the categories of U.S. investors with which a foreign broker-dealer may interact without registering as a broker-dealer under the Exchange Act (in particular, references under the current rule, which are discussed further below, to "major U.S. institutional investors" and "U.S. institutional investors" would be replaced by references to "qualified investors" as defined in § 3(a)(54) of the Exchange Act, which includes institutional entities as well as natural persons that have at least $25 million in investments), (ii) effectively eliminated the requirement that a U.S. broker-dealer "chaperone" contacts between a foreign broker-dealer and qualified investors, (iii) substantially reduced the obligation of a U.S. broker-dealer to "intermediate" transactions between a foreign broker-dealer and qualified investors (and, if the foreign broker-dealer conducts a "foreign securities business," as such term is defined in the proposed amendments and, subject to the other conditions specified therein, permit it to provide full-service brokerage and perform related custody activities for qualified investors), and (iv) codified (and, in some respects, expanded) certain aspects of current SEC staff interpretive guidance issued in connection with Rule 15a-6. *See* SEC Release No. 34-58047 (June 27, 2008). This proposal was withdrawn on November 1, 2013, but the SEC noted that it may consider it at a future date. *See* SEC, RIN 3235-AK15 (Fall 2013).

91 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,016 & n.43 (July 18, 1989) (withdrawing prior no-action letters that had permitted unregistered broker-dealers located in the United States to do business exclusively with non-U.S. persons).

92 Rule 15a-6(a)(1) under the Exchange Act.

93 Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,650 (June 23, 1988).

94 The term "general circulation" is not defined in Rule 15a-6. The meaning of the term may, however, be informed by reference to Rule 902(c)(2) of Regulation S under the Securities Act. *See* § 8.02[1][b].

95 *But see The London International Financial Futures Exchange* ("LIFFE") (avail. May 1, 1992) (permitting LIFFE and certain foreign broker-dealers not registered with the SEC to provide qualified institutional buyers information concerning LIFFE-traded options). *See also Tokyo Stock Exchange, Inc.* (avail. Nov. 20, 2006); *Eurex Deutschland* (avail. July 27, 2005); *Borsa Italiana S.p.A.* (avail. Sept. 24, 2004); *EDX London Limited* (avail. Oct. 29, 2003); *Tokyo Stock Exchange, Inc.* (avail. Nov. 15, 2002); *ParisBourse SA* (avail. Dec. 6, 1999); *Tokyo Stock Exchange* (avail. July 27, 1999); *Osaka Securities Exchange* (avail. July 23, 1999); *Mercato Italiano dei Derivati* (avail. Sept. 1, 1998); *Société de Compensation des Marchés Conditionnels* (avail. June 17, 1996); *The London International Financial Futures and Options Exchange* (avail. Mar. 6, 1996); *Hong Kong Futures Exchange Limited* (avail. Sept. 26, 1995).

96 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 (July 18, 1989).

97 SEC, Division of Trading and Markets, "Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers," Question 9 (Mar. 21, 2013 (updated Apr. 14, 2014)) (hereinafter, the "2013 15a-6 FAQ").

98 Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,651 (June 23, 1988). However, Rule 15a-6 and the Rule 15a-6 Adopting Release detail circumstances and procedures under which distribution of research reports is permitted without triggering a broker-dealer registration requirement. *See* § 14.03[3][b][iii].

99 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,022 n.103 (July 18, 1989). However, a foreign broker-dealer effecting unsolicited transactions on behalf of a U.S. investor in reliance on Rule 15a-6(a)(1) may send confirmations and account statements directly to the U.S. investor in connection with such transactions. 2013 15a-6 FAQ at Question 3.

100 2013 15a-6 FAQ, Question 2.

101 2013 15a-6 FAQ, Question 2.

102 Rule 15a-6(a)(4)(i) under the Exchange Act. Unlike the treatment of broker-dealers and banks for purposes of "qualified institutional buyer" status in Rule 144A under the Securities Act, there is no requirement that any solicited broker-dealers or banks own securities of a minimum value or, in the case of banks, have a minimum net asset value.

103 *See*, *e.g.*, *Wood Gundy, Inc.* (avail. Dec. 9, 1985) (permitting an unregistered foreign broker-dealer to

execute unsolicited orders received from registered broker-dealers filling orders of their U.S. customers); *Bear Stearns/Sun Hung Kai* (avail. Feb. 6, 1976) (permitting an unregistered foreign broker-dealer to fill its own customers' orders for U.S. securities and to maintain an account for its own customers with a registered broker-dealer).

104 For a discussion of certain consequences that may arise when the foreign and U.S. broker-dealer are affiliated, *see* § 14.04.

105 *See* § 14.03[1][c]. The acknowledgment in Rule 15a-6(a)(4)(i) that banks may act in a broker or dealer capacity codified positions taken in pre-Rule 15a-6 no-action letters. *See*, *e.g.*, *National Westminster Bank PLC* (avail. July 7, 1988); *Security Pacific Corp.* (avail. Apr. 1, 1988).

106 The writing of a derivative instrument by a foreign dealer (or any other entity) that may be characterized as a security may be viewed as the offer and sale of that security requiring registration under the Securities Act unless an exemption is available. *See* § 1.02.

The question also arises whether a foreign dealer is an investment company that, if its securities (including possibly OTC instruments it has written that are classified as securities) are held by more than 100 U.S. persons and such persons do not all satisfy the definition of "qualified purchaser," is required to register with the SEC under the Investment Company Act. *See* § 15.06. Many dealers (or their affiliates engaged in derivative transactions and other financial activities) have assets consisting predominantly of securities, as a result of which they might be classified as investment companies. Section 3(c)(2) of the Investment Company Act excludes broker-dealers from the definition of investment company, but the SEC staff has apparently suggested on at least some occasions, though it would appear without statutory support, that the exclusion applies only to those broker-dealers registered with the SEC.

Section 3(c)(2) of the Investment Company Act also excludes companies whose primary activities include "acting as a market intermediary." A "market intermediary" is any person that regularly holds itself out as being willing contemporaneously to engage in, and that is regularly engaged in, the business of entering into "financial contracts" (*e.g.*, options, swaps and repurchase agreements). *See* § 3(c)(2)(B)(i) of the Investment Company Act.

107 Rule 15a-6(a)(4)(ii) under the Exchange Act. Each of these supranational organizations is also deemed a non-U.S. person for purposes of Regulation S under the Securities Act. *See* Rule 902(k)(2)(vi) under the Securities Act; § 8.02.

108 Rule 15a-6(a)(4)(iii) under the Exchange Act (emphasis added). Although the direct solicitation of certain non-U.S. investors temporarily present in the United States is authorized under Rule 15a-6, such solicitation may be subject to the antifraud or other provisions of the U.S. securities laws. In one case, however, the court found that an alleged offer and sale—through phone calls and facsimiles—of foreign securities by a foreign broker-dealer to a non-U.S. person vacationing in the United States were not sufficient to establish jurisdiction for purposes of the antifraud provisions of the Exchange Act under that court's tests regarding the "conduct" and "effect" of the foreign broker-dealer's activities, even if misrepresentations and reliance thereon occurred in the United States. *See Europe & Overseas Commodity Traders S.A. v. Banque Paribas London* 147 F.3d 118 (2d Cir. 1998), *cert. denied*, 525 U.S. 1139 (1999); *see also Interbrew S.A. v. EdperBrascan Corp.*, 23 F. Supp. 2d 425 (S.D.N.Y. 1998). *In Morrison v. National Australian Bank Ltd.*, the Supreme Court replaced the "conducts" and "effects" tests with a "transactional" test (*i.e.*, purchases and sales in the United States or securities listed on U.S. exchanges). The Dodd-Frank Act restored the "conducts" and "effects" tests for actions brought by the SEC or the DOJ and mandated the SEC to study whether such tests should replace the Morrison "transactional" test with respect to private rights of action as well. *See Morrison v. National Australian Bank Ltd.*, 561 U.S. 247 (2010); §§ 929P and 929Y of the Dodd-Frank Act. The SEC released a study in 2012 "on the Cross-Border Scope of the Private Right of Action Under Section 10(b) of the Securities Exchange Act," which did not take a position on whether Congress should override the *Morrison* transactional test for private rights of action. *See* SEC, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934 AS REQUIRED BY SECTION 929Y OF THE [DODD-FRANK ACT] (Apr.

11, 2012).

109 2013 15a-6 FAQ, Question 1.

110 *See* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,649 (June 23, 1988) ("[T]he primary responsibility for protecting foreign investors from wrongful conduct of foreign securities professionals properly lies with foreign securities regulators.").

111 *Cf.* SEC Release No. 34-42906 (June 7, 2000) (granting an Order pursuant to § 15(a)(2) of the Exchange Act exempting certain Canadian broker-dealers from the requirements of § 15(a)(1) of the Exchange Act when soliciting or effecting transactions in securities for U.S. residents or those temporarily in the United States with respect to their Canadian Retirement Accounts); *see also* Rule 237 under the Securities Act and Rule 7d-2 under the Investment Company Act; SEC Release No. 33-7860 (June 7, 2000).

112 *See* § 8.02[1][a].

113 *Cleary, Gottlieb, Steen & Hamilton* (avail. Nov. 22, 1995, revised Jan. 30, 1996) (hereinafter the "1996 Cleary Letter"). An "offshore client" is defined for this purpose as (i) any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for U.S. federal income tax purposes, (ii) any natural person who is not a U.S. resident, or (iii) any entity not organized or incorporated under the laws of the United States substantially all of the outstanding voting securities of which are beneficially owned by a person described in (i) or (ii) above. A condition of the relief in the 1996 Cleary Letter is that the foreign broker-dealer will obtain written assurance from the U.S.-resident professional fiduciaries that the account is managed for an offshore client. Note that the definition of "offshore client" is not the same as the definition of "non-U.S. person" in Regulation S and, in those cases in which the offshore client definition is narrower than the non-U.S. person definition, a foreign broker-dealer effecting a Regulation S transaction with a U.S.-based adviser for the non-U.S. person will not be able to rely on the relief provided by the 1996 Cleary Letter.

A "foreign security" is defined for purposes of the 1996 Cleary Letter as (i) a security issued by an issuer not organized or incorporated under the laws of the United States when the transaction in such security is not effected on a U.S. exchange or through the Nasdaq system (including a depositary receipt issued by a U.S. bank, but only if it is initially offered and sold outside the United States in accordance with Regulation S), (ii) a debt security (including a convertible debt security) issued by an issuer organized or incorporated in the United States in connection with a distribution conducted outside the United States, or (iii) any OTC derivative instrument on an instrument described in (i) or (ii) above; *provided*, *however*, that debt securities of an issuer organized or incorporated under the laws of the United States do not constitute "foreign securities" if they are offered and sold as part of a "global offering" involving both a distribution of the securities in the United States under a Securities Act registration statement and a contemporaneous distribution outside the United States.

Although the no-action position set forth in the 1996 Cleary Letter is technically applicable only to those SEC-registered broker-dealers cited in the letter and their non-U.S. affiliates, it should be possible for other broker-dealers to rely on the position taken in the letter so long as all other requirements of the letter are met.

114 Rule 15a-6(a)(4)(iv) and (v) under the Exchange Act.

115 Rule 15a-6(a)(4)(v) under the Exchange Act.

116 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,017 & n.51 (July 18, 1989).

117 For purposes of certain of the safe harbor rules under Regulation S, an agency or branch of a U.S. person located outside the United States is a U.S. person unless the agency or branch (i) operates for valid business reasons and (ii) is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation by the relevant foreign jurisdiction. *See* Rule 902(k)(2)(v) under the Securities Act. (Rule 15a-6 under the Exchange Act contains no comparable conditions for agencies or branches permanently located outside the United States to be treated as non-U.S. persons.) In addition, the general statement of territorial jurisdiction of the registration provisions of the Securities Act in Regulation S and the Regulation S safe harbor provisions for "Category 1" issuers permit offers and sales outside the

United States even to U.S. residents. *See* § 8.02[1][c][i].

118 In conjunction with the adoption of Rule 15a-6, the SEC issued no-action letters that permitted foreign broker-dealers to distribute research reports in accordance with Rule 15a-6 without such activity triggering a requirement to register under the Advisers Act. *See*, *e.g.*, *Dean Witter Reynolds (Canada)* (avail. Mar. 1, 1990).

119 *See* Rule 15a-6(b)(4) under the Exchange Act.

"U.S. institutional investor" means: (i) a registered investment company, or (ii) a bank, savings and loan association, insurance company, business development company, small business investment company or employee benefit plan as defined in Rule 501(a)(1) of Regulation D under the Securities Act; a private business development company as defined in Rule 501(a)(2); an organization described in § 501(c)(3) of the I.R.C., as defined in Rule 501(a)(3); or a trust as defined in Rule 501(a)(7). *See* Rule 15a-6(b)(7) under the Exchange Act. U.S. branches and agencies of foreign banks are "banks" for purposes of the definition of U.S. institutional investor. *See* § 14.03[1][d].

120 The SEC Release reproposing Rule 144A, which was issued the same day that Rule 15a-6 was adopted, suggested that the "qualified institutional buyer" and "major U.S. institutional investor" definitions were intended to be identical. *See* SEC Release No. 33-6839 (July 11, 1989), 54 Fed. Reg. 30,076, 30,079 n.17 (July 18, 1989). Further, the Rule 15a-6 Proposing Release had provided that corporations generally could be within the definition of "U.S. institutional investor." *See* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,654 n.73 (June 23, 1988). The Rule 15a-6 Adopting Release did not explain why the "institutional investor" definition was revised between proposal and adoption. It is thus not clear whether the different treatment of corporations in Rules 144A and 15a-6 was the result of an unexplained SEC policy decision or was inadvertent.

121 *See Cleary, Gottlieb, Steen & Hamilton* (avail. Apr. 9, 1997); *Cleary, Gottlieb, Steen & Hamilton* (avail. Apr. 28, 1997) (hereinafter collectively the "1997 Cleary Letter"). "Aggregate financial assets" include cash, money-market instruments, securities of unaffiliated issuers, futures and options on futures and other derivative instruments. *See* 1997 Cleary Letter. *See also Roland Berger Strategy Consultants* at n.3 (avail. May 28, 2013).

122 *See* 2013 15a-6 FAQ.

123 The Rule 15a-6 Adopting Release emphasized that even "implied" soft dollar arrangements constitute solicitation. Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,023 (July 18, 1989). For a brief description of "soft dollar" arrangements, *i.e.*, the use of brokerage commission payments to compensate for the provision of research, *see* §§ 14.07[1][a] and 16.09.

124 This condition by its express terms applies only to securities that have been the subject of a research report. *But see* the discussion of "solicitation" in § 14.03[3][b][i].

125 A registered broker-dealer "accepts responsibility" by taking "reasonable steps to satisfy itself regarding key statements in the research," or, where limited information is available, making "certain that neither the facts nor the analysis appear inconsistent with outstanding information regarding the issuer." Rule 15a-6 Adopting Release, 54 Fed. Reg. 30013, 30023 n.116 (July 18, 1989). In addition, research prepared by a foreign broker-dealer that is distributed by a U.S. broker-dealer must contain certain additional disclosures required by applicable SRO rules. *See* § 14.07[3][a] for a discussion of these rules.

126 Subject to these conditions, research also may be distributed *via* an electronic database. *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,023 n.114 (July 18, 1989); *see also James Capel* (avail. Dec. 6, 1989) (permitting a foreign broker-dealer to receive a fee for making its research available electronically).

127 Foreign broker-dealers that are affiliated with SEC-registered broker-dealers and that distribute research reports to U.S. investors are, however, subject to the certification requirements of Regulation AC, whereas foreign broker-dealers without such affiliation that issue research reports to U.S. investors solely in reliance on the exemption from registration provided by Rule 15a-6(a)(2) are exempt from Regulation AC's certification requirements. *See* § 14.07[5][a] for a further discussion of Regulation AC.

128 *NASD* (avail. Dec. 5, 1989).

129 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,018 (July 18, 1989). Transactions resulting from the distribution of quotations on such a quotation system would be deemed "unsolicited."

130 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,018–30,019 (July 18, 1989).

131 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,018 n.66 (July 18, 1989). Among the third-party quotation systems as to which the SEC provided relief is one run by Topic Services, Inc., which disseminated quotations of market-makers in securities listed on the Irish Stock Exchange's Stock Exchange Automated Quotations and SEAQ International Systems (the "Topic System"). The Topic System, at the time of the SEC's approval, provided quotations to approximately 40 U.S. subscribers, made up of a mix of registered broker-dealers and large institutional investors. *See generally* SEC Release No. 34-30033 (Dec. 4, 1991). *Cf. London Traded Options Market* (avail. Sept. 4, 1990); SEC Release Nos. 34-28331 (Aug. 13, 1990), 34-25457 (Mar. 14, 1988) (NASD-Stock Exchange of Singapore). *See Topic Services, Inc.* (avail. Oct. 4, 1989); *Topic Services, Inc.* (avail. Dec. 23, 1987); *Topic Services, Inc.* (avail. June 3, 1987); *Topic Services, Inc.* (avail. Aug. 2, 1986). With respect to other third-party systems, *See NASD* (avail. Dec. 5, 1989); *NASD* (avail. Mar. 18, 1988); *NASD* (avail. June 9, 1987); *NASD* (avail. Oct. 22, 1986); *NASD* (avail. May 7, 1986) (NASD-ISE); *see also Topic Services, Inc.* (avail. Nov. 28, 1986).

132 *See* 1997 Cleary Letter.

133 SEC Release No. 34-27080 (July 31, 1989), 54 Fed. Reg. 32,403, 32,404 (Aug. 7, 1989). The SEC's approval for any individual stock exchange linkage will depend upon the SEC being "satisfied that adequate safeguards and procedures have been established and implemented to protect investors and detect fraudulent or manipulative acts or practices." *See* SEC Release No. 34-27080, 54 Fed. Reg. 32,403, 32,404 (Aug. 7, 1989) (July 31, 1989).

134 SEC Release No. 34-35116 (Dec. 19, 1994); SEC Release No. 34-21925 (Apr. 8, 1985).

135 SEC Release No. 34-22442 (Sept. 20, 1985).

136 SEC Release No. 34-23075 (Mar. 28, 1986).

137 The other exchanges are the Australian Stock Exchange, Euronext (Amsterdam, Brussels, Paris), the Hong Kong Exchanges and Clearing Ltd., the Bolsa Mexicana de Valores, the Bolsa de Valores de Sao Paulo, the Tokyo Stock Exchange and the Toronto Stock Exchange. *See* Press Release, NYSE, 10 Leading Equities Exchanges Jointly Announce Global Equity Market Partnership Talks (June 7, 2000).

138 Subsequent to the adoption of Rule 15a-6, the SEC approved the establishment on a pilot basis of the Nasdaq International Service ("Nasdaq International"), an automated trading system that operated from 3:30 A.M. to 9:00 A.M., New York time, and that was primarily intended to accommodate institutional investors wishing to trade U.S. securities when markets are open in Europe. *See* SEC Release No. 34-29812 (Oct. 11, 1991); *see also* NASD Notice to Members 91-70 (Nov. 1991). In connection with the SEC's approval of Nasdaq International, the SEC staff issued a no-action letter permitting U.K. broker-dealers, not themselves registered with the SEC but affiliated with SEC-registered broker-dealers, to participate in Nasdaq International by executing transactions as agents for their SEC-registered affiliates. *See Nasdaq International Service* (avail. Oct. 11, 1991, revised Jan. 11, 1993); *see also* SEC Release No. 34-46589 (Oct. 2, 2002) (extending the expiration of the Nasdaq International pilot program to October 9, 2003). The Nasdaq International pilot program expired in 2003 and the related NASD rules were removed in 2006. *See* SEC Release No. 34–54084 (June 30, 2006).

139 SEC Release No. 34-41199 (Mar. 22, 1999) (granting relief to Tradepoint based on its small volume) (hereinafter the "Tradepoint Release"). Tradepoint Financial Networks plc was renamed "Virt-X plc" and the Tradepoint Stock Exchange was renamed "Virt-X Exchange Limited." *See Virt-X* (avail. June 21, 2001). In 2008, Virt-X changed its name to SWX Europe. As of April 30, 2009, SWX Europe ceased trading and all business was transferred to the SIX Swiss Exchange. *See* SIX Swiss Exchange message no. 20/2009 (Apr. 17, 2009), *available at* http://www.six-swiss-exchange.com/swx_messages/online/swx_message_200904171332_en.pdf.

140 Under the terms of the exemption, as extended by later no-action relief, Tradepoint's exemption is subject to certain conditions, including that: (i) the average daily dollar value of trades involving a U.S. member (measured on a quarterly basis) does not exceed U.S.$40 million, (ii) Tradepoint's worldwide average trading daily volume (calculated on a dollar basis and measured quarterly) does not exceed ten percent of the average daily volume on the London Stock Exchange, (iii) Tradepoint only offers trading in securities that are both eligible to be traded on the London Stock Exchange and listed by a competent European listing authority in a European Union member state, Norway or Switzerland, and (iv) Tradepoint provides the SEC with a quarterly certification that no trades by U.S. members have been effected in Swiss blue chip securities (in which Tradepoint was expected to obtain a substantial market share through an arrangement with the Swiss Stock Exchange). In addition, Tradepoint must comply with a number of additional conditions, including recordkeeping and reporting requirements, SEC access to books and records, SEC access to real-time quotes and trading information, procedures to ensure the nondisclosure of confidential information, compliance with U.S. trading halts and cooperation with SEC investigations. *Virt-X* (avail. June 21, 2001).

141 *See supra* Note 119. In 2012, the SEC provided no-action relief to the foreign affiliate of a U.S.-registered broker-dealer whereby such foreign affiliate could, through a chaperoning arrangement with the U.S.-registered broker-dealer, engage in certain merger and acquisition activities with certain U.S. customers who, despite having at least $100 million in assets, did not meet the definition of major U.S. institutional investor in Rule 15a-6 or $100 Million Entities in the 1997 Cleary Letter. *See Ernst & Young Corporate Finance (Canada) Inc.* (avail. July 12, 2012). The SEC's relief was limited to situations in which the customer had $100 million in total assets (not just financial assets) and the merger and acquisition activities involved a private placement and resulted in the transfer of control of an entire company or business unit. *See Ernst & Young Corporate Finance (Canada) Inc.* (avail. July 12, 2012).

142 *See Chase Manhattan Corp.* (avail. July 28, 1987); *see generally* § 14.03[3][a].

143 According to the Rule 15a-6 Adopting Release, the chaperoning broker-dealer may not be a bank, even if the bank is acting in a broker or dealer capacity. *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,026 (July 18, 1989). This statement was made in recognition of the fact that banks were at the time exempt from the definitions of "broker" and "dealer" under the Exchange Act. Presumably, since banks now no longer enjoy a blanket exemption from the definitions of "broker" and "dealer," a bank registered as a broker or dealer would be eligible to act as the chaperoning broker-dealer for this purpose (however, as a practical matter, bank registration as a broker or dealer is unlikely). *See* § 14.03[1][a]–[c].

144 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,024 & 30,025 n.149 (July 18, 1989).

145 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,024 n.133 (July 18, 1989). A registered broker-dealer likewise could serve, consistent with its responsibilities as discussed in § 14.03[3][c][ii], as the chaperoning broker-dealer for any number of qualifying foreign broker-dealers.

146 Rule 15a-6 Adopting Release.

147 Rule 15a-6(a)(3)(i)(B) under the Exchange Act. This condition is subject to the limitation that it will not be deemed to have been violated if the qualifying foreign broker-dealer uses its best efforts to obtain requested information, including seeking government assistance and consent of its customers where necessary, but is prevented from providing it by applicable foreign law or regulation. However, if not legally able to respond to the SEC's request for information because of a "blocking statute" or otherwise, a qualifying foreign broker-dealer may have its "qualifying" status and its ability to rely on the Rule 15a-6(a)(3) exemption revoked by the SEC. Revocation would be prospective only, and would be by notice and hearing to which ordinary procedural rights would attach.

148 *See* Rules 15a-6(a)(3)(iii)(C) and (D) and 15a-6(b)(2) under the Exchange Act. The information that the chaperoning broker-dealer must obtain with respect to the qualifying foreign broker-dealer's personnel is specified in Rule 17a-3(a)(12) under the Exchange Act and the review the chaperoning broker-dealer must perform is substantially the same as it would perform for its own personnel. In particular, the chaperoning broker-dealer must determine that these persons are not subject to a "statutory disqualification" (as defined

at § 3(a)(39) of the Exchange Act) and have not been the subject of any foreign sanction "substantially equivalent" to those that would require statutory disqualification. Rule 15a-6(a)(3)(ii)(B) under the Exchange Act; *see* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,028 (July 18, 1989); *see also* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,653 n.70 (June 23, 1988). *See generally* § 14.08[1].

149 *See* Rule 15a-6(a)(3)(iii)(B) under the Exchange Act; 1997 Cleary Letter.

150 *See* Rule 15a-6(a)(3)(ii) under the Exchange Act. This condition of participation by a chaperone applies to visits within the United States to major U.S. institutional investors even though no similar condition applies when the solicitation is done from outside the United States. Participation by the chaperone may be in person or by telephone. *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,029 n.191 (July 18, 1989).

151 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,028 n.179 (July 18, 1989).

152 *See* 1997 Cleary Letter. The 30-day limit is not applied to the foreign broker-dealer as a whole, but separately to each foreign associated person. *See* 2013 15a-6 FAQ, Question 17.

153 *See* Rule 15a-6(a)(3)(i)(A) and (iii)(A)(1) under the Exchange Act.

154 *See* Rule 15a-6(a)(3)(iii)(A) under the Exchange Act.

155 To the extent required by foreign law or as required by a firm's internal policies and procedures applicable to its global business operations, a foreign broker-dealer may send confirmations and account statements directly to U.S. counterparties. However, the chaperoning broker-dealer maintains the obligation to make sure that confirmations and account statement sent to the investor comply with all applicable U.S. requirements. Such statements must clearly identify the U.S. broker-dealer on whose behalf the document is sent. *See* 2013 15a-6 FAQ, Question 4.

156 The margin regulations provide that a registered broker-dealer may arrange for a foreign person (including a foreign broker-dealer) to extend credit for the purpose of purchasing or carrying securities, subject to compliance with the Board's margin regulations applicable to the borrower and lender. *See* § 14.07[6][a]. Note, however, that credit arranged by the registered broker-dealer may be subject to the restrictions of § 11(d)(1) of the Exchange Act. *See* § 14.07[6][c].

157 Rule 17a-7 under the Exchange Act provides that a registered broker-dealer located outside the United States either must maintain all Exchange Act-required records in the United States or provide the SEC with a written undertaking to send its records to the SEC promptly upon the SEC's request. However, the Rule 15a-6 Adopting Release states that all Rule 15a-6-required records must be kept in the United States. Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,029 & n.198 (July 18, 1989).

The 2013 15a-6 FAQ states that the chaperoning broker-dealer must comply with Rules 17a-3 and 17a-4, discussed at § 14.08. While the chaperoning broker-dealer may obtain this information from the foreign broker-dealer or another source, it is responsible for the accuracy of its books and records. *See* 2013 15a-6 FAQ, Question 16.

158 The net capital and customer protection rules are discussed at § 14.07[2]. The responsibilities of the chaperoning broker-dealer include taking net capital charges for any failed transactions. *See* 2013 15a-6 FAQ, Question 15. Note that the customer protection rule provides for the use of designated foreign control locations, so foreign securities need not actually be kept in the United States. *See* Rule 15c3-3(c)(4) under the Exchange Act. *See also* 2013 15a-6 FAQ, Questions 10, 11, 13, 14 and 15. The chaperoning broker-dealer may be a registered introducing broker-dealer as long as the chaperoning broker-dealer has in effect a fully disclosed carrying agreement with another registered broker-dealer that has agreed to comply with the financial responsibility rules. *See* 2013 15a-6 FAQ, Question 12.

159 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,025 & n.150 (July 18, 1989). In addition, under the 1997 Cleary Letter, transactions involving foreign securities, *See supra* Note 121, or U.S. Government securities effected in reliance on Rule 15a-6(a)(3) may now be cleared and settled through the direct transfers of funds and securities between the U.S. investor and the qualifying foreign broker-dealer in situations where the qualifying foreign broker-dealer is not acting as the custodian of the funds or securities

of the U.S. investor. *See* 1997 Cleary Letter. Moreover, in countries whose laws and regulations make some of the above-listed activities illegal or highly impractical for the chaperoning broker-dealer to perform, the SEC has shown a willingness to grant relief on a firm-by-firm, country-by-country basis. *See*, *e.g.*, *Morgan Stanley India Securities Pvt. Ltd.* (avail. Dec. 20, 1996) (staff would not recommend enforcement where chaperoning broker-dealer barred by the law of India from holding funds and securities on behalf of its U.S. customers transacting in Indian securities and Indian trades generally are not entered onto the chaperoning broker-dealer's books and records).

160 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,025 (July 18, 1989).

161 *See generally* § 14.07[1][a].

162 *See* Rule 15a-6 Proposing Release, 53 Fed. Reg. 23,645, 23,654 (June 23, 1988).

163 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,025 (July 18, 1989).

164 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,026 (July 18, 1989). The release states that "if the registered broker-dealer ignores indications of irregularity that should alert the registered broker-dealer … that the foreign broker-dealer is taking advantage of U.S. customers or otherwise violating U.S. securities laws, … the registered broker-dealer's role in the trades may give rise to possible violations of the federal securities laws."

165 *See* Treas. Reg. § 401.7; *see also* 55 Fed. Reg. 27,461 (July 3, 1990) (adopting Treasury exemptive rule); 55 Fed. Reg. 7733 (Mar. 5, 1990) (proposing Treasury exemptive rule). Additional exemptive action was necessary as it is the Treasury, rather than the SEC, that had authority to exempt government securities broker-dealers from Exchange Act registration. *See* § 15C(a)(5) of the Exchange Act. (Rule 15a-6 does by its terms, however, apply to municipal securities activities.)

166 *See* 1997 Cleary Letter.

167 Treasury's exemptive rule differs from Rule 15a-6 in two respects. First, a foreign government securities broker-dealer may, in making use of Treasury's conditional exemptions, enter into a chaperoning relationship not only with a registered broker-dealer but also with a registered government securities broker-dealer or with a financial institution that has given notice of its government securities broker-dealer activities to the appropriate regulatory agency. Second, a foreign government securities broker-dealer that has established a chaperoning relationship with a registered broker-dealer must disclose that fact in any research reports concerning government securities that the foreign broker-dealer distributes to major U.S. institutional investors and $100 Million Entities.

168 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 (July 18, 1989).

169 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 (July 18, 1989).

170 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 & n.94 (July 18, 1989); *see* § 14.11[2] regarding penalties for violation of the Exchange Act.

171 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,021 n.94 (July 18, 1989).

172 SEC Release No. 34-27018 (July 11, 1989), 54 Fed. Reg. 30,087, 30,090 (July 18, 1989).

173 The SEC briefly revived the concept of reliance on home-country regulation in a concept release regarding the regulation of exchanges and alternative trading systems. SEC Release No. 34-38672 (May 23, 1997). In that release, the SEC suggested that one approach to regulating the activities of foreign markets—as opposed to foreign broker-dealers—in the United States would be to rely on the foreign markets' home-country regulation. SEC Release No. 34-38672 (May 23, 1997).

174 *See*, *e.g.*, Ethiopias Tafara & Robert Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007); Erik R. Sirri, Director, SEC Division of Market Regulation, Trading Foreign Shares (Mar. 1, 2007); Roel C. Campos, Commissioner, SEC, SEC Regulation Outside the United States (Mar. 8, 2007) (identifying "thorny issues [that] must be resolved" before implementing mutual recognition); Annette L. Nazareth, Commissioner, SEC, Remarks Before the Brown Spring Forum: Economics, Entrepreneurship & Technology (Apr. 28, 2007); Christopher Cox, Chairman, SEC, Address to the Security Traders Association 11th Annual Washington Conference (May 9, 2007);

Paul S. Atkins, Commissioner, SEC, Remarks before AmCham Germany (May 30, 2007); *see also* Edward F. Greene, *Resolving Regulatory Conflicts between the Capital Markets of the United States and Europe*, 2 CAPITAL MARKETS L.J. 5 (Winter 2007); Edward F. Greene, *Beyond Borders: Time To Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85 (Winter 2007); Edward F. Greene, *Beyond Borders Part II: A New Approach to the Regulation of Global Securities Offerings* (SEC Historical Society Paper, May 2007).

175 Press Release, SEC, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008). The Australian mutual recognition agreement has not yet been used by the SEC.

176 Press Release, SEC, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement (May 29, 2008); Press Release, SEC, Statement of the European Commission and the [SEC] on Mutual Recognition in Securities Markets (Feb. 1, 2008).

177 *See*, *e.g.*, CFTC Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013) (Adopting a policy that, if the CFTC has determined that certain laws and regulations of a foreign jurisdiction are comparable to and as comprehensive as a corresponding category of U.S. laws and regulations, entities or transactions in that foreign jurisdiction that comply with those foreign laws and regulations will be deemed in compliance with such corresponding category of U.S. laws and regulations.); CFTC Rule 23.160, allowing swap dealers and major swap participants to satisfy certain margin obligations to non-U.S. persons by posting margin as required by foreign regulations where the CFTC has issued a "comparability determination" with respect to the foreign jurisdiction's requirements (§17 C.F.R. 23.160); Commission Implementing Decision (EU) 2016/377 of 15 March 2016, 2016 O.J. (L 70) 32 (European Union decision implementing equivalence treatment for U.S. central clearing counterparties registered with the CFTC).

Although the shape of the British exit from the European Union is currently unknown, it is possible that it will further expand the acceptance by the European Union of equivalent foreign regulation, which could lead U.S. regulators (including the SEC) to also consider expanding their recognition of equivalent or comparable foreign regulation.

178 *See* § 14.03[3][c][i].

179 *See* § 14.04[2].

180 *See* § 14.03[3][i].

181 *See* § 14.08[1].

182 *See* § 14.04[2].

183 *See* 1997 Cleary Letter.

184 "Foreign security," for this purpose, is defined by reference to the 1996 Cleary Letter. *See* § 14.03[3][b][ii][C]; *supra* Note 113.

185 In addition, the 1997 Cleary Letter clarifies that a foreign broker-dealer may initiate follow-up contacts with major U.S. institutional investors and $100 Million Entities to whom it has furnished research reports without violating the limitations of Rule 15a-6(a)(2)(ii), if such follow-up contacts occur in the context of a "chaperoning" relationship between a foreign broker-dealer and a U.S. intermediary broker-dealer under paragraph (a)(3) of the rule.

186 Although several prior Regulatory Flexibility Agendas published by the SEC had included a specific reference to consideration of a revision to Rule 15a-6 to focus on the types of securities that are sold by non-U.S. broker-dealers to allow institutional investors to take advantage of the efficiencies of foreign markets, the most recent Regulatory Flexibility Agendas have omitted this item and certain SEC staff members have indicated that further consideration of Rule 15a-6 is not anticipated in the near term. *See*, *e.g.*, SEC Release No. 34-50445 (Sept. 20, 2004); SEC Release No. 34-46512 (Dec. 9, 2002); SEC Release No. 34-45627 (Mar. 22, 2002); SEC Release No. 34-44909 (Oct. 5, 2001); SEC Release No. 34-44154 (Apr. 5, 2001). On the other hand, renewed interest in a "mutual recognition" approach, *see* § 14.03[3][f], may lead the SEC to reconsider its position on making further changes to Rule 15a-6.

187 *Roland Berger Strategy Consultants* (avail. May 28, 2013).

188 In the letter, the staff noted that such contact might include telephone calls, e-mails, and related mailing of general pitch materials regarding the proposed transaction. *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

189 *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

190 *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

191 *See Roland Berger Strategy Consultants* (avail. May 28, 2013).

192 NAFTA, Art. 1406.

193 NAFTA, Art. 1402.

194 *See* § 14.06[1][b].

195 *See* § 14.06[2][b] (regarding certain special requirements imposed by U.S. SROs on nonresident broker-dealers).

196 NAFTA, Art. 1410(1); *see*, *e.g.*, SEC Release No. 34-52209 (Aug. 4, 2005), 70 Fed. Reg. 46,557, 46,558 n.18 (Aug. 10, 2005) (approving changes to NASD Rule 2790 over the objection that it unduly burdened Canadian mutual funds in violation of NAFTA on the ground that "the [SEC] believes that the Rule is grounded in investor protection concerns and is not intended to unduly burden foreign investment companies").

197 *See* Rule 15c3-3(a)(7) under the Exchange Act (permitting broker-dealers whose principal place of business is in Canada to maintain required reserves at a Canadian-regulated bank while requiring broker-dealers whose principal place of business is in any other country to maintain reserves in the United States).

198 *See* 22 U.S.C. §§ 5341–5342 (prohibiting foreign firms from being designated as primary dealers in U.S. government debt obligations unless the home country of the foreign firm accords to U.S. firms the same competitive opportunities as are accorded to domestic firms in the underwriting and distribution of government debt instruments in the firm's home country).

199 The Advisers Act generally requires foreign banks wishing to engage in securities advisory services with the public in the United States to register with the SEC, while domestic banks are generally exempt from registration. (Pursuant to the GLB Act, the Advisers Act was amended, effective May 12, 2001, to require U.S. domestic banks, or departments or divisions thereof, to register with the SEC to the extent they serve as investment advisers to registered investment companies.) *See* § 16.03[2][a].

The United States has also taken reservations for certain provisions of the Trust Indenture Act, the CEA, legislation regulating the provision of surety bonds for U.S. government contracts (31 U.S.C. § 9304) and several banking statutes. *See* NAFTA, Annex VII(A)—United States.

200 The principal obligations of NAFTA Chapter 14 do not apply to existing measures (as of January 1, 1994) maintained by local (*e.g.*, municipal) governments. NAFTA, Art. 1409(1)(a)(iii). Local governments may not, however, enact new measures after NAFTA's entry into force that violate the obligations of NAFTA Chapter 14.

201 However, state law registration of federally licensed branches of foreign banks may be preempted. *See*, *e.g.*, Comptroller, Interpretive Letter No. 590, Fed. Banking L. Rep. (CCH) ¶83,415 (June 18, 1992) (stating that Illinois restrictions on the establishment of Federal branches do not limit the authority of the Comptroller to license Federal branches of foreign banks in Illinois). For a discussion of the federal broker-dealer push-out rules, *see* § 14.03[1][c].

202 *See* §§ 3.02[8][a] and 14.12.

203 NAFTA, Art. 1404.

204 For example, while the SEC has broad powers to subpoena witnesses and evidence, it cannot serve or enforce its subpoenas abroad. *See* § 21(b) under the Exchange Act; *CFTC v. Nahas*, 738 F.2d 487 (D.C. Cir. 1984); *SEC v. Zanganeh*, 470 F. Supp. 1307 (D.D.C. 1978). In addition, foreign banks or other financial record-holding institutions are often forbidden by their domestic laws from divulging information to the SEC.

See § 11.10[4].

205 Congress granted the SEC the legislative authority to gather and provide information and access to its nonpublic records to foreign securities regulatory authorities by amending the Exchange Act; it now allows the SEC to conduct investigations and compel the testimony of witnesses and the production of documents in the United States on behalf of such authorities, even if the alleged conduct would not constitute a violation of U.S. law. *See* §§ 21(a)(2) and 24(c) of the Exchange Act.

206 MOU to Establish Mutually Acceptable Means for Improving Law Enforcement in the Field of Insider Trading (Aug. 31, 1982), reprinted in 22 I.L.M. 1 (1983) (the "1982 Swiss MOU"). The 1982 Swiss MOU was an interim measure to address problems of insider trading because at the time, insider trading was not specifically a violation of Swiss law. Subsequent to the passage of a Swiss insider trading law in 1988, the Swiss MOU ceased to be in effect. In 1987, Switzerland and the United States signed a new MOU (the "1987 Swiss MOU") that provides procedures for collecting information using the 1977 Treaty for Mutual Assistance in Criminal Matters between the Swiss Confederation and the United States. 27 U.S.T. 2019, T.I.A.S. 8302 (entered into force Jan. 23, 1977); MOU, U.S.—Switzerland (Nov. 10, 1987), *reprinted in* 19 SEC. REG. & L. REP. (BNA) 1729 (Nov. 13, 1987). *See infra* Note 213 and accompanying text for discussion of the further amended 1993 Swiss MOU.

207 Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Cayman Islands, Chile, China, Costa Rica, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Germany, Greece, Hong Kong, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, Japan, Jersey, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Mexico, The Netherlands, Norway, Poland, Portugal, Romania, Russia, Singapore, Slovak Republic, South Africa, Spain, Sweden, Switzerland and the United Kingdom. In addition, the SEC has information sharing arrangements with the European Commission, the College of Euronext Regulators, the Inter-American Development Bank and the United Nations Economic Commission for Latin America and the Caribbean. *See* Office of International Affairs, Cooperative Arrangements with Foreign Regulators, http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml.

208 *See* Office of International Affairs, Bilateral Information Sharing Arrangements, *The SEC Speaks in 2004* (Mar. 2004).

209 MOU on Exchange of Information Between the SEC and the CFTC and the United Kingdom Department of Trade and Industry and Securities and Investment Board (the "SIB," now the FSA) on Matters Relating to Securities, SEC Release No. IS-323 (Sept. 30, 1991); *see also* MOU between the SEC and the FSA (as of 2013, the Financial Conduct Authority (FCA)) Concerning Consultation, Cooperation and the Exchange of Information Related to Market Oversight and the Supervision of Financial Services Firms (Mar. 14, 2006).

210 Michael D. Mann, Joseph G. Mari & George Lavdas, *Developments in International Securities Law Enforcement and Regulation*, in CORPORATE LAW AND PRACTICE (Practising Law Institute, 1994).

211 *See supra* Note 7 regarding the extent of SEC asserted authority. The SEC has, in addition, concluded a number of agreements with U.K. financial regulators within the framework of the U.K. MOU, including a joint statement with the CFTC and the U.K. FSA (as of 2011, the FCA) setting forth an agenda for oversight of the OTC derivatives market and a joint initiative with the FSA (as of 2013, the FCA) to assess the global activities of major international securities firms. *See generally* Michael D. Mann, The SEC's International Enforcement Program and Bilateral and Multilateral Initiatives, in CORPORATE LAW AND PRACTICE (Practising Law Institute, 1996). *See also* MOU between the SEC, CFTC, Bank of England and Financial Services Authority (predecessor of the FCA) dated October 27, 1997 relating to the sharing of supervisory information and cooperation in emergency oversight.

212 *See generally* Jill E. Asch, *Comment, Bank Secrecy: A Barrier to the Prosecution of Insider Trading*, 4 EMORY INT'L L. REV. 185 (Spring 1990).

213 Switzerland-United States: Exchange of Letters Concerning the Treaty on Mutual Assistance in Criminal Matters (Nov. 3, 1993), *reprinted in* 33 I.L.M. 168 (1993).

214 Press Release, SEC, SEC, CFTC and Japanese Financial Services Agency Sign Information Sharing Agreement (May 17, 2002) (announcing the signing of Statement of Intent Concerning Cooperation,

Consultation and the Exchange of Information between Japan and the United States).

215 Press Release, SEC, MOU of the SEC and the Securities Bureau of the Japanese Ministry of Finance on Sharing Information (May 23, 1986), *reprinted in* 25 I.L.M. 1429 (1986), as amended by Amendment to the Statement of Intent (Jan. 16, 2006).

216 Press Release, SEC, SEC Announces IOSCO Unveiling of Multilateral Agreement on Enforcement Cooperation (Oct. 31, 2003).

217 IOSCO, Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2002, revised May 2012).

218 IOSCO, List of Signatories to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange Of Information, https://www.iosco.org/about/?subSection=mmou&subSection1=signatories (last visited Oct. 7, 2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.04, SEPARATELY ORGANIZED AND REGISTERED U.S. AFFILIATES

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 § 14.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Notwithstanding Rule 15a-6 and SEC no-action relief granted in connection therewith, the range of U.S. securities activities an unregistered foreign broker-dealer is permitted to undertake remains limited. However, since SEC regulation of a broker-dealer is of the legal entity only and not of an affiliated group, it is possible for an international financial organization to establish a separately incorporated and SEC-registered broker-dealer affiliate that can carry out activities in the United States without subjecting the rest of the organization to SEC registration and regulation. [219]

[1] Regulation of SEC-Registered Affiliates

Registration of a U.S. broker-dealer affiliate by an international financial organization does not of itself increase the activities that a foreign unregistered broker-dealer that is part of that organization or its personnel may undertake in the United States. Nonetheless, the existence of a registered U.S. broker-dealer affiliate can facilitate the unregistered broker-dealer's undertaking of its U.S.-related activities. The registered U.S. broker-dealer affiliate can act as the chaperoning broker-dealer that is necessary for a qualifying foreign broker-dealer to take advantage of the conditional exemptions provided by Rule 15a-6 under the Exchange Act. [220] The registered affiliate can also provide the review and approval and satisfy the other requirements necessary to permit a non-U.S.

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broker-dealer to disseminate research in the United States. [221] The foreign unregistered broker-dealer and the SEC-registered broker-dealer may also trade with each other, both for their own accounts and for the accounts of their respective customers. [222]

A number of aspects of the relationship between a foreign broker-dealer and its affiliated U.S. broker-dealer may raise legal issues. In addition to the question of whether foreign broker-dealers can enter into transactions involving ongoing contractual relationships with U.S. investors, [223] such issues include the use of dual employees, the extent to which the U.S. and foreign broker-dealers can trade with discretion for the account of the other, the extent to which U.S. activity is attributed to the foreign broker-dealer and therefore raises the risk that the foreign broker-dealer is carrying out activities within the United States and the extent to which the foreign broker-dealer may be subject to U.S. taxes in respect of its business with U.S. investors.

[2] Dual Employees

A number of international broker-dealer organizations with both SEC-registered and foreign unregistered entities use personnel that are employees both of the foreign broker-dealer and of the U.S. registered broker-dealer ("dual employees") in contacts with U.S. investors. This practice was approved in the Rule 15a-6 Adopting Release in instances in which the dual employees were "subject to the registered broker-dealer's supervision and control and satisfied all U.S. SRO qualification standards" and were "stationed outside the United States." [224] Where the personnel in question are stationed inside the United States,

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are registered under the auspices of the registered broker-dealer with the appropriate SRO, are subject to the supervision and control of the registered broker-dealer and their activities and transactions are on behalf of, and recorded on the books of, the registered broker-dealer, the practice of dual employment likewise would seem to comport with the requirements of the Exchange Act. However, failure of proper supervision and control by, or of proper attribution of the activities to, the registered broker-dealer could result in difficulties for the registered broker-dealer for failure to supervise its employees properly and for the foreign broker-dealer (and the employee) for failure to register under the Exchange Act. [225]

[3] Relations Between Registered and Unregistered Affiliates

Rule 15a-6 under the Exchange Act permits registered U.S. broker-dealers and unregistered foreign broker-dealers, whether affiliated or not, to trade with each other. [226] In connection with such transactions, the U.S. broker-dealer may be acting as agent or as riskless principal in transactions ultimately between a U.S. customer and a foreign broker-dealer. However, the SEC has expressed concern about dealing activities of foreign broker-dealers in the United States carried out through U.S. affiliates that are effectively controlled by the foreign dealer. In this regard, the SEC stated in the Rule 15a-6 Adopting Release that it

> does not intend this exemption to permit the foreign broker-dealer *to act as a dealer* in the United States through an affiliated registered broker-dealer. The … [SEC] recognizes that dealers in foreign markets may transmit securities positions to U.S. broker-dealer affiliates after the foreign markets close, so that the U.S. affiliates can continue trading those securities. If, however, the foreign broker-dealer *controlled* the registered broker-dealer's *day to day market-making activities* by explicit restrictions on the U.S. broker-dealer's ability to execute orders against the foreign broker-dealer's positions or to take independent positions, *the foreign broker-dealer could be considered a dealer subject to U.S. broker-dealer registration requirements*. [227]

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A similar concern likely would arise if a U.S.-registered broker-dealer were acting as a dealer, even with the ability to take independent positions, as to securities positions that were held offshore by an entity that was not a *bona fide* "foreign dealer" within the meaning of Rule 15a-6, which requires that the dealer be a "non-U.S. resident person." [228] Among the factors that might be relevant to whether a dealer is properly characterized as "foreign" are the nature and level of its activities outside the United States and whether it would be deemed to be carrying out its activities within the United States, for example, by virtue of the fact that actual control over its activities or a portion thereof was exercised by persons in the United States. Certainly a U.S.-registered broker-dealer conducting dealer activities with complete discretion as to securities positions held by an unregistered U.S. affiliate would raise serious questions regarding the broker-dealer registration obligation of that affiliate.

In a 1992 release, the SEC expressed concern about U.S. broker-dealers that arranged trades in U.S. stocks with U.S. institutional customers, which trades were then shown as having been "executed" on the books of a foreign affiliate. [229] This release expressed the view that such transactions are "'overseas' in name only," and are executed overseas to evade U.S. trade reporting requirements, exchange fees or other regulations. Following this SEC statement, the NYSE adopted Rule 410B requiring, among other things, that trades in NYSE-listed securities in the United States that are arranged by an NYSE member but executed by a foreign affiliate be reported to the exchange. [230]

Other factors that may appropriately be the subject of consideration in determining whether activities are carried out within the United States include allocations of profit and loss or capital.

[a] Citicorp/Vickers Exemptive Order

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The single precedent cited by the SEC in connection with its stated concern regarding foreign broker-dealer control of a registered broker-dealer was its 1986 exemptive order to Citicorp and its indirect subsidiary Vickers da Costa Securities, Inc. ("Vickers"), a registered broker-dealer. [231] The order permitted various Citicorp subsidiaries that were unregistered foreign broker-dealers ("Citicorp's Foreign Dealers") and Vickers to enter into an arrangement in which Vickers would serve as broker, or as "riskless principal," in trades ultimately between Vickers' U.S. customers and Citicorp's Foreign Dealers. [232]

The aspect of the Vickers exemptive order cited in the Rule 15a-6 Adopting Release related to the ability of Vickers to act as a Nasdaq market-maker in certain securities. A Nasdaq market-maker in a security must stand ready to continuously buy and sell such security for its own account. [233] However, due to the banking law restrictions then applicable to Vickers as a subsidiary of a bank affiliate, Vickers was not permitted to maintain a position in equity securities. Accordingly, Vickers could act as a Nasdaq market-maker only by immediately passing each long or short position it took to one of Citicorp's Foreign Dealers. The SEC exemptive order approving the Vickers arrangement provided that for each security in which Vickers acted as a Nasdaq market-maker, Citicorp's Foreign Dealers would place with Vickers standing buy/sell orders in a size large enough to permit Vickers to fulfill its market-making responsibilities. The orders were to be placed each week before the opening of trading in the United States. All standing buy/sell orders would contain broad price parameters (either 10% of the market price as of the close at the end of the preceding week or $2 per share, whichever was greater) and give Vickers discretion to execute trades within those parameters. [234] The SEC's exemptive order also provided that Citicorp's Foreign Dealers were "not permit[ted]" to alter their buy/sell orders during the course of the week; however, "in response to significant market changes … [Vickers could] request additional instructions." [235]

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The most plausible interpretation of the SEC's citation to Vickers in the Rule 15a-6 Adopting Release is that it was intended to indicate that, even following adoption of Rule 15a-6, the degree of control possessed by Citicorp's Foreign Dealers over Vickers was so great that, absent specific additional relief, these dealers would be required to register with the SEC. This is particularly the case since the Vickers exemptive order itself provided, as the Rule 15a-6 Adopting Release notes, various "regulatory safeguards" not included in Rule 15a-6 intended to limit the degree of "control" Citicorp's Foreign Dealers had over Vickers. [236]

Another aspect of the Vickers arrangement was not mentioned in the Rule 15a-6 Adopting Release. For securities not quoted on Nasdaq, the SEC exemptive order permitted Vickers to enter quotations into the daily "pink sheets," which provide a quotation medium for these securities. [237] The Vickers exemptive order did not place explicit restrictions upon Citicorp's Foreign Dealers changing through the day the price and size parameters of orders for these non-Nasdaq securities.

[b] Security Pacific No-Action Letter

Between the issuance of the Vickers exemptive order and the adoption of Rule 15a-6, the SEC issued several no-action letters to U.S. and foreign banking groups proposing that group members that were registered U.S. broker-dealers would act as agents in transactions between the registered broker-dealer's U.S. customers and its unregistered foreign broker-dealer affiliates where there was no contact between the U.S. customers and the foreign affiliates. These banking groups received no-action letters rather than exemptive orders. Moreover, as previously quoted, the SEC stated specifically in the Rule 15a-6 Adopting Release that, subject to avoiding a foreign broker-dealer's "control" over an affiliated U.S. broker-dealer's market-making activities, a foreign broker-dealer can "transmit" its close-of-business securities positions to an affiliated U.S. broker-dealer, which "can continue trading those securities." [238] Consequently, it seems quite clear that, had Rule 15a-6 been effective at the time the no-action letters were issued, the rule would have made recourse to no-action relief unnecessary.

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For this reason it is instructive to describe the significant aspects of the SEC's letter to Security Pacific Corporation ("Security Pacific"), the no-action letter describing the widest range of activity in the United States by a registered broker-dealer acting on behalf of its unregistered foreign affiliates, to illustrate a situation that even pre-Rule 15a-6 did not raise SEC "control" concerns as Vickers did. [239]

The Security Pacific no-action letter permitted Security Pacific's registered broker-dealer subsidiary, Burns Fry Hoare Govett ("BFHG"), to act either as agent (broker) or as riskless principal [240] in executing orders placed with it by foreign dealer affiliates. These orders could be specific as to price and volume or could set price and volume parameters. BFHG was to execute as placed the orders that were specific as to price and volume and to execute the other orders as it deemed appropriate within the given parameters (which could be changed at any time).

Unlike Vickers (with respect to securities held on the books of its affiliated foreign dealers), BFHG did not propose to act as a market-maker. BFHG stated that it would not (i) quote a market in those securities or publish such quotes or (ii) advertise or otherwise make known a willingness to buy and sell those securities (except as riskless principal) on a continuing basis. Further, the SEC's letter provided that "where standing buy and sell orders in a security are held by [BFHG, BFHG would not]… execute orders of any of its U.S. customers against those standing orders." [241] While the terms of the no-action letter did not permit BFHG to offer "to buy and sell simultaneously on a continuing basis" [242] on behalf of its foreign dealer affiliates, the SEC apparently did not object to BFHG changing the position it took on behalf of its foreign affiliates from the buy to the sell side, or *vice versa*, of any given security within the course of a day. [243]

Footnotes

219 *But see* § 14.08[3][b].

220 *See* § 14.03[3][c].

221 *See* § 14.03[3][b][iii].

222 *See* § 14.03[3][b][ii]; *see also NASD* (avail. Oct. 11, 1991) permitting certain foreign broker-dealers to act as agent for their affiliated SEC-registered broker-dealers in entering quotations on the Nasdaq International Service. *But see* § 14.03[3][b][ii][A] (regarding issues that may arise where a transaction results in an ongoing contractual relationship between a U.S. customer and a foreign broker-dealer).

223 *See* §14.03[3][b][ii][A].

224 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,017 (July 18, 1989); *see also* NYSE Information Memo No. 91-9 (Mar. 21, 1991) (instituting "Series 17" examination for associated persons of NYSE members who are employed by a U.K. broker-dealer and have passed a qualifying examination in the United Kingdom); NASD Notice to Members No. 91-28 (May 1991) (same). Any foreign office from which employees of a U.S. broker-dealer contact U.S. investors, however, could be subject to regulation and inspection as a "branch office" of the U.S. broker-dealer. *See* § 14.11[1]; *see also* SEC Release No. 34-52402 (Sept. 9, 2005) and SEC Release No. 34-52403 (Sept. 9, 2005) (uniform definition of "branch office" adopted by NYSE and NASD); NASD Notice to Members 06-12 (Mar. 2006) and NYSE Information Memo 06-13 (Mar. 22, 2006) (joint interpretative guidance relating to the uniform branch office definition).

225 *See*, *e.g.*, *O'Brien and Credit Suisse First Boston, LLC*, SEC Release No. 34-51764 (May 31, 2005) (sanctioning Credit Suisse First Boston ("CSFB") for failure to supervise a trader who was located in its New York office, but reported to a supervisor located in an office of an Australian affiliate of CSFB where that supervisor was not a CSFB employee and had not passed any U.S. supervisory licensing exams).

226 *See* Rule 15a-6(a)(4)(i) under the Exchange Act.

227 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 (July 18, 1989) (emphasis added); *see also* § 14.08[2].

For markets in certain securities, including particularly U.S. Treasury securities and Japanese and other government securities, but also extending to other "books" of fixed income securities and the most widely traded equity securities, trading takes place on markets other than the principal domestic markets for the securities. For some securities, there is even 24-hour trading, with activity moving from New York to Tokyo to London affiliated broker-dealers as one market closes and the next opens. For other securities there is trading across the business hours of London and New York. These activities require having one affiliate trading securities positions maintained on the books of another.

228 The term "foreign broker or dealer" is defined as "any non-U.S. resident person (including any U.S. person engaged in business as a broker or dealer entirely outside the United States, except as otherwise permitted by [Rule 15a-6])… whose securities activities, if conducted in the United States, would be described by the definition of 'broker' or 'dealer' in [the Exchange Act]." Rule 15a-6(b)(3) under the Exchange Act.

229 *See* SEC Release No. 34-30920 (July 14, 1992), 57 Fed. Reg. 32,587, 32,592 (July 22, 1992).

230 *See* NYSE Information Memo No. 92-32 (Nov. 13, 1992); NYSE Rules, Rule 410B.

231 *See* Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989); *Citicorp* (avail. Sept. 14, 1986).

232 *See* GUIDE IX.A and XI.E.

233 *See* Nasdaq OMX Stock Market Rules, Rules 4613 and 4751(C)(2).

234 As the Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989), makes clear, from a securities law point of view, the greater the trading discretion allowed Vickers and the lesser the control by Citicorp's Foreign Dealers over Vickers, the stronger the argument that Citicorp's Foreign Dealers need not register as dealers with the SEC. However, the greater the trading discretion allowed Vickers, the stronger the potential argument that Vickers would be engaged in dealing activities in the United States that might be prohibited by applicable banking law. In fact, it has been reported that opposition from the Board led to a determination not to implement the Vickers arrangement. *See generally* GUIDE IX.A and XI.E.

235 *Citicorp* (avail. Sept. 14, 1986).

236 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989); *Citicorp* (avail. Sept. 14, 1986). The Vickers exemptive letter contained, in addition to the conditions regarding foreign dealers' control over Vickers, a number of other conditions not included in Rule 15a-6, including that Vickers maintain its net capital at a level higher than ordinarily required by the SEC's net capital rule, apparently to take into account some measure of credit risk from Vickers' exposure to Citicorp's Foreign Dealers. The exemption also contained conditions similar to those required of qualifying foreign broker-dealers under Rule 15a-6, as discussed in § 14.03[3][c].

237 *See* § 3.01, Note 32 for a discussion of pink sheets.

238 Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 (July 18, 1989).

239 *See Security Pacific Corp.* (avail. July 7, 1988). In 1987, Chase Manhattan Corp. received a no-action letter permitting it to conduct a narrower range of activity than was later afforded to Security Pacific. *See Chase Manhattan Corp.* (avail. July 28, 1987). Subsequent to the issuance of the Security Pacific letter, the SEC issued substantially identical no-action letters to *National Westminster Bank PLC* (avail. July 7, 1988) and *The Bank of Montreal* (avail. June 20, 1989).

240 The Board, however, did not permit the registered broker-dealer to act as riskless principal on behalf of its foreign dealer affiliates, stating that such an activity would fall within the dealing prohibitions of the Glass-Steagall Act. Letter from William W. Wiles, Secretary of the Board, to Dan C. Aardal, Assistant General Counsel, Security Pacific Corp. (Apr. 18, 1988). *See* GUIDE XI.E.

241 *Security Pacific Corp.* (avail. July 7, 1988).

242 Compare the SEC's description of the Vickers arrangement in the Rule 15a-6 Adopting Release, 54 Fed. Reg. 30,013, 30,030 n.205 (July 18, 1989), which is the source of the quoted language.

243 That BFHG could change sides during the course of a day is indicated by, among other things, the fact that

BFHG's foreign dealer affiliates were not explicitly restricted in their ability to change their orders to BFHG during the course of a day, and that BFHG was to report daily to its foreign affiliates "net changes" (presumably meaning buys netted against sells in a security) in their respective accounts.

U.S. Regulation of the International Securities and Derivatives Markets, § 14.05, 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 § 14.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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A foreign entity that establishes an affiliate to engage in activities requiring SEC broker-dealer registration (or determines to engage in such activities itself) will subject the affiliate (or itself) to the most comprehensive and detailed regulatory regime that exists for securities market participants under the U.S. securities laws. [244] The substantive requirements can extend into all areas of a registered broker-dealer's business; the recordkeeping requirements are comprehensive; and audit and inspection by both the SEC and SROs [245] are more frequent and detailed than anything to which other market participants are subject. Further, registered broker-dealers are subject to closer scrutiny, and have greater affirmative obligations, with respect to the prevention of fraudulent and manipulative activity than other market participants. The regulation of registered broker-dealers also extends to their finances and accounting, and therefore officers and employees and outside advisers with financial and accounting expertise are required to cope with the regulatory scheme.

Responsibility for monitoring compliance with the regulatory scheme begins with the registered broker-dealer itself, which is required to institute internal control, supervisory and procedural systems. Primary outside oversight is provided by the SROs, which are responsible for enforcing compliance by their members with the securities laws. Each registered broker-dealer has a designated SRO (the "designated examining authority") charged with primary responsibility for conducting on-site inspections and other reviews of the broker-dealer, including financial and books and records reviews. The SEC also has the power to, and regularly does, conduct audits and inspections, sometimes in coordination with the firm's designated examining authority or other SRO. Both the SROs (subject

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to SEC review) and the SEC may discipline registered broker-dealers for failure to conform to the regulatory scheme. [246]

Footnotes

244 Broker-dealers effecting customer transactions in security futures products are also subject to registration and other requirements under the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 4. Additionally, under Title VII of the Dodd-Frank Act, dealers in swaps and security-based swaps will be required to register with the CFTC and the SEC as swap and security-based swap dealers, respectively. *See* SEC Release No. 34-75611 (Aug. 5, 2015), 80 Fed. Reg. 48,964 (Aug. 14, 2015); CEA § 4s(b)(5); Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613 (Jan. 19, 2012); *see also* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 5.02 (regarding swap dealers) and Chapter 6 (regarding security-based swap dealers).

245 *See* text accompanying *infra* Note 269.

246 Broker-dealers in government securities are subject to a specialized scheme of regulation, the most notable provisions of which are found in § 15C of the Exchange Act and applicable U.S. Treasury Department ("Treasury") rules and regulations. *See*, *e.g.*, Treas. Reg. §§ 400–50. The regulation of government securities broker-dealers is in many respects comparable to, although not as extensive as, that of broker-dealers in nonexempted securities. The Treasury regulations incorporate many of the compliance

requirements contained in the SEC's rules applicable to broker-dealers in other securities. Certain of the more important features of the government securities regulatory scheme are touched upon in the footnotes to this Part B.

There are also certain specialized aspects of the municipal securities regulatory scheme, including a requirement that banks, or identifiable departments or divisions of banks, that are dealers in municipal securities register pursuant to § 15B of the Exchange Act. Broker-dealers and banks (or separately identifiable departments or divisions thereof) engaging in activities in municipal securities, or persons providing advice to or on behalf of municipal entities (or obligated persons) with respect to municipal financial products or municipal securities issuances or soliciting municipal entities (or obligated persons), that require registration under § 15 or § 15B of the Exchange Act must also comply with the rules promulgated by the Municipal Securities Rulemaking Board. Participation by non-U.S. financial organizations in the municipal securities market is quite limited and, accordingly, this Part B does not further discuss the specialized aspects of municipal securities regulation.

Registered broker-dealers providing investment advice that is not solely incidental to the conduct of their business as brokers or dealers or for which they receive special compensation also may be required to register as investment advisers with the SEC under the Advisers Act. *See* § 202(a)(11)(C) of the Advisers Act; § 16.03[2][b].

See also infra Note 247.

U.S. Regulation of the International Securities and Derivatives Markets, § 14.06, REGISTRATION PROCESS

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 § 14.06 (11th and 12th Editions 2014-2017)
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In order to register as a broker-dealer with the SEC, [247] the broker-dealer must also become a member of a national securities association (unless it confines its activities to transactions on national securities exchanges of which it is a member). [248]

[1] SEC Registration and FINRA Membership

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The only existing national securities association is the Financial Industry Regulatory Authority, Inc., or "FINRA." [249] SEC registration and FINRA membership is a combined process that entails the filing of an application, [250] which includes extensive information regarding the proposed business of the broker-dealer (the "Applicant"), its personnel and how it will comply with applicable regulatory requirements. The application process enables the SEC and FINRA to prevent those with histories of violations of the securities laws or comparable offenses, or that are not otherwise qualified, from registering as broker-dealers. [251]

[a] Elements of the Application

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Key elements of the application package include:

- advance reservation of a name, subject to FINRA approval; [252]
- application fees funded to a CRD general account from which registration fees will be paid; [253]
- the Uniform Application for Broker Dealer Registration ("Form BD"), discussed below, used by the SEC, SROs and the 50 states;
- an executed entitlement program agreement for access to FINRA's web-based systems; [254]
- a list of all "associated persons" [255] of the Applicant, a Uniform Application for Registration or Transfer ("Form U-4") for each person that will act in a

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  registered representative or principal capacity for the Applicant and fingerprint cards for all associated persons of the Applicant; [256]
- a Uniform Branch Office Registration form ("Form BR") for all branch offices of the Applicant; and
- a New Member Application form ("Form NMA"). [257]

Additional information submitted electronically on Form NMA and related attachments includes, among other things: [258]

- a detailed business plan;
- documentation of certain regulatory or criminal proceedings against, adverse licensing or registration

determinations with respect to, investigations of, or remedial actions imposed on, the Applicant or any of its associated persons;

- copies of final or proposed contracts with banks, clearing entities or service bureaus, and a general description of any other final or proposed contracts;
- a description of the nature and source of the Applicant's capital, with supporting documentation;
- a description of the Applicant's financial controls;
- descriptions of the Applicant's communications, supervisory, recordkeeping and operational systems;
- copies of the Applicant's compliance policies, written supervisory procedures and continuing education programs; and
- a description of the number, experience, qualifications and responsibilities of supervisors and principals.

Form BD, required to register with the SEC and FINRA, requires the disclosure of certain basic information regarding the broker-dealer, including:

- name, address and telephone number of the broker-dealer;

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- form of business organization of the broker-dealer; [259]
- names of officers and directors of the broker-dealer;
- names and addresses of all affiliates (including those located outside the United States) engaged in the securities or investment advisory business;
- proposed lines of business of the broker-dealer;
- information regarding any disciplinary action taken against the broker-dealer and/or its "control affiliates," [260] including, among others, sanctions for violations of U.S. or non-U.S. criminal laws and securities laws and sanctions imposed by the United States or a foreign government, court, regulatory agency or securities exchange for conduct relating to securities activities or for fraudulent conduct; and
- descriptions of any clearing or recordkeeping arrangements. [261]

The business plan to be filed with the application must set forth all material aspects of the Applicant's business, including an estimate of projected monthly income and expenses for its first year of business, a balance sheet and supporting schedules and a net capital computation. [262] The business plan should provide a description of the Applicant's business activities and marketing plan, its organizational structure, its personnel, its office facilities and branch office structure (if applicable), the technology, communications and operational systems to be employed, contingency plans in the event of systems failures, disaster recovery plans and systems security procedures.

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The procedures to be filed with the application include the Applicant's written supervisory procedures, internal operating procedures (including operational and internal controls), internal inspections plan, written approval process and qualifications investigations procedures. The written supervisory and compliance procedures should detail who will have responsibility for compliance with various regulatory requirements, including such areas as recordkeeping; transaction review; new account documentation; review of advertising and communications; and execution, clearance and settlement procedures. These procedures should also contain, among other things, the Applicant's policies with respect to money laundering, insider trading and confidentiality.

[b] Foreign Applicants

An Applicant for registration as a broker-dealer need not be located in the United States. However, a nonresident Applicant must provide the SEC with an irrevocable consent and power of attorney designating the SEC as its agent for service of process in any civil suit subject to U.S. jurisdiction that: (i) accrues during the period in which it is registered as a broker-dealer, (ii) arises out of its activities as a broker-dealer and is subject to U.S. jurisdiction and (iii) is founded on the Securities Act, the Exchange Act, the Trust Indenture Act, the Investment Company Act or the Advisers Act. [263] A copy of the consent to service must also be forwarded to the CRD with the Form BD application. [264] Nonresident registered broker-dealers are required to keep copies of all Exchange Act required books and records at a location in the United States or must undertake to provide the SEC promptly with all requested records. [265]

[c] Approval Process

After all required documentation, and any other information requested, has been submitted to, and reviewed by, FINRA, an interview will be arranged between the broker-dealer's senior management (generally including, at a minimum, the broker-dealer's president and chief financial officer) and the FINRA analysts assigned to review the application.

The purpose of the interview is to assure FINRA that the broker-dealer's senior management understands its regulatory and compliance responsibilities and has the necessary business experience to engage in the business activities proposed. In addition, if the broker-dealer employs any technology vital to its

business plan (*e.g.*, if the broker-dealer is going to operate an electronic trading platform), FINRA may request a demonstration of such technology.

Following the pre-membership interview, FINRA will issue a decision as to whether membership will be granted or denied. Written notification as to whether the application has been approved will be sent to the Applicant within 30 days after the later of the conclusion of the pre-membership interview and the submission to FINRA of any required additional information. Subject to limited exceptions, FINRA is required to process new membership applications within 180 calendar days from the date of filing. [266]

Assuming the application for SEC registration and FINRA membership has been approved by FINRA, the broker-dealer will be required to sign a "new membership agreement." The new membership agreement sets forth the parameters of the broker-dealer's permitted activities, which are based on the broker-dealer's business plan and can be the subject of detailed negotiations with FINRA. Business operations will only be permitted to commence after FINRA has received the executed new membership agreement.

The SEC does not automatically approve applications for broker-dealer registration. However, the SEC must within 45 days of receipt of a completed application either grant the application or institute proceedings to determine whether it should be denied. [267] In addition, the SEC may for good cause extend such proceedings by 90 days.

Section 15(b)(4) under the Exchange Act lists a variety of offenses for which the SEC may discipline broker-dealers and which also may be used as a basis for delaying approval of, or denying, an application for registration (or, alternatively, for which the SEC may place limits upon the activities of a broker-dealer once registered). Such offenses include having undertaken activities requiring registration prior to registering, having filed a false or misleading Form BD, having been convicted in the United States or abroad of one of a number of enumerated offenses or having been found by a U.S. or foreign financial regulatory authority to have committed a securities law violation.

[2] SRO Membership

As discussed above, even if registered with the SEC, a broker-dealer generally may not commence securities activities until it becomes a member of FINRA. [268] In addition to joining FINRA, a registered broker-dealer may become

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a member of one or more of the SEC-registered national securities exchanges, such as the NYSE and the Nasdaq Stock Market.

FINRA and the national securities exchanges are industry self-regulatory membership organizations, known collectively as "SROs," that are required by the Exchange Act to regulate their member broker-dealers' compliance with both the rules of the SEC and their own rules. Thus, a broker-dealer's membership in, and resulting regulation by, one or more SROs is a crucial element of the U.S. broker-dealer regulatory scheme. [269]

[a] SRO Membership Requirements

Membership in an SRO requires meeting its employee licensing requirements [270] and other standards. Prospective members of an SRO must of course also pay the organization's fees and, in the case of a national securities exchange, obtain membership or the right to trade on that exchange (traditionally referred to as having a "seat" on the exchange).

[b] Members Residing Outside the United States

There is no requirement that a FINRA member have an office in the United States. However, a "foreign FINRA member" must: (i) keep all records and reports required by the SEC and FINRA in English, keep its accounts in U.S. dollars and have available a person fluent in English to assist FINRA in examinations, (ii) reimburse FINRA for additional examination expenses due to the fact that FINRA inspectors must travel further to examine the member, and (iii) clear all transactions with other FINRA members through a registered broker-dealer, registered clearing agency or bank located in the United States, except where the counterparty agrees otherwise. [271]

[c] Designated Examining Authority

FINRA is the "designated examining authority" for all securities firms doing business with the public in the United States. The designated examining authority for a newly registered broker-dealer is required by the SEC, within six months of the broker-dealer's registration, to examine the new broker-dealer as to its compliance with applicable financial responsibility rules and, within a year

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of the new broker-dealer's registration, to conduct a full inspection of the broker-dealer as to its compliance with all securities laws. [272] Further, the designated examining authority has continuing primary responsibility for the regulatory oversight of that broker-dealer's activities.

Footnotes

247 The registration process discussed in this section does not apply in the case of FCMs that become broker-dealers for the limited purpose of dealing or effecting customer transactions in security futures products through the notice registration procedures available under § 15(b)(11) of the Exchange Act. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[2].

248 *See* § 15(b)(8) of the Exchange Act.

Registered government securities broker-dealers are also required to become members of a national securities association (or national securities exchange). *See* § 15C(e) of the Exchange Act. Government-noticed financial institutions (as defined below), which are not required to register with the SEC as brokers or dealers, are not required to become members of a national securities association (or national securities exchange).

249 In 2007, the SEC approved the consolidation of the NASD and the member regulation, arbitration and enforcement functions of the NYSE into a single SRO known as FINRA. *See* SEC Release 34-56145 (July 26, 2007). FINRA is now responsible for regulating all securities firms that do business with the public, including with respect to professional training, testing and licensing of registered persons, arbitration and mediation. FINRA is also responsible, by contract, for regulating, at least in part, Bats BZX Exchange, Bats BYX Exchange, C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Bats EDGA Exchange, Bats EDGX Exchange, International Securities Exchange, ISE Gemini, NASDAQ BX, NASDAQ PHLX, Nasdaq Stock Market, National Stock Exchange, New York Stock Exchange, NYSE Arca and NYSE MKT. Finally, FINRA is responsible for operating industry utilities, such as trade reporting facilities and other OTC operations. In 2010, NYSE Euronext and FINRA entered into an agreement whereby FINRA assumed responsibility for performing market surveillance and enforcement functions, although the NYSE will remain ultimately responsible for oversight of FINRA's performance. *See* Press Release, FINRA and NYSE Euronext, FINRA and NYSE Euronext Complete Agreement for FINRA to Perform NYSE Regulation's Market Oversight Functions (June 14, 2010).

FINRA is now in the process of creating a new consolidated rulebook "intended to achieve, to the extent practicable, substantive harmonization" of the NYSE and NASD rules. *See* SR-NYSE-2007-22 (Feb. 27, 2007); SEC Release No. 34-56142 (July 26, 2007); FINRA Information Notice, Rulebook Consolidation Process (Mar. 12, 2008). The rule proposals will substantially conform the NYSE rules to those of the NASD (although in certain instances the industry committees that were part of the process recommended that FINRA instead adopt the corresponding NYSE rule). The harmonization process is expected to continue until there is a single rulebook. In the interim, FINRA has incorporated into its rulebook certain existing NYSE rules (referred to as the Incorporated NYSE Rules) and will apply them solely to NYSE members in accordance with existing NYSE guidance regarding their application. As the consolidation process is ongoing, this book will refer to the FINRA rule, if consolidated, and to the NASD rule or Incorporated NYSE rule, if not yet consolidated.

250 Generally, applications for registration with the SEC and membership with FINRA are required to be filed through an electronic process to the Central Registration Depository ("CRD"), which is operated by FINRA.

251 Section 15C(a) of the Exchange Act similarly requires government securities broker-dealers that are not either registered broker-dealers under Exchange Act § 15(a) or "financial institutions" to register with the SEC. A government securities broker-dealer that is a "financial institution" need not register with the SEC; however, it must give notice of its government securities activities to the "appropriate regulatory agency."

The term "financial institution" includes both "banks" (as defined in § 3(a)(6) of the Exchange Act) and foreign banks. *See* § 3(a)(46) of the Exchange Act. Government securities broker-dealers registered with the SEC pursuant to § 15C of the Exchange Act are hereinafter referred to as "registered government securities broker-dealers." Financial institutions that are government securities broker-dealers and have given notice of such activities to the appropriate regulatory authority are referred to herein as "government-noticed financial institutions." *See* § 14.03[1][a]–[c] for a discussion of the changes to the broker-dealer registration requirements with respect to banks following the enactment of the GLB Act.

252 Before filing a new membership application ("Form NMA"), the Applicant must apply to FINRA's Department of Registration and Disclosure to reserve a proposed name, subject to certain prohibited names. *See* 18 U.S.C. § 709. Upon approval, the name will be reserved for 120 days and the Form NMA should be filed during this name-reservation period. In general, if an application or amendment is not received within the 120 days, the name reservation is cancelled automatically unless the Applicant applies for and receives an extension.

253 FINRA requires applicants to fund, *via* electronic funds transfer, the general account from which the application, examination, state and other registration fees will be drawn. An Applicant must also submit registration fees for the states in which it will conduct business, as well as all licensing and registration fees for each associated person (as defined below).

254 *See* NASD Rule 1013, FINRA MANUAL. *See generally* FINRA, Registration and Qualification, *available at*

http://www.finra.org/industry/registration-qualification (last visited Oct. 11, 2016).

255 For purposes of the application, the term "associated person" means: (i) a natural person registered under FINRA Rules, or (ii) a sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions, (iii) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant, (iv) any employee of the Applicant, except any person whose functions are solely clerical or ministerial, (v) any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration with FINRA, (vi) any person engaged in an investment banking or securities business controlled directly or indirectly by the Applicant whether such person is registered or exempt from registration with FINRA, or (vii) any person who will be or is anticipated to be a person described in (i) through (vi) above. NASD Rule 1011(b), FINRA MANUAL.

256 *See* § 14.07[3][b].

257 These forms should be submitted at the same time as the Form BD, to FINRA's Department of Registration and Disclosure. FINRA will provide access to the Firm Gateway upon notification that an Applicant's hard-copy forms have been processed. The Firm Gateway provides access to other required forms and is used to prepare and submit forms and documents for a new member application.

258 *See* NASD Rule 1013(a)(1), FINRA MANUAL.

259 There is no requirement that an Applicant have a particular form of organization; corporations, partnerships, limited liability companies, sole proprietorships and individual persons may register. In the case of an Applicant that is a corporation, the Applicant must disclose the identity of all persons who own directly more than 5% of the Applicant's voting shares. If such 5% share owners are not subject to the reporting requirements of the Exchange Act, the Applicant must disclose the identity of all persons who in turn own 25% of the voting shares of such 5% share owners. Applicants must also disclose whether such direct and indirect owners are individuals, domestic entities or entities incorporated or domiciled in a foreign country. For a discussion of the required disclosure of corporate share owners on Form ADV (for registration of investment advisers under the Advisers Act), which is comparable to Form BD, *see* § 16.04.

260 The term "control affiliate" is defined to include those who hold, or have the power to sell or direct the sale of, 25% or more of any class of voting security of a broker-dealer and certain of its officers and each of its directors. *See* Form BD, Explanation of Terms.

261 The Form BD must be amended as necessary to keep it current (even after the broker-dealer's application has been approved by the SEC) and all changes in information must be promptly reported to the SEC. *See* Rule 15b3-1 under the Exchange Act.

262 The business plan and other supporting information submitted to FINRA as part of the membership process are kept confidential.

263 Rule 15b1-5 under the Exchange Act.

264 *See* SEC Release No. 34-31660 (Dec. 28, 1992).

265 Rule 17a-7 under the Exchange Act; *see also* § 14.08[3].

266 Typically, the clock will not begin to run with respect to this time frame unless the application, when filed, is substantially complete, and, indeed, an application that is not substantially complete when filed will likely be rejected.

267 § 15(b)(1) of the Exchange Act.

268 *See* § 14.06[1].

269 *See* §§ 6(b)(2) and 6(c) of the Exchange Act (regulating national securities exchanges) and §§ 15A(b)(3) and 15A(g) of the Exchange Act (regulating FINRA); *see also* § 19(g) of the Exchange Act (requiring SROs to regulate their member broker-dealers).

270 *See* § 14.07[3][b].

271 NASD Rule 1090, FINRA MANUAL.

272 *See* Rule 15b2-2 under the Exchange Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 14.07, SUBSTANTIVE REGULATION

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 § 14.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Registered broker-dealers are subject to the most detailed substantive regulation of all U.S. securities industry participants. This regulation is intended to protect both securities customers and securities markets. While a comprehensive review of such regulation is beyond the scope of this book, this section summarizes the principal aspects of substantive regulation in certain important areas: fraud against customers and insider trading, financial responsibility, activities regulated by SROs, anti-money laundering requirements, research analyst conflicts of interest and borrowing and lending by broker-dealers. [273]

[1] Antifraud Regulation

The general prohibitions against fraudulent activity and manipulation discussed elsewhere in this book of course apply to registered broker-dealers. [274] In addition, antifraud provisions have been applied against registered broker-dealers in distinct ways to prohibit a variety of activities *vis-à-vis* customers, and registered broker-dealers are also subject to some important additional procedural requirements designed to increase broker-dealers' own efforts to police against and prevent insider trading. [275]

[a] Fraud Against Customers

Sections 10(b), 15(c)(1) and 15(c)(2) of the Exchange Act and the rules thereunder prohibit, in broad language, the use of fraudulent, manipulative or

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deceptive devices in connection with the purchase or sale of securities by broker-dealers. [276] Broker-dealers may be found to have committed fraudulent practices if, for example, they fail to send proper confirmations meeting the SEC's requirements, [277] sell (or purchase) a security at a price not related to the market price or with an excessively high mark-up (or mark-down), [278] recommend securities to a customer without having a reasonable basis for the recommendation, [279] churn a customer's account, [280] violate the financial responsibility rules or, unless an exemption is available, sell low-priced stocks of small companies ("penny stocks") except through procedures designed to ensure that the security is a suitable investment for the customer. [281]

Some of these antifraud prohibitions derive from specific provisions of the Exchange Act or the rules thereunder. However, in many cases the courts and the SEC have based antifraud actions on the grounds that a broker-dealer owes a special level of duty to its customers. This duty has been described as a "fiduciary" duty of the sort that an agent owes its principal, but in the broker-dealer context this agency law analysis has been applied even where the broker-dealer is acting

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as principal, at least where the customer is not sophisticated. [282] Another justification for imposing such a duty on a broker-dealer has been the theory that when a broker-dealer "hangs out its shingle," it is making an implied representation that it will deal fairly with its customers; a breach of this implied representation thus gives rise to liability for antifraud violations (the so-called "shingle theory"). [283] Under this theory, which would apply whether the broker-dealer were acting as agent (broker) or principal (dealer), if a broker-dealer charges too much, recommends a security without a reasonable basis or otherwise breaches its implied representation that it will deal fairly, an antifraud violation has occurred. Whatever the theory, the consequences for broker-dealers are clear: behavior perceived as unfair or over-reaching risks being found fraudulent.

A number of practices involving the division of brokerage commissions have been the subject of examination as to whether a broker-dealer's customers are receiving both fair treatment in, and full disclosure of, the division of the commissions that they paid. Among the commission arrangements that have been questioned are:

- "soft dollar" arrangements, in which an investment adviser uses commission dollars to compensate a broker for research or execution-related services provided to the adviser by the broker; [284]
- "directed brokerage," whereby an account fiduciary (such as a pension plan sponsor) directs an investment adviser to route brokerage business to a

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  specified broker-dealer, which in turn agrees to compensate the account through cash payments, the provision of services or otherwise; [285] and
- "payment for order flow," [286] whereby cash payments and other incentives are provided by executing dealers, exchanges and other trading systems that execute customer orders to brokers who direct their own customers' orders to the dealer, exchange or other system that makes the payment. [287]

In addition, § 15 of the Exchange Act was amended by the Dodd-Frank Act to permit the SEC to promulgate rules providing that the standard of conduct applicable to broker-dealers in connection with providing personalized investment advice about securities to retail customers "and such other customers as the [SEC] may by rule provide" shall be the fiduciary standard under § 211 of the Advisers Act applicable to investment advisers, and to provide the SEC with enforcement authority (including sanctions) to enforce such standard. [288] As amended by the Dodd-Frank Act, § 15(k) of the Exchange Act also clarifies that commission-based compensation or other standard compensation in and of itself is not sufficient to establish violation of the standard of conduct as applied to broker-dealers and that broker-dealers do not have a duty of care or loyalty to such customer on an ongoing basis after providing them with personalized investment advice about securities. [289] In 2013, the SEC requested data and information relating to the benefits and costs of implementing various standards of

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conduct for broker-dealers and investment advisers, including a uniform fiduciary standard of conduct. [290] The SEC has not yet proposed a rule pursuant to its authority under § 15(k) of the Exchange Act, and it is not expected that any action will be taken in this regard during the remainder of Chair White's tenure. [291]

In April 2016, however, the Department of Labor issued a final rule defining who is a "fiduciary" of an employee benefit plan under ERISA or an individual retirement account ("IRA") or other plan under the tax code by reason of providing investment advice to the plan or account or its participants or beneficiaries. [292] The rule expands the investor protections afforded by ERISA and the Bankruptcy Code by expanding the circumstances in which a broker-dealer would be considered to be a fiduciary, especially in respect of smaller plans and IRAs that participate in the retail market for retirement products. The rule is designed to address conflicts of interest that arise from compensation paid to financial service providers that could affect their advice to clients. Generally, the rule will require broker-dealers to substantially limit the types of conversations that they may have with clients that might constitute "investment advice" or, alternatively, restructure fee and compensation arrangements, and take other steps, to minimize the impact of those arrangements on the advice given. The rule has been and continues to be controversial, especially as it results in the establishment of a new fiduciary standard for brokers and investment advisers

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not by the SEC or FINRA but by the Department of Labor. The rule applies only to ERISA plans and IRAs, but the structural changes required will likely affect practices with respect to other retail clients. The final rule was effective June 7, 2016, but it will not be applicable until April 10, 2017 in order to provide plans and their affected financial service providers an additional transition period. [293]

[b] Prevention of Insider Trading

The general antifraud provisions of § 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit the purchase or sale of securities by certain persons while knowingly in possession of material nonpublic information relating to those securities in breach of a duty owed to shareholders of the corporation or the source of the information. [294] The general prescription to avoid liability for insider trading has been to disclose the inside information or to abstain from trading until it becomes public.

However, certain financial institutions, particularly full-service broker-dealers that engage in both customer and proprietary sales, trading activities and corporate finance activities, frequently find themselves in possession of inside information regarding corporate finance clients. They thus have had to devise mechanisms to protect against "use" of the inside information in their other activities in order to avoid having to stop sales, trading and research activity in the securities in question. [295] As a result, procedures have been developed by

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broker-dealers and their counsel that generally include (i) “restricted” [296] and "watch" [297] lists made up of securities concerning which inside information has been received somewhere in the organization and (ii) "information barrier" mechanisms (sometimes referred to as "Chinese Walls") to restrict dissemination of inside information. Information barriers involve procedural restrictions on the dissemination of information and, where appropriate, physical separations and restrictions between departments of an organization, particularly between corporate finance personnel and research, sales and trading personnel. [298] Information barriers are designed to regulate, and permit the tracing of, the transmission of inside information. With this combination of procedures, a broker-dealer can attempt to restrict the flow of inside information and trading activity, so that in certain circumstances the broker-dealer can continue certain activities in a security as to which a portion of the organization possesses inside information. These procedures were also originally used to bolster a defense against a charge of insider trading on the basis that the information in question had not been improperly "used."

The SEC moved toward making information barriers mandatory in 1980 when it adopted Rule 14e-3 under the Exchange Act, making it unlawful to engage in trading of securities while "in possession of" information regarding an undisclosed tender offer. [299] Although use by the purported violator no longer had

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to be demonstrated as an element of the offense, a demonstration by the defendant that appropriate information barrier procedures were in place and that the inside information was not in fact used was made an affirmative defense. [300]

The Insider Trading and Securities Fraud Enforcement Act of 1988 (the "Insider Trading Act") [301] took the next step by making information barriers and related procedures mandatory for broker-dealers generally. Broker-dealers are required to "establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of [the broker-dealer's] business, to prevent the misuse … of material, nonpublic information." [302] An insider trading violation by any person directly or indirectly controlled by the broker-dealer will result in a finding of liability against the broker-dealer if the SEC can demonstrate that the broker-dealer "knowingly or recklessly failed to establish, maintain or enforce any policy or procedure required … and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation." [303] This law caused most broker-dealers that had not adopted procedures, or that had relied on informal procedures, to adopt and distribute written information barrier and other compliance procedures and to move further toward physical separation of and restricted physical access to departments in possession of sensitive information.

In addition to requiring that broker-dealers institute procedures to prevent insider trading, the Exchange Act provides the SEC with rulemaking authority to mandate the adoption of specific procedures. [304] Pursuant to this authority, the

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SEC's Division of Trading and Markets (at that time, the Division of Market Regulation) released a report in 1990 (the "1990 Information Barrier Report") summarizing its review of the adequacy of broker-dealers' existing information barrier procedures. [305] The review determined that broker-dealers' information barrier procedures "generally [were]… well conceived and conscientiously executed" and thus concluded that the SEC should not then use its rulemaking authority to require broker-dealers to adopt uniform procedures. [306] Although the 1990 Information Barrier Report endorsed a flexible approach to information barrier procedures, it also concluded that the minimum elements of acceptable information barrier procedures include the following:

- substantial control (preferably by the compliance department) of interdepartmental communications;
- the review of employee trading through the effective maintenance of some combination of watch, restricted and rumor lists;
- memorialization of information barrier procedures; and
- the heightened review or restriction of proprietary trading while the firm is in possession of material nonpublic information.

Surveillance of firm, customer and employee trading was said by the report to be the "single most significant element" of information barrier procedures. [307]

The 1990 Information Barrier Report also emphasized the role of the SROs in ensuring that their members' internal procedures are adequate. Responding to the report, the NYSE and the NASD published for their members a joint statement containing certain minimum elements of adequate broker-dealer information barrier procedures. [308] In addition to emphasizing the need for formal written procedures incorporated within a firm's operating manual, [309] the joint statement

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encouraged the use of restricted and watch lists, with adequate written standards governing their use. The joint statement also emphasized the need for continuing employee education and training regarding applicable federal and state law and the requirements of SROs, as well as the firm's own procedures to prevent the misuse of material nonpublic information. [310] A firm's practices in this regard should provide that policy statements are provided or made available to employees, including revisions to such policies, and that each employee sign an attestation as to his or her understanding of those policies.

The nature of procedures adopted by individual firms has varied. In particular, procedures have appropriately varied depending on the nature of a firm's activities and its access to material nonpublic information. A firm that engages only in mutual fund brokerage may have very simple procedures. A "boutique" broker-dealer engaging in merger and acquisitions advisory activity would normally be expected to have procedures in place to police employee trading and physical safeguarding of inside information and have distributed rules restricting transmission of material nonpublic information. However, such a firm's activities, and therefore its appropriate procedures, might not extend to customer or firm principal trading. The most complex procedures have, of course, been devised by full-service institutions, whose rules commonly involve physical separation of personnel, physical safeguarding of information, restriction of communications between corporate finance, research and sales and trading personnel, review of firm, employee and customer trading for indications of unusual activity, maintenance of "restricted" and "watch" lists, detailed procedures regarding violations and possible violations or regarding seeking appropriate exceptions to procedures involving legal and compliance personnel and many other safeguards. [311]

[c] Prevention of Fraudulent Short Sales

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In addition to the generally applicable antifraud provisions of the Exchange Act, [312] broker-dealers are subject to specific requirements in connection with effecting short sales [313] designed to prevent them from being used for fraud or manipulation. Until 2007, the price at which a broker-dealer (or other person) could effect short sales was restricted by the Rule 10a-1 "tick test," adopted in 1938 and designed to restrict short sellers from effecting short sales in an exchange-traded security when the price of that security is declining, and similarly designed price tests imposed by the SROs. In 2007, after the results of a pilot program indicated that the short sale restrictions had little effect on liquidity and price efficiency, [314] the SEC eliminated Rule 10a-1 and the tick test and prohibited the SROs from imposing price tests on the short sale of any security. [315] However, in 2010, the SEC adopted new short sale restrictions in Rule 201 of Regulation S HO in response to the rapid and steep price declines in securities during the fall of 2008. Among other things, under the short sale price restrictions, a circuit breaker triggers any time a stock has dropped 10% in one day—prohibiting short selling in that security unless the price is above the current national best bid. [316]

Broker-dealers also remain subject to specific requirements under Exchange Act Regulation S HO [317] that are designed to prevent abusive "naked"

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short sales [318] and to address extended "fails to deliver." [319] Under Regulation S HO, broker-dealers must mark all sales of equity securities "long" or "short." [320] A sale may be marked "long" only if the seller owns the security and the broker-dealer reasonably expects to have physical possession or control of the security by the settlement date of the transaction; all other sales must be marked "short" or "short exempt." [321] If a sale is marked "long," the broker-dealer generally must make delivery when due and cannot use borrowed securities to do so. [322] Broker-dealers generally may not accept or execute short sales of equity securities without borrowing or entering into a *bona fide* arrangement to borrow the security or having reasonable grounds to believe the security can be borrowed in time for delivery. [323] Finally, Regulation S HO imposes additional

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delivery requirements on broker-dealers that are participants in registered clearing agencies. Subject to certain limited exceptions, such broker-dealer participants must purchase or borrow securities to close out any fail to deliver positions by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position. [324] Broker-dealers subject to this close-out requirement are also generally prohibited from effecting short sales in the relevant security without borrowing or entering into a *bona fide* agreement to borrow the security. [325]

[2] SEC Net Capital and Other Financial Responsibility Rules

Registered broker-dealers are subject to capital and other financial rules intended to protect their own customers [326] against financial failure of the broker-dealer, as well as to protect market participants generally by preventing a chain reaction of failures that might otherwise occur in a highly interrelated financial system when one financial intermediary fails. [327]

Section 15(c)(3) of the Exchange Act requires that broker-dealers conform to the SEC's rules on "financial responsibility" and related matters including "custody and use of customers' securities and … [cash] balances." [328] Under that

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provision of the Exchange Act, the SEC has adopted (i) the "customer protection rule" (Rule 15c3-3), which governs a broker-dealer's handling of customer funds and securities, and (ii) the "net capital rule" (Rule 15c3-1), which regulates the minimum liquid net assets and maximum debt/equity ratio of a broker-dealer. [329] These rules go well beyond requiring balance-sheet solvency of a broker-dealer. They are intended to assure that a broker-dealer's customer-related assets are protected and that these assets are sufficient to pay its obligations to its customers even in a forced and rapid liquidation during difficult market conditions and in periods of limited liquidity. [330]

In the event that a broker-dealer fails and lacks sufficient assets to repay its customers, SIPA provides for the availability of limited protection to compensate a broker-dealer's customers for certain losses. [331]

While the SEC's net capital and other financial responsibility rules are far too detailed to be considered in full, we discuss certain of their principal areas of coverage below.

[a] SEC Customer Protection Rule

The customer protection rule is intended to separate a firm's activities on behalf of its customers from the risks of the firm's proprietary underwriting and dealing activities by requiring that a broker-dealer hold its customers' assets apart from its own, and thus not put customer assets at risk in the broker-dealer's business. [332] The rule has two parts, one dealing with the treatment of customer securities and the other requiring the broker-dealer to make deposits into a special account intended to benefit its customers.

[i] *Customer Securities and PAB Account Securities*

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The customer protection rule requires a broker-dealer to make a daily determination to ensure that it has possession or "control" [333] of all fully paid securities and "excess margin securities" [334] of its customers. [335] Effective in 2014, this obligation was extended to include fully paid and excess margin securities in accounts containing the proprietary securities and cash of other broker-dealers ("PAB accounts"), except for the PAB accounts of other broker-dealers that did not object after receiving written notice that the carrying broker-dealer

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would be able to use their securities in the ordinary course of its business. [336] Broker-dealers with customer or PAB account securities that should be, but are not, within their possession or control must take action to obtain possession or control. Generally, a broker-dealer must buy in, or otherwise obtain, fully paid or excess margin securities carried on its books as "fails to receive" [337] for more than 30 days. [338] As trades in markets outside the United States may require a longer period to settle than those in the United States, the SEC staff has provided that in the case of fails to receive of foreign-settled, foreign-issued securities a broker-dealer may, in certain circumstances, take a charge to its net capital rather than buying in undelivered securities. [339]

This part of the customer protection rule is supplemented by Rules 8c-1 and 15c2-1 under the Exchange Act, which among other restrictions require that customer margin securities (*i.e.*, those securities that a broker-dealer is not required to keep in its possession or control) may not be subjected to any lien greater in amount than the amount that a broker-dealer's customers collectively owe the broker-dealer. For purposes of these rules, a broker-dealer's "customers" include other broker-dealers whose accounts it carries. [340]

[ii] *Customer Reserve Account and PAB Reserve Account*

The second part of the customer protection rule requires a broker-dealer to make two weekly computations in accordance with a "Reserve Formula." [341] The first computation determines how much money the broker-dealer is holding that is either customers' money or money the broker-dealer has obtained from the use of customer securities that are not in the broker-dealer's possession or control ("customer credits"). From these customer credits, the broker-dealer subtracts the

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amount of money that it is owed by its customers or in customer-related transactions ("customer debits"). [342] If a broker-dealer's customer credits are in excess of its customer debits, the broker-dealer must deposit cash or "qualified securities" [343] representing the excess in a special reserve bank account for the exclusive benefit of customers (commonly called the "customer reserve account"). The second computation is an essentially identical calculation with respect to the broker-dealer's PAB accounts to determine an amount that must be maintained in a special reserve bank account for the exclusive benefit of PAB account holders (commonly called the "PAB reserve account"). [344]

The effect of the two parts of the customer protection rule, and of Rules 8c-1 and 15c2-1 under the Exchange Act, is to create a system in which the excess of the amount a broker-dealer owes to its customers and PAB account holders (or to others in connection with their securities positions) over the amount customers and PAB account holders owe to the broker-dealer (or third parties owe to the broker-dealer in connection with the customers' and PAB account holders' securities positions) is placed in segregated bank accounts, and securities belonging to customers and PAB account holders generally are either kept in the broker-dealer's control or used to secure loans not greater in amount than the aggregate amount the broker-dealer has loaned its customers or PAB account holders on such securities.

[b] SEC Net Capital Rule

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The term "net capital" as used in the SEC's net capital rule does not refer to capital in the ordinary accounting sense of the word but only to that portion of a broker-dealer's net assets that are considered under the rule to be liquid and immediately available to meet the obligations of the broker-dealer. [345] The net capital rule requires that registered broker-dealers maintain regulatory "net capital" in a specified minimum amount, [346] calculated in accordance with the "basic" or the "alternative" method discussed below. [347] The effect of the net capital rule is to limit a broker-dealer's ability to use financial leverage and ensure that its liquid assets are sufficient to meet its obligations. [348]

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Under the "basic" method of calculation, a broker-dealer is generally required to maintain liquid net capital in an amount not less than one-fifteenth of its unsecured indebtedness (as defined in the net capital rule, "aggregate indebtedness"). [349] The consequence of this requirement is that the broker-dealer is required to have a cushion of net liquid assets equal to one-fifteenth of its aggregate indebtedness. Under the "alternative" method of calculation, a broker-dealer is required to maintain net capital equal to the greater of $250,000 or 2% of the aggregate of the debit items as calculated in the reserve formula described in § 14.07[2][a][ii]. The consequence of this requirement is that the broker-dealer is required to cover the amount it owes to its customers with a combination of the amount it deposits in its reserve accounts and the amount that its customers owe to it, calculated in each case in accordance with the customer protection rule, plus a cushion of liquid net capital equal to 2% of what its customers owe to it.

Most broker-dealers calculate their net capital requirement by the basic method; however, the largest broker-dealers (and often smaller broker-dealer affiliates within the same holding company organization) typically calculate by the alternative method. [350] Whichever method a broker-dealer uses to calculate net capital, the minimum amount of net capital that a broker-dealer must maintain, taking into account its aggregate indebtedness or debits, is referred to herein as its "minimum capital requirement."

[i] *Method of Computation*

The computation of net capital by both the basic and alternative methods begins with net worth, as determined under U.S. GAAP. [351] In computing net

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worth, the broker-dealer's securities and commodities positions are marked to the market. To that number are added back satisfactorily subordinated liabilities that generally must, among other requirements, have a term of at least one year. [352] The value of the broker-dealer's assets is then discounted to reflect conservative assumptions about its ability quickly to convert its assets into cash during an environment of difficult liquidity. Nonfinancial and illiquid assets (goodwill, furniture and fixtures, buildings, prepaid expenses and exchange seats) are deducted in their entirety. Certain operational and bookkeeping charges are also deducted. Most unsecured receivables are treated as illiquid assets and deducted from net worth. These deductions leave a remainder consisting of virtually only cash and securities. [353]

The net capital rule requires a broker-dealer to take a 100% charge to its net worth for its securities positions that cannot be sold and payment received reasonably promptly. Thus, securities that have no "ready market," such as certain restricted private placement securities, may have zero value for net capital purposes. [354]

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Broker-dealers are also required to reduce their net worth in the calculation of net capital by certain percentages (commonly called "haircuts") of the market value of their securities and financial assets that do have a ready market. [355] Haircuts are deducted to provide a margin of safety against losses that may be incurred by broker-dealers in liquidating their securities positions; the amount of the haircut depends on the nature, term and liquidity of the security.

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For example, these haircuts range from no haircut at all for U.S. and Canadian government bonds maturing in less than three months [356] to 15% of the market value of equity and noninvestment grade bond positions. [357] Contractual commitments to buy or sell securities are viewed as positions in the securities themselves but with limited offset against other positions. [358]

After all the required deductions have been taken, a broker-dealer with positive net capital has more than one dollar of liquid assets for each dollar of liabilities (except for those liabilities properly subordinated to customers and other creditors). Of course, it is not enough that a broker-dealer have positive net capital; the broker-dealer's net capital must exceed its minimum net capital requirement. [359]

[ii] *Early Warning Requirements*

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In addition to the minimum net capital requirement, the net capital rule and the rules of the SROs specify early warning levels below which a broker-dealer's net capital may not fall without adverse consequences. [360] For example, a broker-dealer computing net capital on the alternative method may not withdraw equity capital in any form to pay shareholders if its net capital is less than the greater of 5% of its debits computed in accordance with the reserve formula or (if also registered under the CEA) 7% of the funds required to be segregated pursuant to the CEA. [361]

The well-publicized closing of the registered broker-dealer Drexel Burnham Lambert ("Drexel") was preceded by large withdrawals of capital from Drexel by its parent holding company, which was not a registered broker-dealer. Shortly thereafter, the holding company filed for bankruptcy. In the wake of these events, the SEC adopted amendments to the net capital rule that require, under certain circumstances, a registered broker-dealer to notify the SEC two business days before withdrawing capital for the benefit of an owner, employee or affiliate. [362] The SEC issued only one order under these amendments before modifying the provision in 2013. [363] As amended in 2013, Rule 15c3-1(e)(3) gives the SEC authority to restrict withdrawals, advances and loans "under such terms and conditions as the Commission deems necessary or appropriate in the public interest or consistent with the protection of investors" for a period of up to 20 business days if the SEC finds that the withdrawals, advances or loans could "be detrimental to the financial integrity of the broker or dealer or may unduly jeopardize the broker or dealer's ability to repay its customer claims or other liabilities." [364]

These net capital rule amendments pertain specifically to transactions between a broker-dealer and its affiliates. The amendments provide that "any transaction" between a broker-dealer and an affiliate that "results in a diminution of the [broker-dealer's] net capital shall be deemed to be an advance or loan of net capital" [365] and thus could require, subject to the other provisions in the rule amendments, the prior approval of the SEC. In 2013, the SEC amended the net capital rule to require that a broker-dealer treat as a liability any capital that is contributed under an agreement giving the investor the option to withdraw it or that is contributed with the intent to withdraw the capital within one year. [366]

[iii] *Alternative, Risk-Based Requirements for Broker-Dealers Subject to Consolidated Supervision*

In 2004, the SEC amended the net capital rule to permit a broker-dealer that maintains $1 billion of "tentative net capital" [367] and $500 million of net capital to apply to the SEC for a conditional exemption from the net capital rule that would allow the broker-dealer to use an alternative, risk-based method for calculating deductions from net capital for market and derivatives-related credit risk. [368] In order to qualify for the exemption, the broker-dealer must comply with certain enhanced net capital, early warning, recordkeeping, reporting and other requirements, and must implement and document an internal risk management system.

In addition—until the program ended in 2008—the broker-dealer's holding company and affiliates (referred to collectively as a "consolidated supervised entity" ("CSE")) were required to consent to group-wide supervision by the SEC and comply with certain other requirements through its CSE Program. Under the CSE Program, the holding company, depending on whether it had a principal regulator (as defined in the rules), was required, among other things, to provide the SEC with information regarding its activities and risk exposures; consent to SEC examination of its nonregulated affiliates; and as part of its reporting requirements, compute, on a monthly basis, group-wide allowable capital and allowances for market, credit and operational risk in accordance with standards adopted by the Basel Committee on Banking Supervision. However, after the near collapse of Bear Stearns and the collapse of Lehman Brothers (two of the

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five CSE investment bank holding companies), [369] the SEC terminated the CSE Program entirely. [370] The remaining CSE holding companies have converted into bank holding companies and are now subject to consolidated supervision by the Federal Reserve, rather than the SEC. The broker-dealers originally owned by CSE holding companies continue to use the alternative, risk-based computation method to compute net capital but the SEC has instructed these broker-dealers to take standardized net capital charges on certain less liquid asset-backed securities positions. [371]

[iv] *Solvency Requirement*

In 2013, the SEC amended Rule 15c3-1(a) to require that, in addition to maintaining net capital no less than its minimum net capital requirement, the broker-dealer must otherwise not be "insolvent." [372] By making solvency a requirement of Rule 15c3-1, the SEC required a broker-dealer to cease conducting a securities business upon insolvency. The SEC defined "insolvent" in Rule 15c3-1(c) to mean circumstances in which the broker-dealer (1) is the subject of any bankruptcy, equity receivership proceeding or any other proceeding to reorganize, conserve, or liquidate such broker-dealer or its property or to apply for the appointment or election of a receiver, trustee, or liquidator or similar official for such broker or dealer or its property; (2) has made a general assignment for the benefit of creditors; (3) is insolvent within the meaning of Section 101 of the United States Bankruptcy Code, or is unable to meet its obligations as they mature, and has made an admission to such effect in writing or in any court or before any agency of the United States or any State; or (4) is unable to make such computations as may be necessary to establish compliance with Rule 15c3-1 or Rule 15c3-3.

[c] Securities Investor Protection Act

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One primary purpose of SIPA is to detail procedures for the liquidation of failed broker-dealers. [373] The second major purpose of SIPA is to provide limited insurance to customers of failed broker-dealers. Such insurance is provided through the Securities Investor Protection Corporation ("SIPC"), [374] a membership corporation that registered broker-dealers are generally required to join, [375] and the SIPC fund created through SIPC's assessments on its member broker-dealers. [376]

SIPA provides that customers of a failed broker-dealer have priority over other unsecured creditors in the distribution of the broker-dealer's customer-related property. Each "customer" of a failed broker-dealer is entitled to receive all of that customer's "customer name securities" and a ratable share of all "customer property" held by the failed broker-dealer. [377]

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The SIPC fund will pay the unsatisfied portion of any claim of a customer up to $500,000, up to $250,000 of which can be for cash the customer had on account with the broker-dealer. [378] Banks, brokers and dealers (each as defined in the Exchange Act) are not eligible to collect SIPC fund insurance. [379] However, a broker-dealer or bank that can establish that assets held with a failed broker-dealer were for the benefit of its own customers will be deemed to stand in the shoes of its customers, and thus would be entitled (to the extent its own customers were so entitled) to SIPC fund insurance. [380]

[3] Self-Regulatory Organizations

As noted above, regulation of broker-dealers by SROs is a crucial element of the broker-dealer regulatory scheme. SROs themselves register with the SEC under the Exchange Act and are subject to substantial SEC regulation. [381] SRO

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proposals to amend their rules generally must be submitted for approval to the SEC. [382] In addition, the SEC has the authority, by rule and in accordance with procedures specified in the Exchange Act, to abrogate, add to and delete from an SRO's rules. [383]

The Exchange Act requires SROs to enforce their own rules and the U.S. securities laws generally against their members. [384] All resulting disciplinary proceedings of an SRO against a broker-dealer or associated person must meet certain standards intended to guarantee due process [385] and the results of such proceedings are subject to SEC review. [386]

[a] SRO Regulation of Broker-Dealers

SROs all have rules that govern conduct by members in order to protect investors, securities markets and the trading markets operated by the SRO in question. [387] While most of the SROs' rules are detailed and focus on specific behavior, the SROs also have general injunctions requiring "fair," "just" or otherwise proper behavior in terms that are less explicit than those found in the securities laws or the SEC's rules. For example, FINRA Rule 2010 provides that members shall in the conduct of their business "observe high standards of commercial honor and just and equitable principles of trade." [388] Such rules have been used, as discussed below, as the authority for enforcing very specific standards of behavior and for carrying out significant disciplinary proceedings against members.

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While there are 20 active securities exchanges that are registered under the Exchange Act [389] and function as SROs, the most important SRO with respect to broker-dealer regulation is FINRA. [390] The following discussion will focus on FINRA rules, but the rules of any other SROs of which a broker-dealer is a member must of course also be followed. While FINRA rules are far too detailed to be considered in full, certain of their principal areas of coverage are worth noting.

[i] *FINRA Rules*

Many of the most important FINRA rules and interpretations derive from FINRA Rule 2010, which requires members, in the conduct of their business, to "observe high standards of commercial honor and just and equitable principles of trade." In many respects, this rule has been interpreted to produce results with respect to customer protection that are similar to those of the "shingle theory" under the antifraud provisions of the securities laws applicable to broker-dealers. [391] In some cases, however, FINRA rules (including NASD rules and Incorporated NYSE rules), including FINRA Rule 2010, and interpretations of those rules go beyond the SEC's positions under the securities laws.

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Certain FINRA rules regulate activities in connection with public securities distributions. FINRA Rule 5110 governs the amount of underwriting compensation that an underwriter may receive in connection with a public offering of securities, [392] FINRA Rule 5130 prohibits an underwriter from selling new issues of equity securities to certain categories of "restricted persons," [393] while FINRA Rule 5131 restricts underwriters from selling new issues of equity securities to certain executive officers or directors of public companies and covered nonpublic companies and from engaging in certain other activities in connection with such new issues. [394] Price maintenance in fixed price public offerings is governed by FINRA Rule 5141, intended to prevent broker-dealers from giving price advantages to certain customers in such offerings (*e.g.*, by giving discounts to institutional but not retail customers) or failing to make a *bona fide* offering of the securities to the public (*e.g.*, by selling the securities to "related persons" of the broker-dealer). [395]

Many of FINRA's Rules cover subjects such as discretionary accounts and activities in connection with the distribution of investment company securities, in which FINRA members are particularly likely to be involved with retail customers. [396] FINRA Rule 2111 requires that members have a reasonable basis to believe that securities they recommend to a customer are suitable for the customer, based on information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. [397]

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FINRA Rule 5310 requires that the broker-dealer use reasonable diligence to obtain a price for the customer that is as favorable as possible under prevailing market conditions (often referred to as the duty of "best execution"), [398] and FINRA Rules 2121 and 2122, respectively, require that prices and commissions charged in over-the-counter securities transactions be "fair" [399] and that charges for services be reasonable and not unfairly discriminatory. [400] Additionally, the SEC adopted rules in 2000 to improve public disclosure of order execution and routing practices. [401] These rules are intended to spur more vigorous competition among market participants to provide the best prices for investor orders. Certain rules provide the authority for more specific interpretations. For example, FINRA Rule 2121 regarding prices and commissions is the authority for detailed interpretations promulgating the so-called "5% policy," to the effect that sales to customers at mark-ups in excess of 5% over the inter-dealer price are almost always excessive and that, depending on the circumstances, lower mark-ups may

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also be excessive. [402] Other important activities covered in the FINRA Rules include the following:

- margin limitations on the extension of credit to customers; [403]
- the sending of advertising materials to customers; [404]
- special rules governing the sale of particularly complex or risky products to customers, including options, warrants, investment company securities, variable contracts of investment companies, limited

partnership interests, collateralized mortgage obligations and security futures; [405]

- members trading as principal while holding an order from a customer on the same side for the security in question; [406]
- members' trading activities that occur in anticipation of the firm's issuance of research reports regarding a security; [407] and
- member's publication or circulation of transactions and quotations. [408]

FINRA has separate rules governing, among other things, relations between its member broker-dealers, arbitration, trade reporting and settlement. [409]

FINRA rules are in certain respects more demanding than those of the SEC. For example, while the SEC's Rule 15c3-1 generally permits broker-dealers to have aggregate indebtedness that is 15 times net capital, [410] FINRA generally does not permit its member broker-dealers to have aggregate indebtedness in excess of 12 times net capital. [411] Further, FINRA may in fact require

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its members to have more capital than its written rules require. FINRA requires that its members impose initial and maintenance margin requirements on their customers' securities-related borrowings, while the Board's rules under the Exchange Act impose only an initial margin requirement. [412] In addition, FINRA members generally cannot disseminate research reports or make recommendations regarding publicly outstanding equity or noninvestment grade debt securities of their direct or indirect parent companies or other "material associated persons" (as defined in Rule 17h-1T under the Exchange Act). [413] FINRA also reserves the right to disapprove of the outside activities of the controlling persons of a member so as to ensure that these persons will, among other things, not be subject to conflicts of interest. [414] Furthermore, FINRA imposes minimum qualification requirements for high-level personnel. [415] The NYSE and the other exchanges also, of course, have detailed rules governing exchange trading and settlements.

Effective in 2017, FINRA has established a streamlined set of rules for "capital acquisition brokers" ("CABs"). Capital acquisition brokers register as broker-dealers with the SEC but elect to be subject to FINRA's CAB Rules (rather than FINRA's regular rules) and to limit their activities to one or more of:

(A) advising an issuer, including a private fund, concerning its securities offerings or other capital raising activities;

(B) advising a company regarding its purchase or sale of a business or assets or regarding its corporate restructuring, including a going-private transaction, divestiture or merger;

(C) advising a company regarding its selection of an investment banker;

(D) assisting in the preparation of offering materials on behalf of an issuer;

(E) providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;

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(F) qualifying, identifying, soliciting, or acting as a placement agent or finder (i) on behalf of an issuer in connection with a sale of newly-issued, unregistered securities to institutional investors or (ii) on behalf of an issuer or a control person in connection with a change of control of a privately-held company; [416] and

(G) effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company through the purchase, sale, exchange, issuance, repurchase, or redemption of, or a business combination involving, securities or assets of the company, to a buyer that will actively operate the company or the business conducted with the assets of the company, in accordance with the terms and conditions of an SEC rule, release, interpretation or "no-action" letter that permits a person to engage in such activities without having to register as a broker or dealer pursuant to § 15(b) of the Exchange Act. [417]

FINRA's CAB Rules differ from FINRA's regular rules principally by elimination of FINRA rules that would not be applicable to a FINRA member engaged only in the limited business of a capital acquisitions broker; however, there are some potential material advantages to operating under the CAB Rules, including:

- Capital acquisition brokers are not subject to FINRA Rules 2121 and 2122, which require FINRA members to charge fair prices and commissions for securities transactions and levy charges for other services that are reasonable and not unfairly discriminatory. Capital acquisition brokers are, however, subject to FINRA Rule 2010, which requires members to observe high standards of commercial honor and just and equitable principles of trade; [418]
- Capital acquisition brokers are subject to a streamlined rule relating to communications with the public that does not prohibit communications from including predictions or projections of performance; [419] and
- The supervisory rules applicable to capital acquisition brokers do not require annual compliance meetings, review and investigation of securities transactions, specific documentation and supervisory procedures, internal inspections or CEO certification about compliance procedures. [420]

There are also some material disadvantages to operating under the CAB Rules, most notably the limitation on the capital acquisition broker's business activities and a prohibition on any person associated with a capital acquisition broker engaging in any securities transaction outside the regular course or scope of that person's employment with the capital acquisition broker (other than investing on his or her own behalf and transactions among immediate family members for which no associated person received selling compensation). [421] This means that capital acquisition broker personnel generally could not be dual employees with another broker, bank or financial institution unless they did not participate in any securities transactions for that other broker, bank or financial institution.

[b] SRO Regulation of Broker-Dealer Personnel

The SEC does not, for the most part, directly regulate the competence or background of broker-dealer personnel, but rather assigns that responsibility to the SROs. The failure of a broker-dealer to register and qualify its personnel in accordance with applicable SRO rules is, however, a violation of Rule 15b7-1 under the Exchange Act that can subject the broker-dealer to fines of up to

$100,000 per violation. [422] FINRA is the primary regulator of the employees of registered broker-dealers. FINRA's rules generally require that any person engaged in the investment banking or securities business of a member firm register with FINRA, [423] and its rules apply to the activities of each "associated person of a member" as well as of each member broker-dealer. [424] FINRA also prescribes four general levels of competency for associated persons of FINRA members: (i) "principals," who generally are officers and other management and supervisory personnel who have taken and passed the FINRA's General Securities Principal ("Series 24") Examination, (ii) "registered representatives," who include other employees of FINRA member firms whose functions are not solely clerical or ministerial and who have taken and passed FINRA's General Securities Representative Examination ("Series 7"), (iii) "research analysts," who include employees of FINRA member firms whose primary functions are the preparation of research reports or whose name appears on research reports and who have taken and passed FINRA's Series 7 Examination and FINRA's Research Analyst Qualification ("Series 86/87") Examination; [425] and (iv) "operations professionals," who generally are personnel performing or supervising certain enumerated "back office" functions and persons with authority materially to commit a member firm's capital to such functions and who have taken and passed FINRA's Operations

Professional Qualification (Series 99) Examination. [426]

Each FINRA member, with very limited exceptions, must have at least two registered principals (who must pass a qualification examination for principals)

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actively engaged in the member's business with respect to each aspect of the member firm's investment banking and securities business. [427] Large firms have many supervisory and management level personnel registered as principals. Principals must be responsible for supervision, solicitation, conduct of business and training. The firm's chief financial officer (or an individual with equivalent responsibilities) must take and pass the Financial and Operations Principal Examination ("Series 27") and register as the member's financial and operations principal (commonly referred to as a "FinOp"). [428] FINRA also requires a member to designate a chief compliance officer and for that officer to be Series 24-licensed. [429] In addition, depending upon the nature of its business, a FINRA member may be required to have other "limited principals"; for example, "registered options and security futures principals" are required if the FINRA member engages in an options or security futures business with the public. [430]

Each associated person of a FINRA member generally must individually register with FINRA by having the member complete Form U4. [431] The form requires information concerning the position that the associated person will have with the broker-dealer, the person's employment and personal history for the past ten years and whether the person has ever been charged or involved with an investment-related crime or comparable crime involving personal dishonesty or is otherwise subject to "statutory disqualification." [432] The required registration of associated persons allows FINRA to serve as the central depository for information on associated persons of its members. [433]

In addition to completing Form U4, the associated persons of a broker-dealer generally must pass one or more qualifying examinations, depending on the types of securities business or investment banking in which they are involved and the level of their responsibilities. Despite certain efforts to ease the burden of the examination process and the number of qualifications necessary to operate

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across international borders, preparation for these examinations can be time-consuming and thus personnel of foreign broker-dealers have in many instances been discouraged from taking the examinations and qualifying as employees of a U.S. broker-dealer. [434]

All registered broker-dealer personnel are also required to complete a two-part continuing education program. [435] The program, which has been approved by the SEC, focuses on current compliance, regulatory, ethical and sales-practice standards. FINRA administers the industry-wide regulatory element of the program *via* computer-based training to broker-dealer personnel in their second year of registration and every three years thereafter, while each broker-dealer is required to implement an ongoing in-house education program to keep its employees up to date on job and product-related subjects. [436] While broker-dealer personnel are not subject to grades or examination with respect to this program, failure to complete the regulatory element of the continuing education program may result in an associated person's FINRA registration being terminated. In addition, failure by a broker-dealer or individual employee to comply with the education program may subject such broker-dealer or employee to disciplinary action. [437]

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When terminating an associated person of a FINRA member, broker-dealers are required to file a Form U5 (Uniform Termination Notice for Securities Industry Registration). This form requires broker-dealers to state the reason for the employee's termination, and if the termination is for misconduct, the broker-dealer must give details regarding this misconduct. [438] Broker-dealers that, in accordance with this requirement, candidly state the basis of dismissal have, however, faced legal actions by dismissed employees for libel or other torts, leading some broker-dealers to support legislation that would grant legal immunity from such claims for broker-dealers acting in good faith. [439] In 2007, the New York Court of Appeals ruled that an employer's statements on a Form U5 are protected by an absolute privilege in defamation lawsuits. [440]

[4] Anti-Money Laundering Compliance Obligations

SEC-registered broker-dealers are subject to a variety of anti-money laundering (or "AML") compliance obligations under the Bank Secrecy Act of 1970 (the "BSA"), [441] as amended by the USA PATRIOT Act (the "PATRIOT Act") [442] and as implemented in regulations adopted by the Financial Crimes Enforcement Network ("FinCEN") (in some cases jointly with the SEC) [443] and in rules adopted by SROs. This section briefly summarizes the most noteworthy of these compliance obligations.

[a] Background

Before the PATRIOT Act was enacted, U.S. broker-dealers that were not affiliates of banking organizations were not subject to the core AML compliance obligations that applied to commercial banks and their affiliates under the BSA.

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Although many other countries with leading financial centers applied AML compliance obligations to investment banking firms, it was unclear to what extent U.S. broker-dealers were vulnerable to money laundering. Most broker-dealers do not regularly accept cash or other monetary instruments, and many broker-dealers have policies against accepting cash. [444]

At the same time, broker-dealers were subject to criminal money laundering laws and to BSA reporting requirements relating to large currency transactions. Broker-dealers also were permitted to file suspicious activity reports ("SARs") under the BSA on a voluntary basis (and many large broker-dealers routinely did so). As a result, many large broker-dealers had adopted AML programs before they were required to do so under the PATRIOT Act.

[b] Anti-Money Laundering Program Requirements

Under § 352 of the PATRIOT Act, all SEC-registered broker-dealers must establish an AML program. [445] Under FinCEN's regulations implementing § 352, a broker-dealer is deemed to be in compliance with § 352 if it complies with the AML requirements of an applicable SRO. [446] Accordingly, FINRA adopted Rule 3310, which requires its broker-dealer members to develop and implement AML programs that contain the key elements identified in § 352. [447] A broker-dealer subject to the AML program requirements of FINRA must adopt written policies and procedures reasonably designed to ensure that it not be used to launder money. The broker-dealer also is required under FINRA Rule 3310 to provide for

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periodic independent testing of its AML program, designate an AML compliance officer and provide ongoing training to employees. [448]

[c] Suspicious Activity Reporting Requirements

As required by the PATRIOT Act, FinCEN has promulgated suspicious activity reporting requirements for registered broker-dealers. [449] Broker-dealers currently are required to file SARs on FinCEN Form 111 for any transaction conducted or attempted by, at or through a broker-dealer involving at least $5,000, where the broker-dealer knows, suspects or has reason to suspect that the transaction (or pattern of transactions): (i) involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade any federal law or regulation or transaction reporting requirement, (ii) is designed to evade BSA regulatory requirements, (iii) has no business or apparent lawful purpose, or is not the type of activity in which the particular customer would normally be expected to engage and for which the broker-dealer upon examination knows of no reasonable explanation, or (iv) involves use of the broker-dealer to facilitate criminal activity. [450]

A broker-dealer that files a SAR is generally prohibited from disclosing the fact that a SAR was filed, or any information that would reveal the existence of a SAR, to any person, including any person involved in the reported transaction. [451] This confidentiality requirement does not, however, prevent broker-dealers from sharing SARs with their parent companies and with other affiliates that are also subject to SAR regulation and a written confidentiality agreement with respect to maintaining the confidentiality of SARs. [452] In addition, under the

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BSA, broker-dealers benefit from a general safe harbor from liability (*e.g.*, defamation liability) for filing a SAR. [453] Although at least one court has suggested that this safe harbor requires that the reporting institution have a "good faith suspicion," [454] the weight of judicial authority has rejected this requirement. [455]

[d] Customer Identification Programs

As part of their broader AML program, registered broker-dealers are required to adopt a written Customer Identification Program ("CIP"). [456] A CIP must include procedures for (i) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable, (ii) maintaining records of the information used to verify the person's identity, including name, address, and other identifying information, and (iii) determining whether the

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person appears on any lists of known or suspected terrorists or terrorist organizations provided to the broker-dealer by any governmental agency. [457] These procedures are not required for certain classes of customers, such as financial institutions (as defined in the BSA) that have a federal functional regulator (or, in the case of state banks, a state regulator), entities with publicly traded shares and certain governmental entities. [458] The CIP rules that apply to broker-dealers, issued jointly by FinCEN and the SEC, contain specific requirements relating to permissible documentary and nondocumentary methods for verifying a customer's identity, recordkeeping requirements, procedures for checking customer names against government lists, and providing notice to customers regarding the collection of identifying information. [459]

The CIP rule for broker-dealers permits broker-dealers to rely on certain types of BSA-regulated financial institutions (including affiliates) to perform the procedures required under the broker-dealer's CIP. Such reliance must be "reasonable under the circumstances," and only BSA-regulated financial institutions that are required to adopt an AML program under § 352 of the PATRIOT Act are eligible. [460] In addition, the financial institution must enter into a contract requiring it to certify annually to the broker-dealer that the financial institution has

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implemented its AML program, and that it (or its agent) will perform specified requirements of the broker-dealer's CIP. [461]

[e] Customer Due Diligence

In May 2016, FinCEN issued a final rule (the "Final CDD Rule") formalizing regulatory expectations regarding customer due diligence and introducing a new requirement for broker-dealers to identify and verify the identity of the beneficial owners of their legal entity customers. [462] Specifically, the Final CDD rule will impose a requirement on broker-dealers to identify and verify the identity of certain of their legal entity customers' "beneficial owners," defined as: (i) each individual directly or indirectly owning 25% or more of the entity's equity interests, and (ii) a single individual with significant responsibility to control, manage or direct a legal entity customer. [463] The deadline for compliance with the requirements of the Final CDD Rule is May 2018. [464]

The Final CDD Rule includes certain exemptions and exclusions, including not requiring beneficial ownership diligence for certain types of publicly traded companies, pooled investment vehicles, regulated financial institutions and trusts. [465] FinCEN has also indicated that, to the extent that existing guidance allows a broker-dealer to treat an intermediary (and not the intermediary's customers) as its customer for CIP purposes, the broker-dealer should treat the intermediary as its legal entity customer for purposes of the beneficial ownership requirement. [466] For example, a broker-dealer that appropriately maintains an omnibus account for an intermediary may treat the intermediary, and not the

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underlying clients, as its legal entity customer for purposes of the beneficial ownership requirement. [467] Additionally, when the Final CDD Rule applies to a broker-dealer's relationship with a legal entity customer, formal reliance on another financial institution to perform the beneficial ownership diligence is possible under the same conditions that apply to reliance for CIP purposes. [468]

[f] Information Sharing Requirements

FinCEN's rule implementing § 314(a) of the PATRIOT Act (the "Information Sharing Rule") gives FinCEN the power to request, on its own behalf and on behalf of federal, state, local and certain foreign law enforcement authorities, information regarding suspected terrorists or money launderers from broker-dealers and other BSA-regulated financial institutions. [469] A financial institution that receives such a request is required to search its records to determine whether it maintains or has maintained any account (within the last 12 months) or has engaged in certain transactions (within the last 6 months) for or on behalf of the named subject or subjects of the request. [470] The Information Sharing Rule clarifies that a financial institution need not take further action with respect to an account or transaction that may be related to a suspected money launderer and that, unless otherwise specified, information requests are not continuing in nature.

The Information Sharing Rule also implements § 314(b) of the PATRIOT Act, which permits financial institutions to share information with each other regarding known and suspected terrorists and money launderers, upon prior

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notice to FinCEN (which notice is effective for one year, subject to renewal). Before sharing information under the Information Sharing Rule, a financial institution must take reasonable steps to verify that the other financial institution with which it intends to share information has submitted its own notice to FinCEN under § 314(b). [471] Section 314(b) and the Information Sharing Rule also provide a safe harbor protecting financial institutions from liability under U.S. federal, state and local law for sharing information or failing to notify the subject of the shared information. [472]

[g] Private Banking and Correspondent Account Due Diligence

Under § 312 of the PATRIOT Act, [473] broker-dealers and other BSA-regulated financial institutions are required to perform due diligence, and in some cases enhanced due diligence, on non-U.S. persons for whom the financial institution "establishes, maintains, administers, or manages" a "private banking account" in the United States. [474] The financial institution is required to take reasonable steps to ascertain the identity of the nominal and beneficial owners of, and sources of funds deposited into, the account. In addition, the financial institution is required to conduct enhanced scrutiny of any account requested or maintained by or on behalf of a senior foreign political figure (also referred to as a "politically exposed person" or "PEP"), or any of his or her immediate family members or close associates in order to detect and report transactions that may involve the proceeds of foreign corruption.

Under § 312, broker-dealers and other BSA-regulated financial institutions are also required to perform due diligence, and in some cases enhanced due diligence, with respect to "correspondent accounts" for non-U.S.

persons. [475] The definition of "correspondent account" for purposes of the PATRIOT Act is extremely broad—far exceeding any conventional understanding of the term

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"correspondent banking account." [476] "Correspondent account" is defined to mean "an account established for a foreign financial institution to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution." [477] The term "account" in the definition of "correspondent account" is defined for broker-dealers to mean "any formal relationship established with a broker or dealer in securities to provide regular services to effect transactions in securities, including, but not limited to, the purchase or sale of securities and securities loaned and borrowed activity, and to hold securities or other assets for safekeeping or as collateral." [478]

In 2005, FinCEN adopted final rules implementing § 312 of the PATRIOT Act, replacing the interim rule that had been in effect since 2002. [479] FinCEN adopted the statutory definition of "correspondent account," but modified the due diligence requirement to be more risk-based. Under the final rule for correspondent accounts for foreign financial institutions and private banking accounts, broker-dealers must establish a due diligence program that includes appropriate, specific, risk-based and, where necessary, enhanced policies, procedures and controls reasonably designed to detect and report known or suspected money laundering activity through or involving any correspondent account or private banking account. [480]

In August 2007, FinCEN adopted rules requiring "enhanced" due diligence for correspondent accounts of foreign banks operating under (i) an offshore banking license, (ii) a license issued by a country designated as noncooperative with international AML principles by an intergovernmental group or organization of which the United States is a member and with which designation the U.S. representative to the group or organization concurs or (iii) a license issued by a country designated by the U.S. Treasury Department as warranting special measures due to money laundering concerns. [481]

[h] Foreign Shell Bank Prohibition and Correspondent Account Recordkeeping Requirements

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Registered broker-dealers are prohibited under § 313(a) of the PATRIOT Act [482] from establishing, maintaining, administering or managing a correspondent account in the United States for or on behalf of any "foreign shell bank" (*i.e.*, a foreign bank that does not have a physical presence in any jurisdiction), unless the foreign bank is a so-called "regulated affiliate." [483] Broker-dealers also must take "reasonable steps" to ensure that a correspondent account maintained for a foreign bank is not used by the foreign bank indirectly to provide banking services to a foreign shell bank (other than a regulated affiliate).

Under § 319(b) of the PATRIOT Act, registered broker-dealers must maintain records identifying the owners and designated U.S. agents for service of process of foreign banks for which they maintain a correspondent account. Records regarding the foreign bank's owners are not required for foreign banks whose shares are publicly traded or that report ownership information to the Board on Form FR Y-7 (which thus excludes most foreign banks with U.S. banking operations). [484]

FinCEN has not mandated a specific method by which broker-dealers must comply with the shell bank prohibition or the correspondent account recordkeeping requirements of the PATRIOT Act. However, FinCEN has promulgated a form of certification that can be used as a safe harbor for compliance with these provisions. In order to satisfy the safe harbor, the certification must be renewed every three years. [485]

[5] Research Analysts and Research Reports

FINRA Rule 2241 addresses the publication of research reports analyzing equity securities by FINRA members and the conduct of research analysts responsible for preparing such reports. The rule requires members to establish, maintain and enforce written policies and procedures reasonably designed to identify and effectively manage conflicts of interest related to the preparation,

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content and distribution of research reports, public appearances by research analysts and the interaction between research analysts and nonresearch personnel. Among other things, these policies and procedures must:

- prohibit prepublication review, clearance or approval of research reports by persons engaged in investment banking services and restrict such review by personnel not responsible for their preparation, content and distribution;
- restrict input by the investment banking department into research coverage decisions to ensure that research management independently makes final decisions regarding research coverage;
- prohibit persons engaged in investment banking activities from supervising or controlling research analysts, retaliating against them as a result of unfavorable research reports or public appearances, directing them to engage in sales or marketing efforts related to an investment banking services transaction, or directing them to engage in any communication with a current or prospective investment banking customer; [486]
- limit determination of the research department budget to senior management (excluding management engaged in investment banking activities) and prohibit compensation based on specific investment banking transactions or contributions to investment banking activities; [487]
- establish information barriers or other institutional safeguards reasonably designed to ensure that research analysts are insulated from the review, pressure or oversight by persons engaged in investment banking activities or other persons (including sales and trading personnel) who might be biased in their judgment or supervision;
- define periods during which the member must not publish research reports or allow public appearances by research analysts, including a minimum of ten days following the date of any initial public offering by the subject company if the member participated as underwriter or dealer in the offering and a

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  minimum of three days following the date of any secondary offering if the member acted as manager or co-manager of the offering; [488]
- restrict or limit research analyst trading in securities covered by the research analyst (and any derivatives or funds whose performance is materially dependent on the performance of such securities), including ensuring that research analysts and related personnel do not benefit from knowledge of the content or timing of the research report before the intended recipients have a reasonable opportunity to act on the information in the report, prohibiting research analyst accounts from trading in a manner inconsistent with a research report or recommendation and prohibiting research personnel from purchasing or receiving pre-IPO securities from issuers engaged in the business that the research analyst follows;
- prohibit explicit or implicit promises of favorable research, recommendations or specific research content as an inducement for the receipt of business or compensation;
- restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity, such as participation in pitches or other solicitations of investment banking services, participation in road shows or other marketing on behalf of an issuer related to an investment banking services transaction; and

- prohibit prepublication review of a research report by a subject company (*i.e.*, a company whose equity securities are the subject of the report) for purposes other than verification of facts.

In addition to requiring members to identify and manage conflicts of interest, Rule 2241 requires FINRA members to establish, maintain and enforce written policies and procedures reasonably designed to ensure that purported facts in research reports are based on reliable information and any recommendation, rating or price target has a reasonable basis and is accompanied by a clear explanation of the valuation method used and a fair presentation of the risks that may impede its achievement. Equity research reports are also required to include:

- specific information regarding the member firm's rating system;
- graphical representations of the member's historic rating or price target for the subject company and subject company's share price;

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- disclosure regarding any financial interest the research analyst or any member of the analyst's household has in the subject company;
- disclosure if the research analyst received any compensation based on the member's investment banking revenue;
- disclosure if the member or its affiliates managed or co-managed a public offering for the subject company in the last twelve months, received any investment banking or other compensation from the subject company in the last twelve months or expects to receive investment banking compensation from the subject company in the next three months;
- disclosure if the member or its affiliates beneficially own 1% or more of any class of common equity of the subject company or if the member is making a market in the subject company's securities;
- disclosure if the research analyst received any compensation from the subject company in the previous twelve months;
- disclosure of any other material conflict of interest of the research analyst, member firm or any associated person of the member with the ability to influence the content of the research report. [489]

These disclosures must either appear on the front page of the research report or the front page must refer to the page on which they can be found (although compendium reports covering six or more companies may direct the reader in a clear manner to where they can be found). [490]

If a FINRA member distributes [491] research reports prepared by a person other than the member (including research reports prepared by a foreign affiliate of the member), Rule 2241 provides that each such third-party research report:

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- must be reviewed and approved by a registered principal or supervisory analyst;
- may not be distributed if the FINRA member knows or has reason to know the research is not objective or reliable;
- unless it is an independent third party research report, [492] must be reviewed in accordance with policies and procedures reasonably designed to ensure that that the third-party research report does not contain any untrue statement of material fact or other false or misleading information that should be known from reading the report or is known based on information otherwise possessed by the FINRA member;
- is accompanied by disclosure of any material conflict of interest that can be reasonably be expected to have influenced the choice of third-party research provider or the subject company of the report; and
- is clearly labeled as a third-party research report so that there is no confusion on the part of the recipient

as to the person or entity that prepared the research report. [493]

Finally, Rule 2241 requires FINRA members to notify its customers if it intends to terminate its research coverage of a company and to accompany that notice by a final research report (or its reasons for terminating coverage if providing a final research report is impractical). [494]

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Any associated person of a FINRA member who functions as a research analyst must pass the Research Analyst Qualification ("Series 86/87") Examination or qualify for an exemption or waiver therefrom. [495] Research analysts must be supervised by a research principal who, in addition to passing the General Securities Principal ("Series 24") Examination, also must have passed either Part II of the Research Analyst ("Series 87") Exam-Regulation or the NYSE Supervisory Analyst ("Series 16") Examination. [496]

Effective in early 2016, new FINRA Rule 2242 applies to debt research many of the same requirements that apply to equity research. There are, however, several important differences between FINRA's debt and equity research rules. Most significantly, Rule 2242 exempts from many of its requirements debt research reports that a FINRA member provides solely to certain institutional investors who have consented to receiving institutional research that is not subject to the independence and disclosure standards applicable to debt research reports provided to retail investors. In addition, Rule 2242 extends many provisions of Rule 2241 designed to address conflicts of interest with the member's investment banking department to also apply to the principal trading and sales and trading departments. Finally, the research analyst qualification and registration requirements currently apply only to equity research analysts, although FINRA is considering whether debt research analysts should be subject to the same or similar requirements.

[a] SEC Regulation AC

In 2003, the SEC adopted Regulation Analyst Certification ("Regulation AC"). [497] Regulation AC requires that research analysts make certain certifications with respect to the views expressed by them in research reports and public

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appearances relating to both debt and equity securities. In particular, a research analyst is required to certify in a research report distributed to U.S. persons that (i) the views expressed in the research report accurately reflect the analyst's personal views on any and all subject securities or issuers discussed therein, and (ii) either (a) no part of the analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report ("related compensation"), or (b) all or part of the analyst's compensation consists of related compensation. If the analyst received any related compensation, the research report must also disclose the amount, source and purpose of that compensation and include cautionary language that the receipt of related compensation could influence the recommendation. [498]

A record containing similar disclosures must also be maintained by the broker-dealer employing the analyst (or circulating to U.S. persons research reports prepared by the analyst) in connection with any public appearances made by the analyst during the prior quarter. [499] In cases where the analyst does not provide, or is unable to make, certifications of the type set forth in clauses (i) and (ii)(a) in the preceding paragraph with respect to public appearances, the broker-dealer must notify its designated examining authority of that fact and include, for 120 days after the notification is made, disclosure in research reports prepared by the analyst that the analyst did not provide the required certifications. [500]

[b] Other Developments

In October 2003, a settlement agreement was entered by the U.S. District Court for the Southern District of New York with respect to enforcement actions by the SEC, NYSE, NASD, NASAA, the Attorney General of the State of New York and various state securities regulators (collectively, the "Regulators") against ten of the largest investment banking firms (the "settling firms") (the "Global Research Settlement"). The Global Research Settlement relates to charges by the regulators that the settling firms were engaged in acts and practices that created or maintained inappropriate influence by investment banking

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personnel over equity research analysts, which created conflicts of interest that were not adequately managed or disclosed. While neither admitting nor denying the allegations made, the settling firms agreed to pay the regulators an aggregate of approximately $1.4 billion, a portion of which is comprised of civil penalties and disgorgement in connection with prior activities and the remainder of which was to be used to fund investor education programs and to pay for the procurement of independent research. [501]

In addition, the settling firms (i) agreed to (a) comply with significant restrictions relating to the interaction between the investment banking and equity research departments of their respective firms, (b) make certain additional disclosures to research recipients regarding (among other things) potential conflicts of interest resulting from investment banking activities, and (c) procure and make available to U.S. customers independent, third-party research on the common stock of certain issuers (collectively, the "forward-looking aspects of the Global Research Settlement"), [502] and (ii) entered into a voluntary agreement restricting allocations of securities in so-called "hot IPOs" (*i.e.*, those initial public offerings where the securities begin trading at a premium in the secondary market) to executive officers and directors of public companies (the "IPO Allocation Initiative").

The forward-looking aspects of the Global Research Settlement and the IPO allocation restrictions agreed to by the settling firms have had a significant impact on the way securities offerings are conducted, even for those firms not

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party to the Global Research Settlement or the IPO Allocation Initiative. In particular, these requirements have served as a basis for additional rulemaking by the SEC and the SROs. [503] Moreover, many firms not parties to the Global Research Settlement have concluded that it is appropriate, from a "best practices" point of view, to adopt many, if not all, of the forward-looking aspects of the Global Research Settlement and the IPO allocation restrictions in order to minimize the likelihood of future regulatory action or civil litigation in connection with their own research analyst and investment banking practices. In addition, certain local governmental and municipal authorities and institutional investors with fiduciary obligations (*e.g.*, pension plans) have insisted that other firms comply with some or all of the forward-looking aspects of the Global Research Settlement and the IPO Allocation Initiative as a condition of doing business with them. [504] The Global Research Settlement and SRO research rules also focused renewed attention on the relationship between issuers and analysts. [505]

It is also important to view the structural reforms and other forward-looking aspects of the Global Research Settlement in the context of the other

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existing and proposed regulations regarding research analyst conflicts of interest discussed above. The Global Research Settlement requirements are in addition to, and do not replace, these other regulations and, in the event of any inconsistency, the more restrictive provision (or relevant part of the provision) will control. The Global Research Settlement does, however, provide that if the SEC adopts a rule or approves an SRO rule or interpretation with the stated intent to supersede any of the provisions of the Global Research Settlement, that rule or interpretation will govern and will supersede the relevant settlement provision. [506] To date, no such rule or interpretation has been adopted; instead, the SEC has reinforced the continuing applicability of the Global Research Settlement. [507]

It is also important to note that not all aspects of the Global Research Settlement are still in place. The settling firms' obligation to make available independent, third-party research was subject to a five-year limitation and expired on July 31, 2009. The settlement also contains a provision that allows the parties to modify the order, subject to court approval, unless the SEC believes such a modification to be against the public interest. In 2010, the settling firms and the SEC agreed to a proposal that, among other things, would have removed the firewall between research analysts and investment bankers, permitting communication between the two groups without the presence of legal counsel. The district court approved some of the proposal, but rejected the modification that would have removed the firewall. [508]

[6] Margin Rules—Restrictions on Lending and Borrowing

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[a] Regulation T

The Exchange Act provides that broker-dealers and members of a national securities exchange may not "extend or maintain credit or arrange for the extension … of credit to or for any customer … on any security" (other than an exempted security or a security futures product) in contravention of such rules as are adopted by the Board. [509]

The basic purpose of this provision and the Board's rules thereunder (which are known as the "margin regulations") [510] is to control the amount of credit available in the economy for financing transactions in securities. The margin regulations stem from the belief that an excessive injection of credit had contributed to the stock market run-up that preceded the 1929 stock market crash. It was also thought that an excessive amount of loans used to finance securities dealings had diverted capital from other more productive sectors of the economy. Margin regulations may also protect individual investors against securities speculation in excess of their resources and deter lenders, especially broker-dealers, from imprudent credit practices. [511] However, these were

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secondary considerations, if not incidental results, in the adoption of these regulations. [512]

The Board margin regulation applicable to broker-dealers is Regulation T. [513] Regulation T imposes initial margin requirements for all "purpose credit" (defined as credit used to purchase, carry or trade in any security, whether debt or equity and whether publicly or privately traded) and specifies the collateral that may be used to satisfy such margin requirements (generally either exempted securities or "margin securities" [514]). In addition, Regulation T establishes payment rules in connection with securities transactions. Pursuant to amendments adopted by the Board in 1996, Regulation T also permits broker-dealers to arrange for the extension or maintenance of credit to or for any customer by third parties, provided the broker-dealer does not willfully arrange credit that violates margin regulations applicable to such third-party lenders or the customer (*i.e.*, Regulations U and X). [515]

[i] *Account Structure*

Regulation T requires that all transactions between a broker-dealer and a customer [516] be recorded in one of the broker-dealer's Regulation T "accounts." More specifically, Regulation T requires that each transaction be recorded in the

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broker-dealer's "margin account" [517] unless it is eligible for one of three special purpose accounts.

Loans to customers that are used to finance the purchase, trading or carrying of equity securities generally are recorded in the margin account. The rule of lending in the margin account, very simply stated, is that a broker-dealer may not extend credit to a customer unless the loan value of the customer's securities (as determined in accordance with Regulation T) in the margin account is sufficient to secure the amount of the credit.

Regulation T imposes only an initial margin requirement. In other words, no matter how low the value of the customer's securities collateralizing the broker-dealer's loan falls after the extension of the loan, no additional margin is required. [518] The requirements for credit used to finance a long position in a security in the margin account are summarized below:

Security	***Required Margin***
Marginable equity securities	50% of market value
Exempted and other nonequity securities	“Good faith”
Exchange-traded and OTC options	Determined by relevant options exchange or SRO
Other securities	100% of market value

Regulation T also prescribes margin requirements for short positions in a security: 100% of the market value of the security sold short plus any "good faith margin" in the case of an exempted security or other nonequity security; 150% of the market value in the case of equity securities; and the amount specified by the relevant options exchange or SRO in the case of exchange-traded and OTC options, respectively. [521]

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Generally, to extend credit and to determine a customer's position in a margin account, freely convertible foreign currency may be treated at its U.S. dollar equivalent, provided that the currency is marked to market daily. [522] To the extent that there is a margin deficiency in a foreign currency/foreign securities position, it may be aggregated with the remainder of the customer's account.

A "margin call" on a customer generally must be satisfied within one "payment period" [523] after any deficiency in the customer's margin account is created or increased by new transactions. [524] If the customer does not make up the deficiency in the allotted time, the broker-dealer is required to cure the deficiency by selling securities in the account, subject to a *de minimis* exception. [525]

In addition to the margin account, Regulation T provides for three special purpose accounts in which certain transactions can be recorded: a "cash account," a broker-dealer credit account and a "good faith account." [526] Securities may be purchased in the customer's cash account if the customer has the funds needed to pay for the securities in the account or the customer agrees to make promptly full cash payment for the security before selling it and does not contemplate selling the security before making such payment. [527] A broker-dealer is generally required to obtain full cash payment for securities purchased in a cash account within one payment period, but a customer may be allowed a longer

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period to pay in certain special circumstances. Up to 35 calendar days is allowed to pay for securities purchased in a delivery versus payment (commonly known as "DVP") transaction, provided that delivery is delayed beyond one payment period because of the mechanics of the transactions (and not because of the customer's unwillingness or inability to pay for the purchased securities). [528] Another special circumstance applies to customer purchases of foreign securities in a foreign market. A customer is generally not required to pay for a foreign security purchased in a cash account until one day after the date on which settlement is required to occur by the rules of the relevant foreign securities market, provided that this period does not exceed 35 calendar days. [529]

Securities may be sold in a customer's cash account (or purchased by a broker-dealer from a customer) only if the security is held in the account at the time of sale or if the broker-dealer accepts in good faith the customer's statement that the customer owns the security and will "promptly" (which is generally understood to mean within one payment period) deposit it in the account. As a result, short sales cannot be effected in the cash account.

The good faith account may be used, among other purposes, to finance transactions in securities entitled to "good faith" margin and to extend nonpurpose credit. A written statement of the customer's intent on Board Form T-4 that discloses the specific reason for the borrowing must be obtained prior to any extension of nonpurpose credit other than to finance commodities and foreign exchange transactions. Broker-dealers may also use the good faith account to borrow and lend securities entitled to "good faith" margin (such as nonequity securities). In contrast, equity securities generally may be borrowed or loaned under Regulation T only with a "permitted purpose" unless the lending entity is an "exempted borrower." [530]

[ii] *Margin Securities*

Historically, "margin securities" (*i.e.*, those securities, other than exempted securities, that a broker-dealer is permitted to accept as collateral satisfying a margin requirement for a purpose loan) were largely limited to securities registered under the Securities Act or the Exchange Act and publicly traded in the United States. [531] However, in recent years the Board has gradually broadened the definition of "margin security," particularly with respect to nonequity and foreign securities. In the amendments to Regulation T adopted by the Board in 1997

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(the "1997 Regulation T Amendments"), [532] for example, the Board amended the definition of "margin security" to include any nonequity security. The 1997 Regulation T Amendments also discontinued the Board's previous practice of qualifying over-the-counter stocks as margin securities through inclusion in a periodically published list of "OTC margin stocks," replacing it with a simple test under which any security listed on the Nasdaq Stock Market is deemed to be a margin security. [533] Further, in an effort to facilitate participation by U.S. broker-dealers in international securities transactions, Regulation T includes in the definition of "margin security" certain "foreign margin stocks" issued outside the United States that are deemed to have a "ready market" for purposes of the SEC's net capital rule. [534]

[iii] *Exempted Borrowers*

In accordance with the amendments made by the NSMIA to §§ 7 and 8 of the Exchange Act, Regulation T 's scope provisions now exclude credit extended by one broker-dealer to another where the creditor broker-dealer has made a good faith determination that the borrower is an "exempted borrower." [535] A broker-dealer is an "exempted borrower" if a substantial portion of its business consists of transactions with persons other than brokers or dealers. [536] "Exempted borrower" status may be established, among other things, by qualifying for one or more of three nonexclusive safe harbors based on the broker-dealer's number of active customer accounts and gross revenues from customer business. [537] A similar amendment to the scope provision of Regulation U also excludes from Regulation

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U credit extended to an exempted borrower. [538] The effect of these changes, taken as a whole, has been to allow broker-dealers that qualify as exempted borrowers to borrow against any securities from any lender, without regard to the Board's margin requirements (which otherwise may be 50% or higher). [539]

[iv] *Portfolio Margining*

In the 1997 Regulation T Amendments, the Board amended Regulation T 's scope provision to allow compliance with any portfolio margining system approved by the SEC as an alternative to compliance with Regulation T. [540] Provisions for portfolio margining systems have been adopted by FINRA and the Chicago Board Options Exchange ("CBOE"). [541] Instead of specifying a fixed margin percentage for individual securities positions, portfolio margining assesses initial and maintenance margin levels based on the risk of a portfolio of positions related to the same underlying instrument, taken as a whole, using theoretical pricing models approved by the SEC [542] and certain assumed fluctuations in the market price of the underlying instrument. This calculation allows qualifying accounts to recognize offsets between positions within each portfolio, possibly reducing margin requirements substantially. [543]

[b] SRO Margin Rules

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Broker-dealers must comply not only with Regulation T, but also with the margin requirements of any SRO of which they are members. The principal SRO margin requirements are contained in FINRA Rule 4210.

One major difference between Regulation T and the margin rules of the SROs, including FINRA Rule 4210, is that the SROs' rules impose a maintenance margin requirement, whereas Regulation T prescribes only an initial margin requirement. [544] In addition, the margin rules of the SROs impose substantially higher margin requirements on certain securities and are in certain other respects more restrictive than those that apply under Regulation T. For example, FINRA Rule 4210 generally imposes a margin requirement of 6% on U.S. Treasury securities with 20 years or more to maturity, whereas Regulation T requires only "good faith" margin. [545] This and similar SRO margin requirements have been a significant factor in motivating U.S. broker-dealers to arrange securities financing for their customers with a foreign affiliate rather than extending credit directly, although the increased level of leverage available in portfolio margin accounts has reduced the level of arranged financing activity.

[c] Credit in Connection with a Distribution

Section 11(d)(1) of the Exchange Act generally prohibits a broker-dealer participating in the "distribution" [546] of a "new issue" [547] of securities from

lending against such securities until 30 days after the completion of the broker-dealer's participation in the distribution. [548] This restriction is intended to manage the potential conflict of interest that may arise if a broker-dealer makes credit available to induce a person to whom it has a fiduciary obligation (*i.e.*, its customer) to purchase securities that the broker-dealer has a significant interest in selling. [549] One result of this restriction is that, without special relief from the SEC, partly paid securities cannot be publicly offered in the United States in a primary offering, or, in some cases, in a secondary offering. [550]

Footnotes

273 In addition, the SEC has promulgated rules pursuant to the GLB Act regarding the privacy of consumer financial information to which registered broker-dealers and certain other entities regulated by the SEC must adhere. *See* SEC Release No. 34-42974 (June 22, 2000, amended by SEC Release No. 34-50781 (Dec. 2, 2004)) (adopting Privacy of Consumer Financial Information (Regulation S-P)) and SEC Division of Investment Management Staff Responses to Questions About Regulation S -P (Jan. 23, 2003); *see also* SEC Release No. 34-61003 (Nov. 16, 2009) (adopting a safe harbor model privacy form to provide disclosures under the GLB Act privacy rules).

274 *See generally* § 11.

275 Transactions in security futures products are also subject to the antifraud and antimanipulation provisions of the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.02[4][a].

276 Broker-dealers are subject to sanctions for fraudulent acts under a number of federal statutes in addition to the Exchange Act, including the Securities Act, the mail fraud sections of the U.S. criminal code and the Racketeer Influenced and Corrupt Organizations Act ("RICO"). *See*, *e.g.*, *Escott v. Barchris Construction*, 283 F. Supp. 643 (S.D.N.Y. 1968) (relating to liability under the Securities Act); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.) (unpublished order), *cert. denied*, 464 U.S. 863 (1983) (relating to mail fraud charge against the employee of a registered broker-dealer); *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987) (relating to RICO claims brought against registered broker-dealer). *See generally* § 11.

277 *See* Rule 10b-10 under the Exchange Act.

278 *See* Rule 15c1-8 under the Exchange Act. Mark-ups over 10% are considered, absent adequate disclosure,

per se fraudulent by the SEC and lower mark-ups may be fraudulent in certain circumstances. *See In the Matter of Ernest E. Suwara Thomas W. Carpenter Dean Witter Reynolds, Inc.*, SEC Release No. 34-18623 (Apr. 6, 1982). FINRA rules require members to charge fair prices and commissions and a FINRA policy guideline provides that mark-ups in excess of 5% are generally not permitted and mark-ups lower than 5% may also, depending on the circumstances, be deemed excessive. *See* FINRA Rule 2121 and supplemental material thereto, FINRA MANUAL (discussed at § 14.07[3][a][i]). The SEC has stated that FINRA's "5% mark-up policy" is not applicable in determining whether a mark-up violates § 10(b) of the Exchange Act. *See*, *e.g.*, *In re D.E. Wine Investments, Inc.*, SEC Release No. 34-43929 (Feb. 6, 2001); *In re Lehman Brothers Inc.*, SEC Release No. 34-37673 (Sept. 12, 1996).

279 *See*, *e.g.*, *Clark v. John Lamella & Co.*, 583 F.2d 594 (2d Cir. 1978).

280 *See*, *e.g.*, *Costello v. Oppenheimer & Co.*, 711 F.2d 1361 (7th Cir. 1983); *Newburger v. Gross*, 563 F.2d 1057 (2d Cir. 1977). Rule 15c1-7 under the Exchange Act specifically characterizes as fraudulent and manipulative the execution of transactions that are "excessive in size or frequency in view of the financial resources and character" of a customer's discretionary account. Further, successful claims have been brought against broker-dealers for churning even nondiscretionary accounts over which they were found to have exercised substantial *de facto* control. *See*, *e.g.*, *Eros v. SEC*, 742 F.2d 507 (9th Cir. 1984).

281 *See* Rules 15g-1 through 15g-9 under the Exchange Act.

282 *See*, *e.g.*, *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944); *In re Trots & Co.*, 12 S.E.C. 531, 535 (1942). *But see* Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20,946 (Apr. 8, 2016) (discussed below).

283 *See*, *e.g.*, *In re Trots & Co.*, 12 S.E.C. 531 (1942); *see also In re Duke & Duke*, 6 S.E.C. 386, 388–89 (1939); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 435 (2d Cir. 1943). *See generally Hanly v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); Randall W. Quinn, *Deja Vu All Over Again: The SEC's Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61.

284 *See* § 16.09 for a more detailed discussion of soft dollar arrangements in the context of the regulation of investment advisers. While the issues that arise in connection with soft dollar arrangements are generally in the first instance the concern of investment advisers, a broker-dealer involved in impermissible soft dollar arrangements, in circumstances where the broker-dealer should have been alerted to a possible violation by the adviser of its fiduciary duties, may risk liability under general antifraud principles. *Cf.*, *e.g.*, SEC Release No. 34-16679 (Mar. 19, 1980) ("aiding and abetting" liability); *see also* § 11.04[2][b].

In 2006, the SEC issued an interpretive release that circumscribes the use of soft dollars and reflects changes in industry practice and technology. The release states that the analysis of permissible brokerage and research services under the "soft dollars" safe harbor of § 28(e) of the Exchange Act requires a three-step process, involving (i) the application of eligibility criteria, (ii) the investment adviser's lawful and appropriate use of the brokerage and research services, and (iii) the investment adviser's good-faith determination that the commissions paid are reasonable in the light of the value of the services received. *See* SEC Release No. 34-54165 (July 18, 2006).

285 In situations in which the relevant account is that of a pension plan subject to ERISA, each of these commission arrangements may raise significant questions thereunder. *See* § 16.09 for a description of directed brokerage arrangements. Directed brokerage also raises in the first instance issues not for the broker-dealer but for the fiduciary directing a customer's account. As with soft dollar arrangements, broker-dealers that participate in directed brokerage arrangements that are not permissible, where they should have been alerted by the circumstances to possible fraud, may risk liability under general antifraud principles. Further, the registered broker-dealer is also responsible for adequate disclosure of such arrangements to its customers (*i.e.*, that a portion of compensation being paid by the customer is being passed on by the broker-dealer), as well as for assuring that the broker-dealer's books and records adequately reflect the directed brokerage arrangements.

286 *See generally* SEC Release No. 34-34902 (Oct. 27, 1994) (requiring certain disclosures to customers in connection with payment for order flow arrangements).

287 *See* Letter from Harvey L. Pitt, Chairman, SEC, to Salvatore F. Sodano, Chairman, AMEX (Jan. 24, 2003).

288 § 15(k) and (m) of the Exchange Act; *see also*, § 913 of the Dodd-Frank Act.

289 § 15(k) of the Exchange Act; *see also* § 913 of the Dodd-Frank Act. Section 913 of the Dodd-Frank Act also required the SEC to conduct a study on the effectiveness of existing legal standards of care for brokers, dealers and investment advisers in connection with providing personalized investment advice to retail customers, and whether to impose a uniform federal fiduciary standard of care on broker-dealers and investment advisers. § 913 of the Dodd-Frank Act. The completed study (submitted to Congress, as required, on January 21, 2011) recommended the adoption of a uniform federal fiduciary standard for brokers and advisers providing personalized investment advice about securities to retail customers "no less stringent than the standard currently applied to investment advisers" under §§ 206(1) and 206(2) of the Advisers Act and suggested that broker-dealers and advisers be required "to act in the best interest of the customer" and to eliminate or disclose all conflicts of interest. STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, SEC (Jan. 21, 2011). In 2013, the SEC released a request for data and other information relating to the duties of brokers, dealers and investment advisers. *See* SEC Release No. 34-69013 (Mar. 1, 2013). In its request for data, the SEC noted that the SEC staff had recommended rulemaking in its 2011 study, but that the SEC had not yet determined whether to commence a rulemaking. *See* 78 Fed. Reg. 14,848, 14,850 (Mar. 7, 2013). ("The [SEC] recognizes that Section 913 of the Dodd-Frank Act does not mandate that we undertake any such rulemaking, and the [SEC] has not yet determined whether to commence a rulemaking. We expect that the data and other information provided to us in connection with this request will assist us in determining whether to engage in rulemaking, and if so, what the nature of that rulemaking ought to be.").

290 SEC Release No. 34-69013 (Mar. 1, 2013).

291 In testimony before the House Financial Services Committee on November 15, 2016, Chair Mary Jo White indicated she did not expect further action by the SEC during the remainder of her tenure. (On November 14, 2016, Chair White announced her plans to resign at the end of the Obama Administration.) *See* http://financialservices.house.gov/calendar/eventsingle.aspx? EventID=401173. Chair White has suggested it is unlikely the SEC will issue a fiduciary rule proposal prior to her departure. *See* Mark Schoeff Jr., *SEC Chairwoman Mary Jo White Says Agency Mulling Fiduciary Duty*, INVESTMENTNEWS (Sept. 12, 2016), http://www.investmentnews.com/article/20160912/FREE/160919991/sec-chairwoman-mary-jo-white-says-agency-mulling-fiduciary-duty.

292 Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8, 2016).

293 Definition of the Term ''Fiduciary''; Conflict of Interest Rule—Retirement Investment Advice, 81 Fed. Reg. 20946 (Apr. 8, 2016).

294 In 2000, the SEC adopted Regulation FD, SEC Release No. 33-7881 (Aug. 15, 2000), which applies to communications with market professionals including broker-dealers and focuses on the problem of selective disclosure. Also in 2000, the SEC adopted Rule 10b5-1 under the Exchange Act, which clarifies that trading while in possession of inside information is presumed to be a violation of § 10(b) of the Exchange Act regardless of actual use of such information. The rule states the general principle that insider trading liability arises when a person trades while aware of material nonpublic information and provides two affirmative defenses to liability when it is clear that a trade was not made on the basis of the material nonpublic information. One defense is available if an entity can show that the individual making decisions to trade on behalf of the entity was not aware of the material nonpublic information and that the entity had implemented reasonable policies and procedures, such as information barriers and restricted lists, to prevent insider trading. The other defense is available in those situations in which a contract to trade is entered into before the person becomes aware of the material nonpublic information. SEC Release No. 33-7881 (Aug. 15, 2000). *See* § 4.10[6] regarding Regulation FD and § 11.05[2] regarding Rule 10b5-1 under the Exchange Act and other insider trading rules.

295 *See*, *e.g.*, *Slade v. Shearson, Hammill & Co.*, Fed. Sec. L. Rep. (CCH) ¶¶94,329, 94,439 (S.D.N.Y.), *remanded* 517 F.2d 398 (2d Cir. 1974), for an illustration of the various conflicts of interest that may arise when a firm acts as investment banker, market-maker and broker for the securities of a single company.

296 When securities are placed on a "restricted list," a firm's activities with respect to such securities are curtailed. Generally, this may mean that the firm ceases trading for its own account in such securities, does not trade for discretionary customer accounts or solicit customer trades, does not issue research reports regarding the securities and orders its employees not to trade for their own accounts in the securities or to advise or cause others to do so. Securities may be restricted for reasons not related to concerns regarding insider trading, such as, for example, the restrictions imposed on distribution participants by Regulation M under the Exchange Act. *See* § 3.02[9].

297 A firm does not typically suspend its ordinary trading activity with respect to securities placed on a "watch list" and, in fact, such lists ordinarily would not be widely disseminated within the firm. Rather, the firm's compliance department will monitor and investigate unusual trading activity in securities that had been placed on the list. A firm also may maintain a "rumor list" made up of issuers involved in recently announced transactions, or which have been the subject of rumors of a transaction, with which the firm is not involved. After placing a security on the rumor list, the firm's compliance department generally would conduct a review of recent activity in the issuer's securities to uncover unusual activity prior to the rumor becoming generally known.

298 Among the procedures that may be adopted in connection with the establishment of information barriers are: the use of project code words, control over distribution of draft documents relating to prospective transactions including the numbering of all such documents, restrictions on access to computer systems and to office communications systems such as fax machines, locked offices and file storage areas and personnel education regarding prohibitions on insider trades and the related sanctions.

299 *See* SEC Release No. 34-17120 (Sept. 4, 1980); § 11.06[4]. The SEC's move to making procedures to prevent insider trading mandatory was a step toward reversing its previous failure to obtain an injunction against a broker-dealer that did not have such procedures in place. *See SEC v. Geon Industries, Inc*., 531 F.2d 39 (2d Cir. 1976); *see also SEC v. Lum's Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973).

300 Rule 14e-3(b)(2) under the Exchange Act.

301 Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); *see* § 11.05[2] for further discussion on insider trading.

302 § 15(g) of the Exchange Act.

303 § 21A(b)(1) of the Exchange Act. Persons liable may be required to pay a penalty of three times the profit gained or loss avoided by the insider trading or $1 million, whichever is greater. § 21A(a)(3) of the Exchange Act.

In 2006, the SEC brought settled administrative proceedings against Morgan Stanley & Co. Inc. and Morgan Stanley DW Inc. (collectively, "Morgan Stanley") fining them $10 million for a failure to maintain and enforce adequate written policies and procedures to prevent the misuse of material nonpublic information. Morgan Stanley failed to conduct surveillance of a large number of employee accounts held at the firm, as well as trading in certain securities in those and other accounts. In addition, Morgan Stanley's written policies did not provide adequate guidance to personnel charged with conducting surveillance and it used inadequate controls with respect to surveillance of its "watch list." *In re Morgan Stanley & Co. Inc.*, SEC Release No. 34-54047 (June 27, 2006); *see also In re Merrill Lynch, Pierce, Fenner & Smith Inc.*, SEC Release No. 34-59555 (Mar. 11, 2009); *In re A. Carlos Martinez*, SEC Release No. 34-57755 (May 1, 2008); *SEC v. Chanin Capital LLC*, SEC Litigation Release No. 20551 (May 1, 2008).

304 § 15(g) of the Exchange Act.

305 SEC, Division of Market Regulation, BROKER-DEALER POLICIES AND PROCEDURES DESIGNED TO SEGMENT THE FLOW AND PREVENT THE MISUSE OF MATERIAL NONPUBLIC INFORMATION (Mar. 1990) ("1990 Information Barrier Report"); *see also* SEC, Division of Market Regulation, BROKER-DEALER INTERNAL CONTROL PROCEDURES FOR HIGH YIELD SECURITIES (Oct. 1993) (separate review of broker-dealers' information barrier

procedures relating to noninvestment grade securities).

306 Nonetheless, the 1990 Information Barrier Report indicated that the SEC would engage in rulemaking were its recommendations with respect to information barrier procedures not implemented by broker-dealers.

307 1990 Information Barrier Report.

308 NYSE Information Memo 91-22 (June 28, 1991); NASD Notice to Members 91-45 (July 1991).

309 The NYSE and the NASD endorsed the SEC's warning in the 1990 Information Barrier Report against the use of a "loose mixture of internal memoranda, excerpts from employee manuals and certifications." 1990 Information Barrier Report at 38; NYSE Information Memo 91-22 (June 28, 1991); NASD Notice to Members 91-45 (July 1991).

310 For example, the NASD Conduct Rules provide that an associated person of a FINRA member may not open a trading account with another member (the "executing member") without informing the executing member of his association with another FINRA member and providing his employer (the "employing FINRA member") with notice of the account. At the request of the employing FINRA member, the executing member must provide the employing FINRA member with a record of all trades in the account. NASD Rule 3050, FINRA MANUAL; NASD Notice to Members 91-27 (May 1991); *see also* Incorporated NYSE Rule 407, FINRA MANUAL.

311 For example, full-service firms that participate in securities markets and the credit markets often have access to nonpublic information (*e.g.*, "syndicate information") about companies to whom they have extended loans or whose loans they have acquired. Such firms should have policies and procedures in place to assure that such nonpublic information is not misused in their securities trading activities, a particularly acute concern for firms that hedge their credit exposures with securities transactions, or security-based swap agreements subject to the insider trading prohibitions of the Securities Act and the Exchange Act. Industry groups have provided recommendations regarding policies and procedures relating to material nonpublic information received by credit market participants. *See*, *e.g.*, Loan Syndication and Trading Association ("LSTA"), Statement of Principles for the Communication and Use of Confidential Information by Loan Market Participants (Dec. 2006); Joint Market Practices Forum ("JMPF"), Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants (Oct. 2003; European Supplement, May 2005); *see also* Joint Statement Regarding the Communication and Use of Material Nonpublic Information (Dec. 2006) (12 trade associations reaffirm their commitment to fair and competitive markets in which inappropriate use of material nonpublic information is not tolerated, referencing the LSTA and JMPF, and others', statements of principles). *See also* SEC Office of Compliance Inspections and Examinations, STAFF SUMMARY REPORT ON EXAMINATIONS OF INFORMATION BARRIERS: BROKER-DEALER PRACTICES UNDER SECTION 15(G) OF THE SECURITIES EXCHANGE ACT OF 1934 (Sept. 27, 2012).

312 *See* § 14.07[1].

313 A "short sale" is "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." Rule 200(a) of Regulation S HO under the Exchange Act.

314 *See* SEC Release No. 34-54891 (Dec. 7, 2006).

315 *See* SEC Release No. 34-55970 (June 28, 2007).

316 *See* SEC Release No. 34-61595 (Feb. 26, 2010); Rule 201 of Regulation S HO under the Exchange Act.

317 Rules 200–203 of Regulation S HO under the Exchange Act.

In addition, Rule 105 of Regulation M specifically addresses manipulative short selling in connection with a public offering by prohibiting persons who effected short sales during a specified period prior to the pricing of a registered offering from purchasing securities in the offering, subject to certain enumerated exceptions. *See* §§ 3.02[9][d] and 11.05[3][c]; *see also* SEC Release No. 34-56206 (Aug. 6, 2007) (adopting amendments to Rule 105 to eliminate the former "covering" component of the rule and to make certain other changes).

318 Abusive "naked" short selling generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard settlement cycle. *See* SEC Release No. 34-56212 (Aug. 7, 2007). In 2008, the SEC adopted a "naked" short selling antifraud rule under which it is unlawful for "any person to submit an order to sell an equity security if such person deceives a broker or dealer, a participant of a registered clearing agency, or a purchaser about its intention or ability to deliver the security on the date delivery is due, and such person fails to deliver the security on or before the date delivery is due." SEC Release No. 34-58774 (Oct. 14, 2008); Rule 10b-21 under the Exchange Act.

319 Large and persistent failures by sellers of securities to deliver the securities they have sold on the scheduled settlement date (referred to as "fails to deliver") may have a negative effect on the market for the relevant securities by depriving shareholders of certain benefits of ownership, such as voting and lending, effectively converting without the consent of the buyer a contract for delivery within the standard settlement cycle into an undated futures-type contract, damaging the reputation of the relevant securities and potentially enabling manipulative conduct. *See* SEC Release No. 34-56212 (Aug. 7, 2007).

320 Although Regulation S HO imposes this requirement on broker-dealers, broker-dealers often contractually require customers to inform them whether a sell order is long or short.

321 Rule 200(g) of Regulation S HO under the Exchange Act; *see also* SEC Release No. 34-61595 (Feb. 26, 2010) (addressing when a broker-dealer may mark qualifying sell orders as "short exempt").

322 Rule 203(a)(1) of Regulation S HO under the Exchange Act. Rule 203(a)(2) provides for exceptions to this general requirement for certain good-faith mistakes and where the broker-dealer knows, or has been reasonably informed by the seller, that the seller owns the security and would deliver it prior to the scheduled settlement but the seller failed to do so. The SEC has noted that it may be unreasonable for a broker-dealer to accept the customer's assurances where it has been repeatedly required to use borrowed shares to make delivery on sales marked "long." *See* SEC Release No. 34-50103 (July 28, 2004).

323 Rule 203(b)(1) of Regulation S HO under the Exchange Act. Under Rule 203(b)(2) of Regulation S HO under the Exchange Act, this "locate" requirement generally does not apply to orders from other broker-dealers (provided the broker-dealer accepting the order has not agreed to be responsible for obtaining a "locate"), sales of securities the seller owns and intends to deliver as soon as all restrictions on delivery have been removed (although securities must be borrowed or the short position closed out if the securities are not received within 35 days after the trade date), or sales by a market-maker in connection with *bona fide* market-making activities in the security sold.

324 Rule 204 of Regulation S HO under the Exchange Act. Rule 204 provides several limited exceptions to this "close-out" requirement, including a three-settlement-day grace period for fail to deliver positions attributable to *bona fide* market-making activities by a registered options market maker and fail to deliver positions that the clearing agency participant reasonably allocates to another registered broker-dealer for which it clears (in which case the close-out and pre-borrow obligations are imposed on such other registered broker-dealer). In addition, there is an extended grace period of 35 settlement days where the fail to deliver position is in a security sold pursuant to Rule 144 under the Securities Act, in order to allow additional time for the mechanics of effecting the transfer of the security. *See* SEC Release No. 34-60388 (July 27, 2009).

325 Rule 204(b) of Regulation S HO under the Exchange Act. This "pre-borrowing" requirement applies to any broker-dealer for which the clearing agency participant clears and, unlike the locate requirement of Rule 203(b)(1), does not have an exception for short sales in connection with market-making activities.

326 "Customers," in the context of the financial responsibility rules, generally are those persons who deposit funds or securities with a broker-dealer in the course of the broker-dealer's securities business. For the various ways in which the term "customer" is defined in some of the relevant provisions, *see* Rule 15c3-3(a)(1) under the Exchange Act (customer protection rule), Rule 15c3-1(c)(6) under the Exchange Act (net capital rule) and § 16(2) of the Securities Investor Protection Act, Pub. L. No. 91-598, 84 Stat. 1636 (1970) ("SIPA").

327 These requirements and protections (including the net capital rule and SIPA) generally do not apply to

FCMs that have notice-registered as broker-dealers for the limited purpose of trading security futures products. *See* § 15(b)(11)(B) of the Exchange Act. In addition, limited purpose broker-dealers who restrict their securities activities to dealings in OTC derivative products are subject to a customized regime that includes a variety of exemptions from, among other rules, rules under § 15(c)(3) of the Exchange Act. *See* Rule 15a-1 under the Exchange Act.

328 § 15(c)(3)(A) of the Exchange Act.

329 The rules under § 15(c)(3) are not the only measures the SEC has instituted to assure the solvency of broker-dealers. The extensive books and records requirements contained in Rules 17a-3 and 17a-4 under the Exchange Act arose out of the "paperwork crisis" of 1967–1970 in which broker-dealers' back offices were unable to keep accurate records of their trades. The inability of individual broker-dealers to track, and thus to fulfill, their trade obligations led to a series of broker-dealer failures. Similarly, Rule 17a-13 under the Exchange Act requires quarterly securities examinations, counts, verifications of securities inventories, comparisons between these inventories and the records that the broker-dealer keeps and the recording of any differences between the inventories and the records. Rules 17f-1 and 17f-2 under the Exchange Act, which deal with the problem of securities theft (including the question of just what securities are in inventory), also supplement the explicitly financial rules. *See generally*, SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, Part I, Chapter 3 (1963) (describing the regulatory framework for broker-dealers and highlighting areas in which investors need additional protection).

330 *See*, *e.g.*, Statement of Richard Breeden, Chairman, SEC, before Senate Comm. on Banking, Housing & Urban Affairs, Concerning the Bankruptcy of Drexel Burnham Lambert Group Inc. (Mar. 12, 1990).

331 *See generally* § 14.07[2][c] (discussing SIPA).

332 *See generally* SEC Release No. 34-9882 (Nov. 21, 1972), 37 Fed. Reg. 25,224, 25,226 (Nov. 29, 1972); SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,824 (Aug. 21, 2013). For a more detailed discussion of the customer protection rule, *see* Michael P. Jamroz, *The Customer Protection Rule*, 57 BUS. LAW. 1069 (May 2002). Pursuant to § 15C of the Exchange Act, registered government securities broker-dealers and government-noticed financial institutions are subject to customer protection rules generally identical to those applicable to registered broker-dealers. *See* Treas. Reg. § 403.4 (regulations applicable to registered government securities broker-dealers); Treas. Reg. §§ 403.5 and 450.4 (regulations applicable to financial institutions that are government securities broker-dealers).

333 The rule designates (or provides that the SEC may upon application designate) certain locations, including overseas locations, other than in the actual physical possession of the broker-dealer, as acceptable control locations. Rule 15c3-3(c) under the Exchange Act; *see also* SEC Release No. 34-10429 (Oct. 12, 1973) (acceptable control locations for foreign securities).

334 "Excess margin securities" are those securities purchased by a customer with a loan from a broker-dealer that are more than the amount of securities that the broker-dealer is permitted to use to obtain funding for such loan. Generally speaking, securities with a market value in excess of 140% of a broker-dealer's loan to its customer are "excess margin securities." Rule 15c3-3(a)(5) under the Exchange Act.

335 Special rules apply to securities borrowed from customers and securities subject to "hold in custody" repurchase agreements. *See* Rule 15c3-3(b)(3) and (4) under the Exchange Act.

Rule 15c3-3(b)(3) specifies conditions under which a broker-dealer is not required to maintain possession or control of fully-paid or excess margin securities borrowed from any person under written agreements, including that the broker-dealer provides to the lender eligible collateral, marks to market the securities borrowed and collateral posted on a daily basis and provides additional collateral if the value of the collateral held by the lender is less than the value of the securities borrowed, and includes in the agreement a prominent notice that SIPA may not protect the lender. Prior to 2003, Rule 15c3-3(b)(3) required broker-dealers to collateralize securities loans with cash, US treasury securities or irrevocable letters of credit (although SEC interpretations and no-action letters had permitted some additional flexibility). In 2003, the SEC amended Rule 15c3-3(b)(3) to permit it to expand, by order, the categories of collateral a broker-dealer may post when borrowing securities from a customer and issued an order under the amended rule permitting a wider range of collateral to be posted by broker-dealers. SEC Release No. 34-47480 (Mar. 11, 2003) (amending Rule 15c3-3(b)(3)); SEC Release No. 34-47683 (Apr. 16, 2003) (order expanding the types of permitted collateral).

Rule 15c3-3(b)(4) allows a broker-dealer that has custody of securities subject to a repurchase agreement not to maintain possession or control of the securities subject to the repurchase agreement during the trading day if the broker-dealer provides certain specified notices and warnings to its counterparty (including that the Securities Investor Protection Corporation has taken the position that SIPA does not protect the counterparty) and follows the procedural requirements of the rule.

336 *See* SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,830 (Aug. 21, 2013); SEC Release No. 34-70701 (Oct. 17, 2013), 78 Fed. Reg. 62,930 (Oct. 22, 2013) (extending effective date of certain amendments).

337 "Fails to receive" are securities that a broker-dealer should have received on the settlement date for a transaction (which for most securities transactions in the United States is generally three business days after the trade date) but did not. *See generally* Rule 15c6-1 under the Exchange Act (providing for settlement of securities transactions no later than three business days with specific exceptions); SEC Release No. 34-35750 (May 22, 1995) (exemption from three business day settlement convention in connection with certain transactions involving foreign securities).

338 Rule 15c3-3(d)(2) under the Exchange Act. For government securities that are mortgage-backed securities, the broker-dealer is not required to take action until the securities are on its books as fails to receive for more than 60 days. Treas. Reg. § 403.4(h).

339 *See Securities Industry Association* (avail. July 16, 1988).

340 *See FINRA Interp. Handbook*, SEA Rule 15c3-3(a)(1) /04.

341 The Reserve Formula is set forth in Exhibit A to Rule 15c3-3a under the Exchange Act.

342 The Reserve Formula also takes securities fails to deliver and fails to receive into account and so serves as a mechanism to encourage a broker-dealer to maintain its securities delivery and inventory systems in good order.

343 "Qualified securities" are securities issued by the United States or in respect of which the principal and interest are guaranteed by the United States. By interpretation, broker-dealers are also permitted (subject to certain limits) to use qualifying certificates of deposit to satisfy their reserve account deposit obligations. *See FINRA Interp. Handbook* at 2023, SEA Rule 15c3-3(a)(6)/012.

344 The bank at which the reserve accounts are maintained must provide the broker-dealer with a written agreement, the minimum terms of which are specified in the customer protection rule, stating that the funds in the reserve account are being kept for the exclusive benefit of the broker-dealer's customers or the PAB account holders, as applicable. Rule 15c3-3(f). Broker-dealers must maintain these reserve accounts at unaffiliated banks and limit the deposit at any bank to 15% of the bank's equity capital as reported by the bank in its most recent Call Report. Rule 15c3-3(e)(5). *See also* SEC, Division of Trading and Markets, Frequently Asked Questions Concerning the Amendments to Certain Broker-Dealer Financial Responsibility Rules (Mar. 6, 2014) (noting that the definition of "affiliated" is that contained in Rule 15c3-3(a)(13)). The Call Reports for U.S. branches of foreign banks do not contain an equity capital line item, and therefore, in order to maintain a reserve account at such a branch, the broker-dealer needs to request exemptive relief from the SEC. *See* SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,834–35 (Aug. 21, 2013); *Kris Dailey* (avail. Feb. 26, 2014) (providing no-action relief where a foreign bank has an exemptive request pending on or before March 3, 2014 and the broker-dealer uses the foreign bank's equity capital, as reported in the foreign bank's most recent financial statement, in lieu of a Call Report, to calculate the 15% bank equity capital threshold).

345 For a more detailed discussion of the net capital rule, *see* Michael P. Jamroz, *The Net Capital Rule*, 47 BUS. LAW. 863 (May 1992). At the time he wrote the article, Mr. Jamroz was one of the SEC staff members primarily responsible for the rule's interpretation.

346 Broker-dealers that hold customer funds or securities are required to maintain at least $250,000 in net capital. Those that clear customer transactions but do not hold customer funds or securities are subject to a $100,000 minimum net capital requirement; all other broker-dealers are required to maintain either $5,000, $25,000 or $50,000 in net capital, depending on whether they receive securities and the type of securities business in which they are engaged. In addition, broker-dealers that act as market-makers are subject to additional capital requirements. *See* Rule 15c3-1(a)(2) under the Exchange Act; SEC Release No. 34-31511 (Nov. 24, 1992); *see also* SEC Release No. 34-31512 (Nov. 24, 1992) (increasing minimum net capital requirements imposed on broker-dealers to the levels described above). The stated dollar amounts of minimum capital that a broker-dealer is required to maintain can be misleading in that the net capital rule requires substantial deductions from a broker-dealer's net worth in determining its regulatory capital, as discussed at § 14.07[2][b][i].

Treasury's version of the net capital rule, applicable to registered government securities broker-dealers, the "liquid capital rule," was designed with special consideration of the financings customary in the government securities market. For example, as compared to the nonexempt securities market, there is a greater use in the government securities market of hedging devices and of repurchase and reverse repurchase agreements. A major GAO report on the regulation of government securities broker-dealers found that the differences between the two rules were of little practical effect. GAO/GGD 90-114, U.S. GOVERNMENT SECURITIES: MORE TRANSACTION INFORMATION AND INVESTOR PROTECTION MEASURES ARE NEEDED at 43 (Sept. 1990). In 1995, Treasury adopted several amendments to the "liquid capital rule" to parallel amendments to the net capital rule adopted or proposed by the SEC. *See* Amendments to Regulations for the Government Securities Act of 1986, Treas. Reg. § 402.2(b)(1).

347 In 2004, the SEC adopted amendments to the net capital rule that permit certain broker-dealers to apply to the SEC for a conditional exemption from the net capital rule to use a risk-based method for calculating deductions from net capital for market and derivatives-related credit risk. Broker-dealers obtaining such exemptions are subject to additional minimum capital requirements. *See* § 14.07[2][b][iii].

348 In 2013, the Division of Trading and Markets stated that it is considering recommending that the SEC propose an amendment to the net capital rule that would prohibit a broker-dealer that carries customer accounts from having a ratio of total assets to regulatory capital in excess of a certain level. SEC, Broker-Dealer Leverage Ratio, RIN: 3235-AL50 (Fall 2013), *available at* http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201310&RIN=3235-AL50 (last visited Oct. 11, 2016).

349 A newly registered broker-dealer must maintain net capital equal to at least one-eighth of its aggregate indebtedness for the first year of its business. Or, if the broker-dealer is also registered as an FCM under the CEA, the broker-dealer must not allow the funds required to be segregated pursuant to the CEA to be greater than 25 times its net capital. *See* Rule 15c3-1(a)(1) under the Exchange Act. SROs often impose more restrictive requirements in connection with the approval of membership of new broker-dealers.

350 *See* SEC Release No. 34-18417 (Jan. 13, 1982); *see also* Statement of Richard Breeden, then-Chairman, SEC, before Senate Comm. on Banking, Housing & Urban Affairs, Concerning the Bankruptcy of Drexel Burnham Lambert Group Inc. at 10 (Mar. 12, 1990). Although a broker-dealer may initially elect either method of calculation, it may not thereafter switch without the SEC's permission.

351 However, the assets and liabilities of a related entity of the broker-dealer generally are not taken into account in computing net capital. The primary exception to this rule is where a broker-dealer guarantees the liabilities of a related entity (which is generally a subsidiary that is also an SEC-registered broker-dealer). In that situation, the broker-dealer consolidates its own assets and liabilities with those of the related entity. If the consolidation decreases net capital, the lower net capital figure is used. If the consolidation increases the broker-dealer's net capital, the increase can be taken into account only if the broker-dealer provides its designated examining authority and the SEC with assurance that the net assets of the guaranteed entity can be quickly distributed to the broker-dealer in the event of the broker-dealer's liquidation.

352 Generally, a satisfactory subordination agreement must provide as follows: the lender acknowledges that its loan is subordinate to the claims of all present and future creditors, including customers; the broker-dealer may use the cash freely as part of its business and is subject to the general risks of the business; the payment obligation of the broker-dealer is suspended if, after any such payment, the broker-dealer's aggregate indebtedness would exceed 12 times its net capital; and the loan is for a term of at least one year. The minimum one-year term does not apply to properly subordinated revolving loans. In addition, in connection with underwritings or other "extraordinary activities," a broker-dealer may, three times during any 12-month period, enter into subordination agreements that have a term of not more than 45 days. Except in the case of certain subordinated loans from its partners or shareholders (which must have a term of at least three years), not more than 70% of a broker-dealer's regulatory capital may consist of subordinated loans. *See* Rule 15c3-1(d) under the Exchange Act.

All subordination agreements must be approved by the broker-dealer's designated examining authority and may not be terminated or modified without that SRO's approval. FINRA makes available standardized subordinated loan agreements that are required to be used by its members in order to accelerate the approval process.

353 These various required deductions make it relatively expensive for a broker-dealer to engage in any substantial business other than buying and selling readily marketable securities, as the assets associated with other businesses generally have no value for net capital purposes. This is one reason many broker-dealers operate as part of a holding company structure, where other affiliates engage in businesses (*e.g.*, nonsecurities activities) that do not require broker-dealer registration or compliance with broker-dealer net capital requirements.

354 Rule 15c3-1(c)(2)(vii) under the Exchange Act. "Ready market" is defined at Rule 15c3-1(c)(11) under the Exchange Act; *see also* SEC Release No. 33-6862 (Apr. 23, 1990) (capital treatment of Rule 144A-eligible securities).

In 1996, a no-action letter was issued to the Securities Industry Association (the "SIA") (which in 2006 combined with The Bond Market Association to form the Securities Industry and Financial Markets Association ("SIFMA")) permitting broker-dealers to apply haircuts of less than 100% to proprietary positions in certain "restricted securities" (as defined in Rule 144(a)(3) under the Securities Act) that cannot be publicly offered or sold, such as certain nonconvertible debt securities, convertible debt, convertible preferred stock, preferred stock, commercial paper and securities freely convertible into publicly traded securities or securities with registration rights that provide for an exchange offer. *See Securities Industry Association* (avail. Mar. 30, 1996) (the "1996 SIA Letter"). Similarly, in 2000, the SEC provided the SIA with no-action relief permitting broker-dealers to apply haircuts of less than 100% to certain single-rated investment-grade asset-backed debt securities. *See Securities Industry Association* (avail. July 27, 2000).

The SEC also has to some degree liberalized its prior very conservative approach to the valuation of foreign securities for purposes of the net capital rule. The GAO in 1992 published a report criticizing the SEC for its then-existing policy in this regard. *See* GAO/GGD-92-41, SECURITIES MARKETS: CHALLENGES TO HARMONIZING INTERNATIONAL CAPITAL STANDARDS REMAIN at 8 (Mar. 1992). Shortly after this GAO report, the SEC issued a no-action letter to the SIA, in response to an SIA request that had been sent to the SEC almost two years earlier that expanded the types of foreign convertible and nonconvertible debt securities, preferred stock and sovereign-issued debt securities that broker-dealers are permitted to treat as having a "ready market." *See Securities Industry Association* (avail. June 12, 1992); *see also Sanwa-BGK Securities* (avail. Feb. 27, 1992) (capital treatment of certificates of deposit issued by banks organized in the Cayman Islands). Subsequently, the SEC staff issued a letter treating foreign equity securities listed on the Financial Times-Actuaries World Indices (now known as the FTSE World Index) as having a ready market. *See Securities Industry Association* (avail. Aug. 13, 1993). The 1996 SIA Letter expanded the category of foreign securities entitled to a capital charge of less than 100% to include (i) convertible and nonconvertible debt and preferred stock if the issuer has issued common stock included in the Financial Times-Actuaries World Indices and (ii) certain investment-grade commercial paper.

In 2012, the SEC staff issued a no-action letter to FINRA expanding the types of equity securities of a foreign issuer that can be considered as having a ready market. *See Grace B. Vogel* (avail. Nov. 28, 2012). In particular, the SEC staff said that an equity security of a foreign issuer can be considered as having a ready market under Rule 15c3-1(c)(11) if (1) it is listed for trading on a foreign exchange located in a country that is recognized on the FTSE World Index, where the security has been trading on that exchange for at least the previous 90 days; (2) daily quotations for bid and ask or last sale prices for the security provided by the foreign securities exchange on which the security is traded are continuously available to broker-dealers in the United States through an electronic quotations system; (3) the median daily trading volume (calculated over the preceding 20 business day period) of the security on the foreign securities exchange is at least 100,000 shares or $500,000; and (4) the aggregate unrestricted market capitalization in shares of such security exceeds $500 million over each of the preceding 10 business days. *See Grace B. Vogel* (avail. Nov. 28, 2012).

355 The net capital rule also provides for "concentration charges" if a broker-dealer's net capital before haircuts includes securities of a single class or series of an issuer that have a market value of more than 10% of such net capital.

356 Rule 15c3-1(c)(2)(vi)(A) and (C) under the Exchange Act.

357 For debt securities generally, the haircuts are intended to take into account market risk, credit risk, price volatility and the liquidity of the particular debt instruments. Reduced haircuts are permitted for certain debt securities positions that are hedged by other positions in debt securities, options or other market instruments within certain maturity parameters. In 1997, the SEC proposed to modify the haircuts applicable to most interest rate instruments, including government securities, investment-grade nonconvertible debt securities, pass-through mortgage-backed securities and interest rate swaps, but thus far no additional action has been taken with respect to this proposal. *See* SEC Release No. 34-39455 (Dec. 17, 1997), which was incorporated into SEC Release No. 34-39704 (Feb. 27, 1998). In order to be able to deduct a haircut for commercial paper, nonconvertible debt securities and preferred stock, a broker-dealer must be able to determine that such securities represent only a minimal amount of credit risk in accordance with policies and procedures that consider a variety of different risk factors. *See* Rule 15c3-1(c)(2)(vi)(E), (F), (H) and (I). Prior to 2014, a broker-dealer could rely instead on credit ratings issued by nationally recognized statistical rating organizations to make this credit determination. However, the SEC amended these provisions to require an internal credit determination, implementing Section 939A of the Dodd-Frank Act, which requires all federal agencies to eliminate references to ratings as standards of creditworthiness. *See* SEC Release No. 34-71194 (Jan. 8, 2014).

358 Rule 15c3-1(c)(2)(viii)–(ix) under the Exchange Act.

359 In 1997, the SEC issued a concept release seeking comment on how the net capital rule could be modified to incorporate the evolving risk management techniques being utilized in the securities markets, in particular, the extent to which securities firms should be permitted to use statistical models to calculate their net capital requirements. SEC Release No. 34-39456 (Dec. 17, 1997), which was incorporated into SEC Release No. 34-39704 (Feb. 27, 1998). Similarly, the SEC's adopting release regarding the establishment of a new broker-dealer registration category for so-called "OTC derivatives dealers" (a regime sometimes referred to as "BD Lite") states that such entities will, subject to SEC approval, be permitted to calculate their net capital using proprietary "value-at-risk" or other statistical models. SEC Release No. 34-40594 (Oct. 23, 1998); *see* § 14.09. In 2004, the SEC adopted amendments to the net capital rule that permit certain broker-dealers to apply to the SEC for a conditional exemption from the net capital rule to use a risk-based method for calculating deductions from net capital for market and derivatives-related credit risk. *See* § 14.07[2][b][iii].

360 *See*, *e.g.*, Rules 15c3-1(e) and 17a-11 under the Exchange Act. Rule 17a-11 under the Exchange Act requires that a broker-dealer notify the SEC and its designated examining authority if its net capital falls below specific levels. The SRO that is the broker-dealer's designated examining authority may, among other things, require the broker-dealer to restrict further development, contract its activities or transfer its public customer accounts. *See*, *e.g.*, FINRA Rule 4120, FINRA MANUAL.

361 Rule 15c3-1(e)(2) under the Exchange Act.

362 *See* SEC Release No. 34-28927 (Feb. 28, 1991); *see also* SEC Release No. 34-28347 (Aug. 15, 1990).

363 The SEC issued only one order under Rule 15c3-1(e)(3)—to limit withdrawals from REFCO Securities, LLC and REFCO Clearing, LLC, after their parent company announced that its financial statements could no longer be relied upon and had ceased all activities for a 15-day period. *See* SEC Release No. 34-52606 (Oct. 13, 2005).

364 Rule 15c3-1(e)(3)(i).

365 Rule 15c3-1(e)(4)(iv) under the Exchange Act.

366 *See* Rule 15c3-1(c)(2)(i)(G); SEC Release No. 34-70072 (July 30, 2013), 78 Fed. Reg. 51,830 (Aug. 21, 2013)

367 "Tentative net capital" means the net capital of the broker-dealer before deductions for market and credit risk, increased by the balance sheet value (including counterparty net exposure) resulting from transactions in derivative instruments that otherwise would be required to be deducted. Tentative net capital includes securities for which there is no ready market if the value of the securities is computed using mathematical models the SEC has approved for computing capital deductions for the securities. *See* Rule 15c3-1(c)(15) under the Exchange Act.

368 SEC Release No. 34-49830 (June 8, 2004); *see also* SEC Release No. 34-55559 (Mar. 29, 2007) (approving amendments to the NYSE's net capital and early warning rules (Rules 325 and 326) adopting relevant thresholds for broker-dealers calculating their net capital according to the alternative risk-based method).

369 Goldman Sachs, Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") and Morgan Stanley were the other three CSE investment bank holding companies. JP Morgan and Citigroup were the two CSE bank holding companies.

370 *See* Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008) (announcing the end of the CSE Program). The extent to which the 2004 net capital rule change and the CSE Program contributed to the 2007–2009 financial crisis has been the subject of much debate. *Compare* Stephen Labaton, "*Agency's '04 Rule Let Banks Pile Up New Debt*," N.Y . TIMES, Oct. 3, 2008, p. A1, *with* THE FINANCIAL INQUIRY CRISIS REPORT (Jan. 2011) at 153–54 (noting that CSE holding companies were actually more highly leveraged in the 1990s than they were after the 2004 rule change).

371 *See* Chairman Mary Schapiro, Testimony Concerning the Lehman Brothers Examiner's Report, Before the House Financial Services Comm., Apr. 20, 2010, at 11.

372 Rule 15c3-1(a). *See* SEC Release No. 34-70073 (July 30, 2013), 78 Fed. Reg. 51,824, 51,855 (Aug. 21, 2013).

373 For a general discussion of the liquidation procedures applicable to a failed broker-dealer, *see* Stephen P. Harbeck, *Stockbroker Bankruptcy: The Role of the District Court and the Bankruptcy Court under the Securities Investor Protection Act*, 56 AM. BANKR. L.J. 277 (1982). *See also* SIPA, TRUSTEE'S GUIDE (a manual distributed to trustees of broker-dealers being liquidated in accordance with SIPA); COLLIER ON BANKRUPTCY ¶¶741–52 (16th ed. 2009).

374 Customers of a registered government securities broker-dealer are not eligible for SIPC insurance. Customers of a government-noticed financial institution likewise do not receive SIPC insurance but are eligible to receive FDIC insurance. *See generally* GAO/GGD 90-114 U.S. GOVERNMENT SECURITIES: MORE TRANSACTION INFORMATION AND INVESTOR PROTECTION MEASURES ARE NEEDED at 61–63, (Sept. 1990) (discussing SIPC insurance and recommending that Congress expand SIPC coverage to all government securities brokers and dealers).

375 *See* § 3(a)(2) of SIPA. Certain broker-dealers with limited activities, including OTC derivatives dealers, are excluded from membership in SIPC. While any broker-dealer that has more than half its business outside the United States appears to be excluded from SIPC membership by the express language of the act (*see* § 3(a)(2)(A)(i) of SIPA), the SEC likely takes the position that virtually every broker-dealer with any U.S.

customers must become a SIPC member. Telephone conversation with Michael Don, Deputy General Counsel and Secretary of SIPC, Aug. 24, 1990. Rule 10b-10(a)(9) under the Exchange Act requires broker-dealers to disclose, in a written confirmation to the customer at or before completion of a transaction, that the broker-dealer is not a SIPC member, if such is the case.

376 § 4(c) of SIPA. SIPC is required to assess its member broker-dealers when the balance in the SIPC fund falls below $100 million and has discretion as to whether to impose assessments otherwise. From 1996 through early 2009, SIPC imposed an annual assessment of $150 on each member broker-dealer. *See* SIPC 2006 Annual Report at 8.9. Since April 2009 annual assessments have been based on one-quarter of 1% of the net operating revenues of SIPC members. *See* SIPC News Release, SIPC to Reinstitute Assessments of Member Firms' Operating Revenues (Mar. 2, 2009); *see also* SIPC, Assessment Rate, *available at* http://www.sipc.org/for-members/assessment-rate (last visited Oct. 11, 2016).

377 § 8 of SIPA. SIPA defines a "customer" as "any person (including any person with whom the [failed broker-dealer] deals as principal or agent [*i.e.*, another broker-dealer]) who has a claim on account of securities received, acquired, or held by the [failed broker-dealer] in the ordinary course of its business as a broker or dealer … [including any person who has deposited cash with the [failed broker-dealer] for the purpose of purchasing securities]… and any person who has a claim … arising out of sales or conversions of securities.…" § 16(2) of SIPA. "Customer name securities" are those securities that are registered (or in the process of being registered) in the particular customer's name and are not transferable by the broker-dealer by delivery, power of attorney or otherwise. § 16(3) of SIPA; *See* Collier on Bankruptcy ¶6741.03 (16th ed. 2009); *see also In re Bevill, Bressler & Shulman, Inc.*, 59 B.R. 353 (D.N.J. 1986). "Customer property" generally includes all property (other than customer name securities) received, acquired, or held by a failed broker-dealer that was, or should have been, set aside for customers. § 16(4) of SIPA.

378 § 9(a) and (d) of SIPA. The cash must have been on account for the purpose of purchasing securities or as a result of a sale of securities. *See* SEC Release No. 34-18262 (Nov. 17, 1981). Section 929H of Title IX of the Dodd-Frank Act raised the cash limit from $100,000 to $250,000.

379 *See* § 9(a)(5) of SIPA.

380 *See* § 9(a)(5) of SIPA.

381 *See*, *e.g.*, § 6 of the Exchange Act (registration of the national securities exchanges) and § 15A of the Exchange Act (registration of national securities associations, *i.e.*, FINRA). Most of the provisions giving the SEC extensive regulatory authority over the SROs and setting the standards that the SROs must follow in proceedings involving their own members were adopted in 1975 amendments to the Exchange Act. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 16, 89 Stat. 97, 147–48 (1975). In 2004, the SEC proposed new rules and rule amendments relating to the governance, administration, transparency and ownership of SROs, the periodic reporting of information by SROs regarding their regulatory programs, and the listing and trading by the SROs of their own or affiliated securities. *See* SEC Release No. 34-50699 (Nov. 18, 2004). The comment period with respect to these proposals was extended to March 8, 2005, *see* SEC Release No. 34-51019 (Jan. 11, 2005), but the proposed rule was withdrawn in 2011.

Pursuant to amendments codified in the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000) (hereinafter the "CFMA"), § 2(a)(1)(D) of the CEA and § 6(h) of the Exchange Act require that security futures products be traded on exchanges that are registered under both the CEA and the Exchange Act. Accordingly, futures exchanges may register as national securities exchanges for the limited purpose of trading security futures products, and *vice versa*. *See* § 6(g) of the Exchange Act. In addition, CFTC-registered futures associations (such as the National Futures Association) are considered to be registered national securities associations for the limited purpose of supervising FCMs that notice register as broker-dealers for purposes of security futures product trading. *See* § 15A(k) of the Exchange Act. Such notice-registrants are exempt from certain of the requirements otherwise applicable to national securities exchanges and national securities associations. §§ 6(g)(4), 15A(k)(3) and (4) of the Exchange Act. *See generally* U.S. Regulation of the International Securities and Derivatives Markets, Twelfth Edition, Derivatives Markets, Chapter 4.

382 § 19(b) of Exchange Act; *see also* Rule 19b-4 under the Exchange Act.

383 § 19(c) of the Exchange Act. However, the SEC cannot require the SROs to adopt rules that go beyond the SEC's own proper purposes under the Exchange Act. *See Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

384 § 19(g) of Exchange Act. This obligation is subject to enforcement by the SEC. In 2013, for example, the Chicago Board Options Exchange settled a proceeding brought by the SEC alleging failure to enforce or even fully comprehend rules to prevent abusive short selling, pursuant to which the CBOE was fined $6 million. *See* SEC Charges CBOE for Regulatory Failures, SEC Press Release 2013-107 (June 11, 2013).

385 *See*, *e.g.*, §§ 6(d) and 15A(h) of the Exchange Act.

386 *See* § 19(d) and (e) of the Exchange Act and Rule 19d-3 thereunder.

387 FINRA in particular is required under the Exchange Act to adopt rules intended to prevent fraudulent and manipulative acts. *See* § 15A(b)(6) of the Exchange Act.

388 FINRA Rule 2010, FINRA MANUAL.

389 These exchanges are Bats BYX Exchange, Inc. (formerly BATS Y-Exchange, Inc.), Bats BZX Exchange, Inc. (formerly BATS Exchange, Inc.), Bats EDGA Exchange, Inc. (formerly EDGA Exchange, Inc.), Bats EDGX Exchange, Inc. (formerly EDGX Exchange, Inc.), BOX Options Exchange LLC, C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, LLC, ISE Gemini, ISE Mercury, Miami International Securities Exchange, NASDAQ BX, Inc. (formerly NASDAQ OMX BX, Inc.; Boston Stock Exchange), NASDAQ PHLX LLC (formerly NASDAQ OMX PHLX, LLC; Philadelphia Stock Exchange), National Stock Exchange, Inc., New York Stock Exchange, NYSE MKT LLC (formerly NYSE AMEX and the American Stock Exchange), the Investors Exchange LLC, the Nasdaq Stock Market LLC, As previously noted, FINRA is the only registered national securities association.

As noted in *supra* Note 381, futures exchanges and registered futures associations may notice register as limited-purpose national securities exchanges and national securities associations in connection with the trading of security futures products.

Following the SEC's adoption in 1998 of Regulation ATS, certain electronic trading systems have registered as for-profit national securities exchanges, such as NYSE Arca and the Nasdaq Stock Market. *See* §§ 14.10 and 3.01, Note 4; SEC Release No. 34-53128 (Jan. 13, 2006).

390 *See supra* Note 280 and accompanying text.

391 *See* § 14.07[1][a]. Guidance for FINRA Rule 2111 states in part:

> Implicit in all member and associated person relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of FINRA's rules, with particular emphasis on the requirement to deal fairly with the public. The suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct.

FINRA Rule 2111 (Suitability), Supplementary Material.01 (General Principles), FINRA MANUAL.

392 FINRA Rule 5110, FINRA MANUAL; *See* SEC Release No. 34-30587 (Apr. 15, 1992); FINRA Regulatory Notice 08-57 (Oct. 2008); *see also* FINRA Rule 5121, FINRA MANUAL, which contains special rules regarding offerings by a member of its own or its affiliates' securities.

393 FINRA Rule 5130, FINRA MANUAL. Rule 5130 is intended to ensure that FINRA members make a *bona fide*

public offering of new issues of equity securities at the public offering price. FINRA Rule 5130 replaced the NASD's prior interpretation, issued under Rule 2110 of the NASD Conduct Rules (now FINRA Rule 2010), prohibiting "free-riding" and "withholding" in connection with the underwriting of "hot issues." FINRA Rule 5130 is limited in its application to initial public offerings of equity securities, but applies to all such offerings regardless of whether they constitute "hot issues." *See* NASD Notice to Members 03-79 (Dec. 2003); FINRA Regulatory Notice 08-57 (Oct. 2008); *see also* § 3.06[2][a].

394 FINRA Rule 5131, FINRA MANUAL; *see also* § 3.06[2][b].

395 FINRA Rule 5141 FINRA MANUAL; *see* § 3.06[3]. FINRA Rule 5141 replaced the set of rules and interpretations commonly known as the Papilsky Rules, and like its predecessor, in some circumstances at least, permits tiered pricing for volume purchases where the pricing structure is disclosed in the offering prospectus.

396 FINRA Rules 2341, 5141, FINRA MANUAL.

397 FINRA Rule 2111, FINRA MANUAL. FINRA Rule 2111(b) incorporated earlier NASD interpretive guidance as to the manner in which a broker-dealer may satisfy its suitability obligation with respect to institutional customers. *See* FINRA Rule 2111, FINRA MANUAL; FINRA Regulatory Notice 13-31 (Sept. 2013) . In addition, to address concerns over the increasing use of the Internet by broker-dealers to provide information to prospective investors, FINRA issued a policy statement regarding the application of the suitability rule to online communications. The policy statement does not alter member obligations under the suitability rule, but provides "guidelines to assist members in evaluating whether a particular communication could be viewed as a 'recommendation.'" *See* NASD Notice to Members 01-23 (Apr. 2001). FINRA has also provided guidance regarding the applicability of NASD Rule 2310 (now FINRA Rule 2111) to recommendations of structured products. *See* NASD Notice to Members 05-59 (Sept. 2005). In addition, the Department of Labor's 2016 rulemaking expanded fiduciary duties for financial institutions engaged in advising employee benefit plans under ERISA. *See* 81 Fed. Reg. 68, 20946 (Apr. 8, 2016); § 14.07[1][a].

398 FINRA Rule 5310, FINRA M ANUAL. FINRA amended NASD Rule 2320 (now FINRA Rule 5310) to expressly provide that the duty of best execution applies to any transaction for or with a customer or a customer of another broker-dealer, resolving an ambiguity about the application of the rule where a broker-dealer receives a customer order from another broker-dealer for the purpose of order handling or execution. (The duty of best execution does not apply, however, when another broker-dealer is simply executing a customer order against the broker-dealer's quote.) SEC Release No. 34-54339 (Aug. 21, 2006). In 2015, FINRA issued guidance regarding the duty of best execution in which it noted that developments in order routing technology makes order-by-order review of execution quality possible for equity securities and standardized options and then identified large-sized orders and internally executed orders as two situations in which order-by-order (as opposed to regular and rigorous) review may be required. FINRA Regulatory Notice 15-46 (Nov. 2015).

399 FINRA Rule 2121, FINRA MANUAL.

400 FINRA Rule 2122, FINRA MANUAL.

401 SEC Release No. 34-43590 (Nov. 17, 2000). Pursuant to Rule 11Ac1-5 under the Exchange Act (redesignated as Rule 605 of Regulation NMS), market centers that trade national market system securities are required to make publicly available monthly electronic reports that include uniform statistical measures of execution quality. Under Rule 11Ac1-6 (redesignated as Rule 606 of Regulation NMS), broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that identify venues to which customer orders are routed for execution. Broker-dealers are also required to disclose to customers, upon request, the venue to which their individual orders were routed. The SEC staff has addressed frequently asked questions about Rule 11Ac1-5 in SEC, Division of Corporation Finance, Staff Legal Bulletin No. 12A (Sept. 6, 2001), Fed. Sec. L. Rep. (CCH) ¶60,012, and about Rule 11Ac1-6 in SEC, Division of Corporation Finance, Staff Legal Bulletin No. 13A, Fed. Sec. L. Rep. (CCH) ¶60,013 (Oct. 16, 2001).

402 FINRA Rule 2121, Supplementary Material.01 (Mark-Up Policy) and.02 (Additional Mark-Up Policy For

Transactions in Debt Securities, Except Municipal Securities), FINRA MANUAL. *See generally* NASD Notice to Members 92-16 (Apr. 1992); NASD Notice to Members 07-28 (June 2007). Supplementary Material.02(b)(9) provides for an exception to Rule 2121 (and the interpretations thereunder) for transactions with qualified institutional buyers ("QIBs") purchasing or selling noninvestment grade debt securities when the broker-dealer has determined that the QIB has the capacity to evaluate independently the investment risk and in fact is exercising independent judgment in deciding to enter into the transaction.

403 FINRA Rule 4210, FINRA MANUAL.

404 FINRA Rules 2210 and 2220, FINRA MANUAL.

405 FINRA Rule 2300 series and Rule 2216, FINRA MANUAL.

406 FINRA Rule 5320, FINRA MANUAL.

407 FINRA Rule 5280, FINRA MANUAL.

408 FINRA Rule 5210, FINRA MANUAL; *see also* FINRA Notice 14-28 (June 2014).

409 *See* FINRA Rules 6000 through 14,000 series, FINRA MANUAL

410 *See* § 14.07[2][b].

411 FINRA provides that a member whose aggregate indebtedness is more than ten times net capital must notify FINRA and may not grow its business further if such condition continues to exist for more than 15 consecutive business days. Additionally, if a FINRA member's aggregate indebtedness rises above 12 times its net capital, the member must actively reduce its liabilities. *See*, *e.g.*, FINRA Rules 4120(a)(1)(B), 4120(c)(1)(B), FINRA MANUAL. FINRA rules similarly have more stringent requirements for member firms that adopt the alternative method for calculating net capital.

412 *See* FINRA Rule 4210, FINRA MANUAL; *see also* § 14.07[6].

413 *See infra* Note 602.

414 *See* FINRA Rule 3270, FINRA MANUAL. It was relatively unusual for the NYSE to disapprove of a person's proposed outside activities.

415 *See* § 14.07[3][b] below.

416 For this purpose, a "control person" is a person who has the power to direct the management or policies of a company through ownership of securities, by contract, or otherwise. Control is presumed to exist if, before the transaction, the person has the right to vote or the power to sell or direct the sale of 25% or more of a class of voting securities or in the case of a partnership or limited liability company has the right to receive upon dissolution, or has contributed, 25% or more of the capital. A "privately-held company" is one that does not have any class of securities registered, or required to be registered, with the SEC under § 12 of the Exchange Act or with respect to which the company files, or is required to file, periodic information, documents, or reports under § 15(d) of the Exchange Act. FINRA CAB Rule 016(c)(1)(F), FINRA MANUAL.

417 FINRA CAB Rule 016(c), FINRA MANUAL.

See supra § 14.03[h] for discussion of the no-action letters referenced in item (G).

Because a CAB's activities must be limited to this list, a broker cannot register as a CAB if it carries or acts as an introducing broker with respect to customer accounts, holds or handles customer funds or securities, accepts orders from customers to purchase or sell securities either as principal or as agent for the customer (except as permitted by items (F) and (G) of this list), has investment discretion on behalf of any customer, engages in proprietary trading of securities or market-making activities, or participates in or maintains an online platform in connection with offerings of unregistered securities pursuant to Regulation Crowdfunding or Securities Act Regulation A, or effects securities transactions that would require the broker or dealer to report the transaction under the FINRA's trade reporting rules.

418 FINRA CAB Rule 201, FINRA MANUAL.

419 FINRA Rule 2210(d)(1)(F), with limited exceptions, prohibits member communications that "predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast." The parallel provision of FINRA CAB Rule 221 only prohibits member communications

that "imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast."

420 FINRA CAB Rules 300, 313, FINRA MANUAL.

421 FINRA CAB Rule 238, FINRA MANUAL.

422 *See also* § 14.08[1].

423 NASD Membership and Registration Rules, Rules 1020 and 1030, FINRA MANUAL. In addition, FINRA has issued interpretations, modeled after Rule 206(4)-3 under the Advisers Act, that regulate the involvement of registered broker-dealers with foreign "finders" of business. *See* NASD Membership and Registration Rules, Rule 1060(b), FINRA MANUAL; Incorporated NYSE Rule Interpretations, Rule 345(a)(i)/Interpretation 03, FINRA MANUAL.

424 For purposes of FINRA's rules, "associated person of a member" generally includes any registered natural person (or applicant for registration), sole proprietors, partners, officers, directors and branch managers of the member firm, any natural person occupying a similar status or performing similar functions, any natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member (whether or not such person is registered or exempt from registration). FINRA By-Laws, Art. I, Paragraph (rr), FINRA MANUAL. Note that this is not the same as the definition of "associated person of a broker or dealer" under the Exchange Act, *see* § 3(a)(18) of the Exchange Act, nor is it the same as the definition of "associated person" in NASD Rule 1011, which is applicable solely for purposes of the Rule 1010 Series (Membership Proceedings).

425 NASD Membership and Registration Rules, Rule Series 1020 and 1030 and Rule 1050, FINRA MANUAL (registration of principals, representatives and research analysts). Rule 1030 permits associated persons who act as representatives in certain limited areas to take a more focused examination than the Series 7 and receive a limited representative registration.

426 FINRA Rule 1230(b)(6), FINRA MANUAL.

427 NASD Rule 1021(e), FINRA MANUAL.

428 NASD Rule 1022(b), FINRA MANUAL.

429 NASD Rule 1022(d), FINRA MANUAL.

430 NASD Rule 1022(f), FINRA MANUAL.

431 NASD Rule 1013(a)(2), FINRA MANUAL. Certain associated persons of government-noticed financial institutions must file Form G-FIN-4 with the appropriate regulatory agency.

432 "Statutory disqualification" is defined in § 3(a)(39) of the Exchange Act.

433 FINRA has developed a centralized computer tracking system of all registered representatives and broker-dealers against whom actions have been taken or complaints have been made; access to such system is available to all SROs, broker-dealers, investors and the SEC. *See* § 14.08[1]. In addition, FINRA permits retail investors to review information on the professional background, business practices, and conduct of FINRA member firms and their associated persons through its BrokerCheck service. Member firms are required to include a "readily apparent reference and hyperlink"on their websites to BrokerCheck. FINRA Rule 2210, FINRA Manual; FINRA Regulatory Notice 15-50 (Dec. 2015).

434 FINRA allows a qualified registered representative in good standing with the Securities Association of the United Kingdom to become qualified as a general securities representative in the United States by passing a modified general securities representative examination (the Series 17 examination). NASD Notice to Members 90-69 (Oct. 1990). A modified version of the general securities representative examination has also been developed by the NYSE for qualified representatives in good standing with Canadian and Japanese securities regulators. *See* SEC Release Nos. 34-37112 (Apr. 12, 1996) (Japan), 34-36825 (Feb. 9, 1996) (Canada), 34-36708 (Jan. 11, 1996) (Japan).

In 2005, the NASD, the NYSE, and the Securities & Investment Institute (the United Kingdom's principal financial services qualifications provider) announced their agreement to create the Global Capital Markets Qualification (GCMQ) examination, a common qualifications test for capital market professionals that would allow such professionals to operate more easily in both the United States and in the United Kingdom. *See* Press Release, NASD, NASD, NYSE Regulation and U.K.'s Securities & Investment Institute Agree to Create New, International Securities Qualification Exam (July 26, 2005). Although the original press release predicted a late 2006 launch, thus far there have been no subsequent announcements or further developments after the consolidation of the NASD and NYSE into FINRA.

435 *See* Incorporated NYSE Rule 345A FINRA MANUAL; FINRA Rule 1250, FINRA MANUAL; SEC Release No. 34-35341 (Feb. 8, 1995) (order approving proposed rule changes of SROs relating to a continuing education requirement for registered persons); *see also* SEC Release No. 34-50456 (Sept. 27, 2004) (order approving amendments to rule changes of SROs eliminating all currently effective exemptions from the Regulatory Element of the Continuing Education Program).

436 *See* SEC Release No. 34-35341 (Feb. 8, 1995); SEC Release No. 34-50456 (Sept. 27, 2004); FINRA Regulatory Notice 11-33 (July 2011).

437 *See* SEC Release No. 34-35341 (Feb. 8, 1995); SEC Release No. 34-50456 (Sept. 27, 2004); FINRA Regulatory Notice 11-33 (July 2011).

438 FINRA By-Laws, Art V, Sec. 3(a); NASD Notice to Members 04-09 (Feb. 2004); *see also* FINRA Regulatory Notice 10-39 (Sept. 2010) (reminding members of their obligation to provide timely, complete and accurate information on Form U5).

439 A proposal by FINRA to provide its members with qualified immunity in arbitration proceedings for statements made in good faith in certain disclosure on Forms U4 and U5 ended when FINRA withdrew the proposed rule in 2005. *See* SEC Release No. 34-39892 (Apr. 21, 1998) (giving notice of the proposed rule); NASD, Withdrawal of Proposed Rule Change (Oct. 4, 2005).

440 *Rosenberg v. MetLife, Inc.*, 866 N.E.2d 439 (N.Y. 2007). *But see Moreland v. Perkins, Smart & Boyd*, 240 P.3d 601, 637 (Kan. Ct. App. 2010) (disagreement with *Rosenberg* and holding that statements on a Form U5 are subject only to a qualified privilege).

441 Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 1118 (1970).

442 USA PATRIOT Act, Pub. L. No. 107-56, 115 Stat. 272 (2001). The full name of the PATRIOT Act is the "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001."

443 In 2010, the BSA regulations administered by FinCEN were transferred from 31 C.F.R. Part 103 to 31 C.F.R. Chapter X. *See* 75 Fed. Reg. 65,806 (Oct. 26, 2010).

444 *See* GAO-02-11-1, ANTI-MONEY LAUNDERING: EFFORTS IN THE SECURITIES INDUSTRY (Oct. 2001).

445 *See* 31 U.S.C. § 5318(h); § 352 of the PATRIOT Act. In April 2016, FinCEN proposed a rule that would include funding portals that are involved in the offering or selling of crowdfunding securities pursuant to § 4(a)(6) of the Securities Act in the definitions of ''broker or dealer in securities'' and ''broker-dealer'' under the regulations implementing the BSA in order to subject such funding portals to the AML program and other AML requirements currently applicable to SEC-registered broker-dealers. *See* Amendments to the Definition of Broker or Dealer in Securities, 81 Fed. Reg. 19,086 (Apr. 4, 2016).

446 *See* 31 C.F.R. § 1023.210(b)(1); *see also* 67 Fed. Reg. 21,110, 21,111 (Apr. 29, 2002).

447 *See* FINRA Rule 3310, FINRA MANUAL; *see also* NASD Notice to Members 02-78 (Nov. 2002); NASD Notice to Members 02-21 (Apr. 2002); NYSE Information Memo 02-16 (Apr. 12, 2002); 74 Fed. Reg. 47,630 (Sept. 16, 2009) (adopting NASD Rule 3011 as FINRA Rule 3310 (without substantive changes). *See generally* FINRA, AML FAQs, *available at* http://www.finra.org/industry/faq-anti-money-laundering-faq (last visited Sept. 9, 2016); SEC, AML Source Tool, *available at* http://www.sec.gov/about/offices/ocie/amlsourcetool.htm (June 20, 2012) (last visited Sept. 9, 2016); SIFMA Anti-Money Laundering and Financial Crimes Committee, 2008 Guidance for Deterring Money Laundering and Terrorist Activity (Feb. 2008).

448 Firms that elect to be treated as "capital acquisition brokers" will be subject to a rule requiring them to implement a written AML program, similar to FINRA Rule 3310, but which will permit such firms to conduct

the required independent testing every two years rather than every year as required by FINRA Rule 3310. *See* FINRA Regulatory Notice 16-37 (Oct. 2016).

449 *See* 31 U.S.C. § 5318(g), PATRIOT Act § 356 (requiring adoption of final regulations applying BSA suspicious activity reporting requirements to broker-dealers); 31 C.F.R. § 1023.320; *see also* NASD Notice to Members 02-47 (Aug. 2002).

450 31 C.F.R. § 1023.320(a)(2). In promulgating its SAR Rule for broker-dealers, FinCEN clarified how introducing and clearing brokers may coordinate the filing of a single SAR for a reportable transaction. *See* 67 Fed. Reg. 44,048, 44,051–52 (July 1, 2002). *See also* FinCEN, Guidance to Financial Institutions in Filing SARs Regarding the Proceeds of Foreign Corruption (Apr. 17, 2008).

451 31 U.S.C. § 5318(g)(2); 31 C.F.R. § 1023.320(e); 75 Fed. Reg. 75,593, 75,595 (Dec. 3, 2010).

452 In 2006, FinCEN and the federal banking agencies issued guidance clarifying that financial institutions (including broker-dealers) may share SARs with their head offices or controlling companies (subject to certain requirements) but may not share SARs "horizontally" with other affiliates. *See* FinCEN, Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies (Jan. 20, 2006). In 2010, FinCEN adopted rules clarifying that the SAR confidentiality requirement extends to the SAR and "any information that would reveal the existence of a SAR," which would include all material prepared in connection with detecting and reporting suspicious activity whether or not a SAR was ultimately filed, but does not include "the underlying facts, transactions, and documents upon which a SAR is based." 75 Fed. Reg. 75,593, 75,595 (Dec. 3, 2010). The rules further provide that SARs or any information that would reveal the existence of a SAR may not be disclosed to any person, other than as specifically authorized, which for broker-dealers, would, so long as no person involved in the transaction is notified, permit sharing with (1) FinCEN, (2) any federal, state or local law enforcement agency, (3) any federal regulatory authority that examines the broker-dealer for BSA compliance, (4) any SRO that examines the broker-dealer for SAR rule compliance at the request of the SEC, (5) other financial institutions in connection with preparing a joint SAR, (6) in connection with certain employment references or termination notices or (7) within the broker-dealer's corporate organizational structure for purposes consistent with Title II of the BSA. 31 C.F.R. § 1023.320(e); *see also* 75 Fed. Reg. 75,593, 75,595 (Dec. 3, 2010). Additional guidance released by FinCEN in 2010 clarified that certain financial institutions (including broker-dealers) may share SARs that it has itself filed "horizontally" with certain affiliates that are also subject to a SAR regulation, subject to written confidentiality agreements with the affiliates agreeing to protect the confidentiality of SARs. *See* FinCEN, Guidance on Sharing Suspicious Activity Reports by Securities Broker-dealers, Mutual Funds, Futures Commission Merchants, and Introducing Brokers in Commodities with Certain U.S. Affiliates (Nov. 23, 2010).

453 31 U.S.C. § 5318(g)(3); 31 C.F.R. § 1023.320(f).

454 *Lopez v. First Union Nat'l Bank*, 129 F.3d 1186, 1192–93 (11th Cir. 1997).

455 *See Stoutt v. Banco Popular*, 320 F.3d 26 (1st Cir. 2003); *Lee v. Bankers Trust Co.*, 166 F.3d 540, 544–45 (2d Cir. 1999).

456 *See* 31 C.F.R. § 1023.220; 68 Fed. Reg. 25,133 (May 9, 2003); *see also* Joint Press Release, Department of Treasury, FinCEN and federal financial regulators, Treasury and Federal Financial Regulators Issue Final PATRIOT Act Regulations on Customer Identification (Apr. 30, 2003); FinCEN and other federal financial regulators, Interagency Interpretive Guidance on Customer Identification Program Requirements under Section 326 of the USA PATRIOT Act (Apr. 28, 2005); SEC, Guidance from the Staffs of the Department of the Treasury and the SEC: Questions and Answers Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003), *available at* http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm (last visited Sept. 9, 2016).

457 In its first enforcement action under the PATRIOT Act, in May 2006, the SEC sanctioned broker-dealer Crowell, Weedon & Co. for failing to document properly its actual customer identity verification procedures in its CIP. *See In the Matter of Crowell, Weedon & Co.*, SEC Release No. 34-53847 (May 22, 2006); *see also* FinCEN, FIN-2008-G002, Customer Identification Program Rule No-Action Position Respecting

Broker-Dealers Operating Under Fully Disclosed Clearing Agreements According to Certain Functional Allocations (Mar. 4, 2008) (FinCEN stating that it will take no action against a clearing firm not complying with the CIP rule with respect to a customer introduced pursuant to a clearing agreement with an introducing broker that allocates the functions of opening and approving customer accounts and directly receiving and accepting orders from the introduced customer exclusively to the introducing firm).

458 *See* 31 C.F.R. § 1023.100(d).

459 *See* 31 C.F.R. § 1023.220(a).

460 31 C.F.R. § 1023.220(a)(6); *see also Securities Industry and Financial Markets Association* (avail. Jan. 9, 2015) extending, until the earlier of (i) January 9, 2017 or (ii) the date upon which an AML program rule for investment advisers becomes effective, a no-action position first taken in *Securities Industry Association* (avail. Feb. 12, 2004) (SEC staff no-action position indicating that a broker-dealer may rely on a registered investment adviser to perform elements of the broker-dealer's CIP with respect to shared customers).

In 2010, FINRA recognized that there are limited "legitimate business arrangements" pursuant to which the identities of the beneficial owners of multiple sub-accounts to a master account may not be disclosed to the broker-dealer and, therefore, the broker-dealer may rely on information provided by others as to whether to treat a master/sub-account as having a single beneficial owner. For example, when a registered broker-dealer procures clearing services pursuant to an omnibus clearing arrangement on a basis in which the sub-account owners' identities are not disclosed to the clearing broker, the clearing broker may rely on information provided by the registered broker-dealer, absent actual or inquiry notice. FINRA Regulatory Notice 10-18 (Apr. 2010). *See also* Guidance from the Staffs of the Department of the Treasury and the SEC, Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003), *available at* http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm (last visited Sept. 9, 2016).

461 *See* 31 C.F.R. § 1023.220(a)(6); *see also Securities Industry and Financial Markets Association* (avail. Jan. 9, 2015).

462 *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,397 (May 11, 2016); 31 C.F.R. § 1010.230. *See also* FinCEN, FIN-2016-G003, Frequently Asked Question Regarding Customer Due Diligence Requirements for Financial Institutions (July, 19, 2016). The Final CDD Rule applies to a set of financial institutions that is generally consistent with the scope of financial institutions currently subject to BSA CIP requirements (*i.e.*, banks, broker-dealers, mutual funds, futures commission merchants and introducing brokers in commodities). The Final CDD Rule amends the rules implementing the AML program requirement for all such financial institutions to expressly codify the existing "four pillars" of BSA AML programs (internal controls, independent testing, BSA compliance officer and training) and to add a new fifth pillar requiring appropriate risk-based procedures for conducting ongoing customer due diligence. *See*, *e.g.*, 31 C.F.R. 1023.210.

463 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,409 (May 11, 2016); 31 C.F.R. § 1010.230.

464 Final CDD Rule, 81 Fed. Reg. 29,397, 29,398 (May 11, 2016).

465 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,412 (May 11, 2016); 31 C.F.R. 1010.230(e).

466 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,415-16 (May 11, 2016).

467 *See* Guidance from the Staffs of the Department of the Treasury and the SEC, Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule (Oct. 1, 2003). Other financial institutions subject to the Final CDD Rule would also be able to rely on existing guidance that applies for CIP purposes. *See also, e.g.*, Guidance from the Staffs of the Department of the Treasury and the SEC, Questions and Answers Regarding the Mutual Fund Customer Identification Rule (Aug. 11, 2003); FinCEN, FIN-2006-G004, Frequently Asked Question regarding Customer Identification Programs for Futures Commission Merchants and Introducing Brokers (Feb. 14, 2006); FinCEN, FIN-2006-G009, Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries (May 10, 2006).

468 *See* 31 C.F.R. § 1020.220(a)(6).

469 31 C.F.R. § 1010.520. In 2008, the Agreement on Mutual Legal Assistance between the United States and the European Union was ratified, giving EU member states access to the FinCEN 314(a) program. *See* 75 Fed. Reg. 6560 (Feb. 10, 2010); *see also* FinCEN, FinCEN's 314(a) Fact Sheet (Oct. 25, 2016) (describing the success of the FinCEN program). In 2010, the Information Sharing Rule was amended to include state, local and foreign (to the extent necessary to satisfy reciprocal treaty obligations) law enforcement agencies. 75 Fed. Reg. 6560 (Feb. 10, 2010).

470 *See* FinCEN Press Releases dated Apr. 2, 2003 (responding to industry comments regarding the information sharing process, and Dec. 17, 2004 (describing law enforcement-related results of the information sharing process under § 314(a)); *see also* GAO 10-622T, BETTER COMMUNICATIONS COULD ENHANCE THE SUPPORT FINCEN PROVIDES TO LAW ENFORCEMENT (Apr. 2010).

471 Financial institutions wanting to share such information with one another may satisfy the notice requirement by filing a standard 314b registration form with FinCEN, enabling the submission of such information through use of electronic mail. *See* FinCEN, Financial Institution Notification Form, *available at* http://www.fincen.gov/statutes_regs/patriot/section314b.html (last visited Sept. 9, 2016).

472 *See* 31 C.F.R. § 1010.540; § 314(b) of the PATRIOT Act.

473 31 U.S.C. § 5318(i); § 312 of the PATRIOT Act.

474 31 U.S.C. § 5318(i). Section 312 of the PATRIOT Act defines the term "private banking account" as an account (or combination of accounts) that (i) requires a minimum aggregate deposit of funds or other assets of not less than $1 million, (ii) is established on behalf of one or more individuals who have a direct or beneficial ownership in the account and (iii) is assigned to, or is administered or managed, in whole or in part, by an officer, employee or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account. *See* 31 U.S.C. § 5318(i)(4)(B).

475 *See also* 31 C.F.R. § 1010.610.

476 A "correspondent banking account" is commonly understood to mean a deposit account established by one bank for another bank to receive deposits and make payments.

477 31 C.F.R. § 1010.605(c)(1)(i); *see also* 31 U.S.C. § 5318A(e)(1)(B) (similarly defining "correspondent account" for banks).

478 31 C.F.R. § 1010.605(c)(2)(ii).

479 *See* 71 Fed. Reg. 496 (Jan. 4, 2006); 71 Fed. Reg. 16,040 (Mar. 30, 2006).

480 31 C.F.R. §§ 1010.610(a) and 620(a); *see also* FinCEN Guidance, FIN-2006-G009, Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries (May 10, 2006).

481 72 Fed. Reg. 44,768 (Aug. 9, 2007); 31 C.F.R. § 1010.610(b); *see also* FinCEN, FIN-2010-G001, Interagency Guidance on Obtaining and Retaining Beneficial Ownership Information (Mar. 5, 2010).

482 31 U.S.C. § 5318(j), *amended by* § 313(a) of the PATRIOT Act.

483 31 C.F.R § 1010.630. The prohibition on dealings with foreign shell banks also applies to U.S. banks and U.S. branches and agencies of foreign banks, but does not apply to other categories of BSA-regulated financial institutions.

The term "regulated affiliate" includes any foreign shell bank that (i) is an affiliate of a depository institution, credit union or foreign bank that maintains a physical presence in the United States or a foreign jurisdiction and (ii) is subject to supervision by a banking authority in the jurisdiction regulating such affiliated depository institution, credit union or foreign bank. *See* 31 C.F.R. § 1010.605(n).

484 31 C.F.R. § 1010.630(a)(2).

485 31 C.F.R. § 1010.630(b).

486 This does not prevent a research analyst from attending a pitch meeting in connection with an initial public offering of an "emerging growth company" ("EGC") that is also attended by investment banking personnel, provided that the research analyst does not engage in otherwise prohibited conduct during such meetings,

including efforts to solicit investment banking business. FINRA Rule 2241.01(b), FINRA MANUAL. FINRA members subject to the 2003 Global Research Settlement (described in §14.07[5][b] below) remain prohibited from participating in EGC pitch meetings.

487 In addition, compensation of any research analyst primarily responsible for the preparation of a research report must be reviewed and approved at least annually by a committee that reports to a member's board and that does not have any representation by the member's investment banking department. FINRA Rule 2241(b)(2)(F), FINRA MANUAL.

488 These prohibitions are not required with respect to "emerging growth companies," and may have exceptions for significant news or events occurring during these periods. FINRA Rule 2241(b)(2)(I), FINRA MANUAL.

489 FINRA Rule 2241(c), FINRA MANUAL.

In public appearances, a research analyst must similarly disclose if the analyst (or any member of the analyst's household) has a financial interest in the subject company's securities, if the member or its affiliates beneficially owns 1% or more of any class of the subject company's common equity, if the analyst knows or has reason to know the member or its affiliates received any compensation from the company or the subject company was a client of the member in the preceding twelve months, any other material conflict of interest of the research analyst or member that the research analyst knows or has reason to know. FINRA Rule 2241(d), FINRA MANUAL.

These disclosures in research reports or public appearances are not required to the extent they would reveal material non-public information regarding specific potential future investment banking transactions. FINRA Rule 2241(c)(5), (d)(2), FINRA MANUAL.

490 FINRA Rule 2241(c)(6), (7), FINRA MANUAL.

491 A FINRA member is not considered to have distributed an independent third-party research report that is made available on request, through a member-maintained website, or to a customer in connection with a solicited order in which a registered representative informed the customer of the availability of independent research and the customer requests such independent research.

492 An "independent third-party research report" is a research report produced by a person with no affiliation or business or contractual relationship with the FINRA member or its affiliates that is reasonably likely to inform the content of its research reports and makes content determinations without any input from the distributing member or its affiliates. FINRA Rule 2241(a)(3), FINRA MANUAL.

493 In March 2004, the NASD and NYSE issued a joint memorandum that provided interpretive guidance regarding the research analyst and research reports rules (the "2004 Joint Memorandum"). *See* NASD Notice to Members 04-18 (Mar. 2004) and NYSE Information Memo 04-10 (Mar. 9, 2004). Among other things, the 2004 Joint Memorandum stated that if a broker-dealer distributes a "globally branded" research report that was prepared by an affiliate but that uses a single marketing identity encompassing the broker-dealer, then all of the analyst conflict rules would apply to that report. In addition, under certain circumstances, foreign-based analysts employed by a foreign affiliate of the member may be viewed by the NASD and NYSE as "associated persons" of the member requiring, among other things, licensing and member-firm supervision. *See* NASD Notice to Members 04-18 (Mar. 2004) and NYSE Information Memo 04-10 (Mar. 9, 2004). These statements regarding globally branded research and foreign-based analysts engendered considerable controversy within the industry. In 2008, FINRA responded by creating an exemption from the research analyst qualification requirements for certain foreign-based analysts who contribute only to globally branded or foreign affiliate research reports. *See* NASD Rule 1050, FINRA M ANUAL; Incorporated NYSE Rule Interpretation 344/02, FINRA MANUAL; SEC Release No. 34-57278 (Feb. 6, 2008).

494 FINRA Rule 2241(f), FINRA MANUAL.

495 *See* NASD Notice to Members 04-25 (Mar. 2004). A research analyst employed by a foreign broker-dealer affiliate of the FINRA member is not required to register as a research analyst and pass the examination unless the research analyst is also an associated person of the FINRA member. *See* NASD Notice to

Members 04-25 (Mar. 2004).

496 *See* NASD Notice to Members 04-81 (Nov. 2004).

497 *See* SEC Release No. 34-47384 (Feb. 20, 2003). Regulation AC applies to both U.S. and foreign broker-dealers (subject to the limited exception noted below) and certain of their affiliates in respect of research reports prepared by research analysts that have been distributed to U.S. persons. Regulation AC, however, does not apply to those affiliates with respect to which the broker-dealer has established and enforced information barriers and other appropriate policies and procedures reasonably designed to prevent the broker-dealer from influencing the affiliate or the content of research reports prepared by the affiliate or its personnel (this provision is intended to prevent the broker-dealer from doing indirectly through an affiliate what it could not do directly without complying with the certification requirements of the regulation). In addition, Regulation AC includes certain exemptions related to (i) the distribution by a broker-dealer or other covered person of third-party research, (ii) offshore appearances by research analysts employed outside the United States by a non-U.S. entity, (iii) activities of the news media, (iv) activities of investment advisers not required to register under the Advisers Act, and (v) research reports on foreign securities prepared by a foreign broker-dealer that is not affiliated with an SEC-registered broker-dealer and that provides such research reports to major U.S. institutional investors in accordance with Rule 15a-6(a)(2) under the Exchange Act. *See also* SEC, Division of Trading and Markets, Responses to Frequently Asked Questions Concerning Regulation Analyst Certification (rev. Apr. 26, 2005), in which the SEC staff clarifies a number of issues regarding Regulation AC, including the general application of Regulation AC to foreign broker-dealers and the circumstances under which foreign broker-dealers that are not associated with SEC-registered broker-dealers may disseminate research reports to U.S. investors without becoming subject to the requirements of Regulation AC.

498 Rule 501 of Regulation AC.

499 Rule 502(a) of Regulation AC.

500 Rule 502(b) of Regulation AC.

501 The ten settling firms were: Bear, Stearns & Co. Inc.; Credit Suisse First Boston LLC; Goldman, Sachs & Co.; Lehman Brothers Inc.; J.P. Morgan Securities Inc.; Merrill Lynch; Morgan Stanley & Co. Inc.; Citigroup Global Markets Inc. (formerly, Salomon Smith Barney Inc.); UBS Warburg LLC; and U.S. Bancorp Piper Jaffray Inc. *See* SEC Litigation Release No. 18438 (Oct. 31, 2003).

Two other firms involved in related enforcement actions, *Deutsche Bank Securities Inc.*, SEC Litigation Release No. 18854, and *Thomas Weisel Partners LLC*, SEC Litigation Release No. 18855, reached a settlement with the Regulators on August 26, 2004 and agreed to pay a total of $87.5 million and $12.5 million, respectively. The terms of these two settlement agreements were substantially the same as the settlements entered into with the other ten firms and, for purposes of the remainder of this discussion, the terms "Global Research Settlement" and "settling firms" include these two additional firms. In March 2007, Banc of America Securities LLC reached a similar settlement with the Regulators and became subject to many of the same requirements as the other firms with respect to the separation of research and investment banking operations. *See* SEC Release No. 34-55466 (Mar. 14, 2007).

502 The settling firms and the Regulators agreed to amend certain provisions of the forward-looking aspects of the Global Research Settlement, which amendments were entered by the district court on September 24, 2004. On November 2, 2004, the staff of the SEC's Division of Market Regulation (since renamed the Division of Trading and Markets) issued an interpretive letter to Cleary, Gottlieb, Steen & Hamilton, acting on behalf of the settling firms, which addressed a number of questions regarding the forward-looking aspects of the Global Research Settlement. *See* Letter, dated Nov. 2, 2004, to Dana G. Fleischman of Cleary, Gottlieb, Steen & Hamilton re: Global Research Settlement. Further information with respect to the Global Research Settlement may be found on the SEC website, at www.sec.gov/spotlight/globalsettlement.htm.

503 For example, the NASD and NYSE revised their rules to incorporate certain of the Global Research Settlement's requirements, including the prohibition on research analysts' participation in certain company-

sponsored or investment banking-sponsored roadshows. *See* SEC Release No. 34-51593 (Apr. 21, 2005). Further, in recognition of the IPO Allocation Initiative and following through with certain suggestions made in the IPO Task Force Report, FINRA adopted Rule 5131, which addresses quid pro quo allocations, spinning and flipping. *See* FINRA Rule 5131, FINRA MANUAL. For further information with regard to the IPO Task Force Report, *see* § 3.06[2][b].

In addition, the SEC has published an interpretation of Regulation M highlighting certain prohibited attempts to induce aftermarket purchases during the restricted period. SEC Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations, SEC Release No. 34-51500 (Apr. 7, 2005); *see also* § 3.02[9].

504 For example, the Treasurer of the State of California, one of the nation's largest bond issuers and a major investor *via* its pension funds, announced that new conflict of interest and disclosure standards (the "Investment Protection Standards") would be imposed on investment banks that do business with the state, which standards largely mirror the terms of the Global Research Settlement. *See* News Release, California State Treasurer Phil Angelides, Treasurer Angelides Announces Tough New Requirements for Investment Banks That Do Business With State of California (May 8, 2003). The California Public Employees Retirement System and the California State Teachers Retirement System (the nation's largest and third largest public pension funds, respectively) also voted to impose the Investment Protection Standards on those investment banks that do business with them. *See* Gilbert Chan, *Pension Fund Calls for Reforms*, THE SACRAMENTO BEE, Aug. 19, 2003; News Release, California State Treasurer Phil Angelides, Treasurer Angelides Wins CalSTRS Approval of Key Shareholder Protection Initiatives (July 9, 2003).

505 *See*, *e.g.*, CFA Institute Best Practice Guidelines Governing Analyst/Corporate Issuer Relations (Nov. 12, 2004), a joint product of the CFA Institute (formerly known as the Association for Investment Management and Research) and the National Investor Relations Institute, which addresses such issues as analyst independence as it applies to analysts' relationships with corporate issuers, access to corporate executives, retaliation by issuers against analysts, pre-publication review of analyst research reports by the issuer and issuer-paid research.

506 Because of the global nature of the operations of the settling firms, the settling firms (and their affiliates) may also be subject to requirements regarding research analyst conflicts of interest and related matters in other jurisdictions (both outside the United States and within the United States under state or local law). For example, the Financial Conduct Authority of the United Kingdom (the "FCA") takes a principles-based approach, which requires regulated firms to develop and publish policies to ensure that their research analysts do not compromise their objectivity. *See* Business Standards, Conduct of Business Sourcebook, COBS 12, FCA HANDBOOK (Jan. 2013); *see also* Hong Kong Securities and Futures Commission, CODE OF CONDUCT FOR PERSONS LICENSED BY OR REGISTERED WITH THE SECURITIES AND FUTURES COMMISSION, paragraph 16 (Mar. 2014); International Organization of Securities Commissions, IOSCO STATEMENT OF PRINCIPLES FOR ADDRESSING SELL-SIDE SECURITIES ANALYST CONFLICTS OF INTEREST (Sept. 2003).

507 *See*, *e.g.*, SEC, Jumpstart Our Business Startups Act, Frequently Asked Questions About Research Analysts and Underwriters (Aug. 22, 2012), *available at* https://www.sec.gov/divisions/marketreg/tmjobsactresearchanalystsfaq.htm (last visited Dec. 19, 2016).

508 *See*, *e.g.*, Susanne Craig & Kara Scannell, *SEC Tried to Ease Curbs*, WALL STREET J. (Mar. 17, 2010).

509 § 7(c)(1) of the Exchange Act. Section 7(d) of the Exchange Act empowers the Board to impose restrictions on securities-related lending by lenders other than broker-dealers and certain of their associated persons and § 7(f) authorizes restrictions on borrowers. Section 7(c)(2) of the Exchange Act makes it unlawful for a broker-dealer or member of a national securities exchange to extend or maintain credit or collect margin in connection with any security futures product except in compliance with regulations promulgated by the Board or by the SEC and CFTC jointly pursuant to authority delegated by the Board. The Board has delegated margin-setting authority in connection with security futures products to the SEC and CFTC jointly. *See* Letter of the Board, dated March 6, 2001, to James E. Newsome, then-Acting Chairman of the CFTC, and Laura S. Unger, then-Acting Chairman of the SEC. Margin requirements in connection with

security futures products are required to be consistent with the margin requirements for comparable exchange-traded options and in particular, initial and maintenance margin levels may not be lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded options. § 7(c)(2)(B) of the Exchange Act. In 2002, the SEC and the CFTC adopted rules to establish margin requirements for security futures. *See* SEC Release No. 34-46292 (Aug. 1, 2002).

510 A customer who purchases securities "on margin" pays only a portion of the purchase price and receives an extension of credit for the remainder. The margin regulations, among other things, specify the minimum amount of cash or margin the purchaser must put up as collateral in connection with a transaction involving borrowing on securities.

511 The credit practices of broker-dealers received increased attention with the expansion of prime brokerage services and the proliferation of hedge funds. *See*, *e.g.*, *Hedge Funds and Systemic Risk: Perspectives of The President's Working Group on Financial Markets: Hearing before the House Financial Services Comm.*, 110th Cong. (July 11, 2007) (testimony regarding SEC initiatives by Erik R. Sirri, Director, SEC Division of Market Regulation); Annette L. Nazareth, SEC Commissioner, Remarks Before the PLI Hedge Fund Conference (June 6, 2007); Ben S. Bernanke, Chairman, Federal Reserve Board, Hedge Funds and Systemic Risk, Remarks at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference (May 16, 2006).

512 *See* H. Rep. No. 1383, 73d Cong., 2d Sess. (1934); 78 CONG. REC. 7703 (Apr. 30, 1934).

513 12 C.F.R. Part 220. Regulation T also applies to certain associated persons of broker-dealers, including their subsidiaries (broker-dealers and other persons covered by Regulation T are known as "creditors"). Regulation U (12 C.F.R. Part 221) governs securities-related lending by banks and certain other lenders not subject to Regulation T. Regulation X (12 C.F.R. Part 224) governs U.S. persons, and certain foreign persons controlled by U.S. persons, who borrow outside the United States to finance a purchase of securities of U.S. issuers and, in some cases, who borrow in the United States to finance a purchase of any securities.

514 *See* § 14.07[6][a][ii].

515 *See* 12 C.F.R. § 220.3(g). Prior to the 1996 amendments to Regulation T, a broker-dealer generally could not (except in certain limited circumstances) arrange for an extension of credit by a third party to a customer on terms better than Regulation T would allow the broker-dealer to extend directly. *See* 61 Fed. Reg. 20,386 (May 6, 1996). Note, however, that there continues to be an "arranging prohibition" in Regulation U. *See* 12 C.F.R. § 221.3(a)(3). For a discussion of restrictions on lending in connection with a distribution by broker-dealer participants, *see* § 14.07[6][c].

516 For purposes of Regulation T, a "customer" of a "creditor," *see supra* Note 513, is defined as (i) any person or persons, other than an "exempted borrower," to or for whom the creditor extends, arranges, or maintains any credit or who would be considered a customer of the creditor according to the ordinary usage of the trade, (ii) any partner of the creditor who would be considered a customer absent the partnership relationship, and (iii) any joint venture in which the creditor participates which would be considered a customer if the creditor were not a participant. 12 C.F.R. § 220.2.

517 12 C.F.R. § 220.4.

518 In contrast, FINRA imposes "maintenance" margin requirements on its members. *See* § 14.07[6][b].

521 12 C.F.R. § 220.12.

522 12 C.F.R. § 220.3(i).

523 A "‘payment period" is defined in Regulation T (12 C.F.R. § 220.2) as the standard securities settlement cycle in the United States plus two business days. Effective June 7, 1995, the standard settlement cycle was reduced from five business days to three, at which time a "payment period" was correspondingly reduced from seven business days to five. *See* SEC Release No. 34-33023 (Oct. 6, 1993); *see also* SEC Release No. 34-34952 (Nov. 9, 1994).

524 12 C.F.R. § 220.4(c)(3)(i).

525 12 C.F.R. § 220.4(d).

526 12 C.F.R. § 220.8 (cash account); 12 C.F.R. § 220.7 (broker-dealer credit account) 12 C.F.R. § 220.6 (good faith account).

The "broker-dealer credit account" may be used for certain transactions with other broker-dealers. For example, the account may be used for purchase and sale transactions between two self-clearing broker-dealers acting for their own behalf if the seller will promptly deliver the securities against payment of the purchase price. *See* Fed. Res. Reg. Serv. ¶5-615.78 (staff opinion, Jan. 28, 1998). The account may also be used to effect and finance transactions for another SEC-registered broker-dealer that gives written instructions that all transactions in the account will be for such broker-dealer's customers.

In addition to these three special purpose accounts, Regulation T provides for a "special memorandum account" that is linked to the customer's margin account. 12 C.F.R. § 220.5. It is used to hold customer funds not required by Regulation T to be maintained in the margin account (such as margin excess, interest or dividend payments, and funds deposited to satisfy a maintenance margin call under SRO rules or the broker-dealer's "house" requirements) and has the effect of preserving a customer's ability to use or withdraw such funds. No securities are purchased in a special memorandum account; instead, the purchase is recorded in the margin account and funds can be transferred from the special memorandum account to the margin account to satisfy the Regulation T margin requirement.

527 12 C.F.R. § 220.8(a)(1).

528 12 C.F.R. § 220.8(b)(2).

529 12 C.F.R. § 220.8(b)(1)(ii).

530 12 C.F.R. § 220.10(a); *see also infra* § 14.07[6][a][iii].

531 The types of securities defined as "margin securities" are specified at 12 C.F.R. § 220.2.

532 *See* 63 Fed. Reg. 2806 (Jan. 16, 1998).

533 *See* 63 Fed. Reg. 2806, 2815 (Jan. 16, 1998); 12 C.F.R. § 220.2. This provision became obsolete on August 1, 2006, when the Nasdaq Stock Market began operating as a national securities exchange.

534 12 C.F.R. § 220.2. Securities deemed to have a "ready market" for purposes of the SEC's net capital rule include equity securities of foreign issuers that are listed on the FTSE World Index and certain other equity securities listed for trading on a foreign exchange located in a country recognized on the FTSE World Index. *See FINRA Interp. Handbook* Rule 15c3-1(c)(11)(i) Interpretation/02; *Grace B. Vogel* (avail. Nov. 28, 2012); *William Wollman* (Feb. 9, 2016). Technically, "foreign margin stock" also includes equity securities that appear on a List of Foreign Margin Stock published by the Federal Reserve Board, but that list has not been published since 2004. FRB Press Release (Mar. 3, 2004).

535 *See* 12 C.F.R. § 220.1(b)(3)(ii); *see also* 12 C.F.R. § 220.10(c) (expressly permitting exempted borrowers to lend securities without regard to Regulation T and broker-dealers to borrow securities from an exempted borrower without regard to Regulation T).

536 *See* 12 C.F.R. § 220.2.

537 Under the safe harbor provided in 12 C.F.R. § 220.2, exempted borrowers include any registered broker-dealer that:

- Maintains at least 1000 active accounts on an annual basis for persons other than brokers, dealers, and persons associated with a broker or dealer;
- Earns at least $10 million in gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer; or
- Earns at least 10 percent of its gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer.

538 *See* 12 C.F.R. §§ 221.1(b)(3) and 221.2.

539 SRO margin requirements may still apply to certain loans by a member to an exempted borrower and

capital charges or "haircuts" may need to be taken to the extent those loans are not adequately margined. *Cf. FINRA Interp. Handbook* Rule 15c3-1(c)(2)(iv)(B) Interpretation/093 (requiring broker-dealers, including exempted borrowers, engaged in "nonpurpose" securities borrowing transactions solely for the purpose of financing positions of another broker-dealer to maintain equity at least equal to the haircut deduction required under the SEC's Net Capital Rule or take a charge against its own capital for any deficiency).

540 FINRA Rule 4210(g), FINRA MANUAL; CBOE Rule 12.4.

541 *See* SEC Release No. 34-54918 (Dec. 12, 2006) (NYSE); SEC Release No. 34-54919 (Dec. 12, 2006) (CBOE); SEC Release No. 34-55471 (Mar. 14, 2007) (NASD).

542 Currently, the only model that has been approved by the SEC is The Options Clearing Corporation's Theoretical Intermarket Margining System ("TIMS").

543 Before implementing portfolio margining for any customer, a firm must receive approval from its designated examining authority and establish a comprehensive risk analysis methodology. The firm must maintain a separate securities account for portfolio margining, and only certain equity securities and futures are eligible for portfolio margin treatment. *See generally* FINRA Rule 4210(g), FINRA MANUAL. Significant regulatory uncertainty remains as to how accounts that hold both securities and futures will be handled. *See* Cleary Gottlieb Steen & Hamilton LLP, *SEC Approves Amendments to NYSE and CBOE Margin Rules that Substantially Expand Portfolio Margining*, at 23-25 (Jan. 3, 2007) (on file with the Business Development Department of Cleary Gottlieb Steen & Hamilton LLP). However, in a 2012 no-action letter, the SEC staff stated that it would not recommend enforcement action if a broker-dealer, when calculating its net capital using a theoretical option pricing, groups a U.S.-listed security futures contract on individual stocks with equity options on, and positions in, the same underlying instrument. *See FINRA* (avail. May 4, 2012).

544 The Board has authority to prescribe maintenance margin requirements but generally has not done so.

The SRO margin rules also supplement Regulation T in a variety of other ways, such as providing detailed margin requirements for options, *see* FINRA Rule 4210(f)(2), FINRA MANUAL, and specific requirements for day trading, *see* FINRA Rule 4210(f)(8)(B), FINRA MANUAL and § 14.10[4].

545 *See* FINRA Rule 4210(e)(2)(A), FINRA MANUAL.

546 The Exchange Act does not define the circumstances under which a broker-dealer will be deemed to have participated in a "distribution" for purposes of § 11(d)(1). Several SEC no-action letters have found that certain traditional private placements under § 4(2) (now § 4(a)(2)) of the Securities Act were not subject to § 11(d)(1). *See*, *e.g.*, *Synergia Resources XX* (avail. Mar. 20, 1986); *Brandywine Associates II* (avail. Nov. 12, 1973). Although the SEC has not expressed a view on whether §11(d)(1) applies to Rule 144A offerings generally, the SEC staff has issued no-action letters to that effect in particular circumstances. *See*, *e.g.*, *Ontala Forest Products Inc.* (avail. Dec. 14, 1994) (§ 11(d) of the Exchange Act does not apply to a Rule 144A offering to a limited number of qualified institutional buyers); Suncor Inc. (avail. Feb. 25, 1992).

547 A secondary offering of securities can in some circumstances constitute a new issue for purposes of § 11(d) of the Exchange Act. *See*, *e.g.*, *Oakwood Homes* (avail. Oct. 11, 1978).

548 The SEC has taken the position that for purposes of § 11(d)(1), shares of registered investment companies and unit investment trusts, including most mutual funds and exchange-traded funds ("ETFs"), are distributed in a continuous manner. Broker-dealers selling such securities are therefore deemed to be participating in a "distribution" of a new issue, and thus require an exemption from § 11(d)(1) to provide financing on such securities. Rule 11d1-2 under the Exchange Act provides an exemption for credit on securities issued by a registered open-end investment company or unit investment trust that have been owned by the borrower for more than 30 days or purchased pursuant to a plan for the automatic reinvestment of the dividends on such security. The SEC has also provided exemptive relief allowing broker-dealers involved in the issuance of ETF shares to extend credit on those shares without violating § 11(d)(1), subject to certain conditions. These conditions include a broad prohibition on compensation to the broker-dealer from the ETF or other persons associated with the ETF to promote or sell ETF shares, a requirement that the relevant ETF shares be issued by a "qualifying ETF," and the passage of a 30-day start-up period for the ETF. *See Derivative Products Committee of the Securities Industry Association*

(avail. Nov. 21, 2005) (This no-action letter addresses additional topics that may be of concern to broker-dealers trading or financing ETF shares, such as describing significant restrictions on the ability of broker-dealers to receive compensation (including "12b-1 fees") from the ETF or any related parties to promote or sell such ETF shares.). In 2012, the SEC staff clarified that the broker-dealer would be eligible for the relief even if it receives payment in-kind, such as the donation of experts from an ETF research team to speak at a webcast, from ETF sponsors, advisers or service providers to fund educational and training programs for clients and investment professionals. *See Elliott R. Curzon* (avail. Aug. 23, 2012).

549 *See* H. Rep. No. 1383, 73d Cong., 2d Sess. 22 (1934) (§ 11(d) of the Exchange Act strikes at "one of the greatest potential evils inherent in the combination of the broker and dealer function in the same person, by assuring that he will not induce his customers to buy on credit securities which he has undertaken to distribute to the public").

550 *See supra* Note 547. The SEC, however, has exempted certain "direct participation programs" (*see* Rule 3a12-9 under the Exchange Act), and granted no-action or exemptive relief in a number of cases to permit broker-dealers to effect installment sales, or other sales of partly-paid securities, to U.S. persons in connection with global offerings. *See*, *e.g.*, *Cleary Gottlieb Steen & Hamilton LLP* (avail. Sept. 12, 2006) (up to 40% of global offering sold within the United States to qualified institutional buyers under Rule 144A); *Telecom Corp. of New Zealand* (avail. Feb. 25, 1998) (up to 20% of global offering publicly offered in the United States).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.08, INTERNAL PROCEDURES

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 § 14.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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To assure compliance with applicable rules and regulations, registered broker-dealers are required to follow detailed procedures with respect to a number of their internal practices, including hiring, supervisory procedures and recordkeeping. [551]

[1] Hiring

A broker-dealer's compliance responsibilities for its employees [552] and other associated persons begin in the hiring process. A broker-dealer is required to obtain from an employment applicant the information specified in FINRA's Form U-4. [553] The broker-dealer must affirmatively verify the information that an applicant provides. [554] All of the required information must be kept current after the applicant becomes an employee. Failure to register personnel with FINRA is a violation of Rule 15b7-1 under the Exchange Act. [555]

As a result of increasing concern regarding sales practice abuses by broker-dealer employees who are able to obtain new employment despite past misconduct, the staff of the SEC, in coordination with the NASD and NYSE, made a number of recommendations to improve employee monitoring and reporting procedures. [556] In addition to recommending that broker-dealers improve their compliance procedures and monitoring and recording of data on employees generating regulatory actions, complaints and arbitration damages, the SEC staff

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has also recommended that broker-dealers increase the frequency and scope of their reports to SROs regarding such employees. [557]

To assist in the hiring and supervising processes, FINRA maintains a centralized, industry-wide computer tracking system of all employees and broker-dealers against whom actions have been taken or complaints have been made; access to such system is available to all SROs, broker-dealers, investors and the SEC. [558] In connection with the expanded monitoring and access to records of such employees and broker-dealers, the staff of the SEC recommended that broker-dealers more rigorously screen employees with histories of misconduct by, among other things, involving the legal and compliance departments in hiring, providing written justification when an applicant is hired against the advice of such departments and encouraging SROs to sanction broker-dealers who hire recidivist problem employees. [559] The SEC also announced that a registered representative against whom it imposed an unqualified bar (*i.e.*, one that does not allow for reapplication after a specified time period) permanently excluding such representative from participation in the securities industry will be, absent extraordinary circumstances, unable to successfully petition for reentry. [560]

[2] Supervision

A broker-dealer is liable for any violation of the securities laws committed by any of its associated persons unless the broker-dealer can establish a defense that: (i) the broker-dealer "established procedures and a system for applying such procedures" that could reasonably be expected to "prevent and detect" a violation, (ii) the procedures were properly performed, and (iii) the supervisor had no reason to suspect any violation. [561]

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In 1992, the SEC for the first time fined and suspended persons that had been executive officials, including the former chief executive officer of a broker-dealer, for their failure to provide adequate supervision of employees, which failure was, in the SEC's view, compounded by the officials' failure to report prior securities law violations to government authorities. [562] The Supervisory Release announcing the fines and suspensions was intended by the SEC to serve as a significant statement of its policies regarding supervision, and to put officers of broker-dealers generally on notice of the SEC's views. [563] The Supervisory Release states that the federal securities laws "require a vigorous response even to indications of wrongdoing." It continues by stating that even if supervisory knowledge "is limited to ‘red flags' or ‘suggestions' of irregularity," a supervisor cannot discharge his responsibilities by relying on employees' unverified statements denying wrongdoing; instead, a supervisor must independently "follow-up and review" the irregularity. Further, where more than one supervisor is involved in considering the actions to be taken in response to possible misconduct, there must be a "clear assignment" of follow-up responsibilities to particular individuals, with the chief executive officer of the broker-dealer bearing "ultimate responsibility." [564]

The Supervisory Release also states that a broker-dealer's in-house lawyers or compliance personnel who do not have actual supervisory authority over an individual engaged in wrongdoing may be found to be "supervisors" where the lawyer or compliance officer has the "requisite degree of responsibility, ability, or authority to affect the conduct of the employee whose behavior is at issue." Where the lawyer or compliance officer takes "appropriate steps but management fails to act," the lawyer or compliance officer "should consider" disclosure of the matter to the broker-dealer's board of directors, resignation or disclosure to regulatory authorities. [565]

Like the SEC, FINRA does not prescribe any particular system of supervision or specific procedures that must be implemented. This is left to the individual broker-dealer and is expected to vary with the size of and activities

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engaged in by the broker-dealer. FINRA does, however, provide certain minimum standards for a system of internal supervision. [566] Each broker-dealer is required to (i) "establish and maintain a system [of written procedures] to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA and Municipal Securities Rulemaking Board ("MSRB") rules," [567] (ii) have in place mandatory cycles of independent inspections for its supervisory branch offices, nonsupervisory branch offices and unregistered locations, [568] (iii) designate and specifically identify to FINRA one or more principals charged with establishing, maintaining and enforcing a system of "supervisory control policies and procedures" that test, verify and, where necessary, create additional or amended supervisory procedures of the member broker-dealer, [569] (iv) designate and specifically identify to FINRA a principal to serve as chief compliance officer [570] and (v) have its chief executive officer execute an annual compliance and supervision certification with respect to the member broker-dealer's written compliance policies and supervisory procedures. [571]

[3] Recordkeeping and Financial Reporting

[a] Reports Concerning the Broker-Dealer

The Exchange Act's extensive books and records requirement [572] serves to assist the SEC and SROs in enforcing the Exchange Act's substantive regulatory requirements. [573] For example, the books and records requirement is an important

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adjunct to the financial responsibility rules. [574] In addition, the records that a broker-dealer keeps of its own trades allow the SEC and the SROs to audit the broker-dealer's compliance with the trading, anti-manipulative and antifraud restrictions of the securities laws. [575] Moreover, the records that a broker-dealer keeps of employment applications allow the SEC to verify that the broker-dealer is in compliance with the rules related to associated persons.

Rules 17a-3 and 17a-4 are the most significant Exchange Act provisions regarding broker-dealer recordkeeping. [576] The records required by Rule 17a-3 include, in addition to ordinary balance sheets, a "blotter" [577] of all purchases and sales of securities, blotters for securities and cash received and disbursed, customer ledgers, records of every confirmation sent with respect to a securities transaction, records of every purchase and sale for the account of the broker-dealer and records of every brokerage order or other instruction given or received for the purchase or sale of securities, whether or not executed. Rule 17a-4 provides that a registered broker-dealer must, among other things, maintain its checkbooks, bank statements, bills, originals of all communications received and copies of all communications sent (including inter-office memoranda and communications) relating to its business and all written business agreements, as well as a description of the broker-dealer's procedures concerning its handling of fully paid and excess margin securities. The SEC has stated that the records required to be maintained under Rule 17a-4 are not limited to physical documents, and that internal (or "intra-office") electronic communications relating to a broker-dealer's "business as such" are covered by the rule. [578] The location in which and

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the length of time for which a broker-dealer must keep records are also set out in Rule 17a-4. [579]

The financial statements and reports that must be prepared by a broker-dealer are described in Rule 17a-5, which was substantially amended in 2013. [580] Prior to 2013, the rule required, among other things, the preparation of an annual audited financial statement that included the following: (i) statement of financial condition, (ii) statement of income (loss), (iii) statement of cash flows, (iv) statement of changes in stockholders' equity, and (v) statement of changes in liabilities subordinated to claims of general creditors. [581]

Pursuant to the 2013 amendments, with respect to fiscal years ending on or after June 1, 2014, a broker-dealer must file certain annual reports within 60 calendar days of the end of its fiscal year. [582] Pursuant to the amended rule, all registered broker-dealers are required to file with the SEC an annual financial report containing the same types of information included in the financial statements required prior to the 2013 amendments (as described in the paragraph above). [583] Further, a PCAOB-registered independent public accountant must prepare a report based on an examination of the broker-dealer's financial report in

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accordance with PCAOB standards. [584] In addition, a broker-dealer is required to file either a "compliance report" (if it holds customer funds or securities) or an "exemption report" (if it does not hold customer funds or securities) and a PCAOB-registered independent accountant must prepare a report based on an examination of certain statements in the broker-dealer's compliance report or exemption report. [585] All reports must be filed with the SEC and, if the broker-dealer is a member of SIPC, with SIPC. [586] The broker-dealer must also file a supplemental report on the status of its membership in SIPC (including a report of an independent public accountant that covers the SIPC annual general assessment reconciliation or exclusion from membership forms). [587]

The compliance report must contain (1) a statement as to whether the broker-dealer has established and maintained internal controls providing it with reasonable assurance that non-compliance with the financial responsibility rules will be prevented or detected on a timely basis, (2) a statement as to whether the internal controls were effective during the most recent fiscal year, [588] (3) a statement as to whether the controls were effective as of the end of the most recent fiscal year, (4) a statement as to whether the broker-dealer is in compliance with Rule 15c3-1 and Rule 15c3-3(e) as of the end of the most recent fiscal year, and (5) a statement as to whether the information the broker-dealer used to state whether it was in compliance with Rule 15c3-1 and Rule 15c3-3(e) was derived from the books and records of the broker-dealer. [589]

The exemption report must include, to the best knowledge and belief of the broker-dealer, (1) a statement that identifies the provision in Rule 15c3-3(k) under which the broker-dealer claimed an exemption from Rule 15c3-3, (2) a statement that the broker-dealer met the identified exemption provisions in Rule 15c3-3(k) throughout the most recent fiscal year without exception or that it met them as described in the report, and (3) if applicable, a statement that identifies each exception during the most recent fiscal year in meeting the identified provision in Rule 15c3-3(k) and that describes the nature of each exception. [590]

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If the independent accountant determines during the course of preparing its reports that the broker-dealer is not in compliance with the financial responsibility rules or if it determines any material weakness exists in a broker-dealer's internal control over compliance with the financial responsibility rules, the accountant must immediately notify the broker-dealer, and if the notification concerns compliance with the financial protection rules, the broker-dealer must file a notification with the SEC and its designated examining authority. [591]

In addition, pursuant to the 2013 amendments, a broker-dealer is required to file a "Form Custody" with its designated examining authority within 17 business days after the end of each calendar quarter and within 17 business days after the end of the broker-dealer's fiscal year where that date was other than the end of a calendar year. [592] The Form contains nine categories of questions about the broker-dealer's custodial activities. [593]

Broker-dealers are also generally required to file with the SEC or with their designated examining authority certain financial statements (commonly known as "FOCUS Reports") at the end of each month and additional reports quarterly. [594] Within 105 days of the end of its fiscal year, a broker-dealer must provide each of its customers with an audited statement of financial condition and related notes. [595] A broker-dealer also has to provide each customer with an unaudited mid-year statement of financial condition. [596] If, in connection with its most recent annual reports, the report of the accountant covering the broker-dealer's compliance report identified a material weakness, the broker-dealer must include with its statement of financial condition a statement that one or more material weaknesses have been identified and that a copy of the accountant's report is available for the customer's inspection at the SEC's Washington, D.C. office and the regional office for the region where the broker-dealer has its principal place of business. [597]

[b] Reporting Rules Concerning Affiliates

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Until 1992, the SEC's regulation of broker-dealers had been only of the registered entity and, through the NASD and other SROs, of its officers and employees. [598] SEC regulation of affiliated persons other than employees was generally limited to ensuring that the registered broker-dealer was not associated with or controlled by persons or entities deemed unfit for involvement in the securities business, such as persons who had been convicted of securities law violations.

In 1990, Congress adopted § 17(h) of the Exchange Act providing for maintenance of records and filing with the SEC of information to be specified by the SEC regarding affiliates of registered broker-dealers. [599] The records to be kept by the registered entity and the information to be filed relate to the activities of the affiliates and the resulting risks to, and potential impact on, the financial and operational condition of the registered broker-dealer. In mid-1992, the SEC adopted "Final Temporary" rules under § 17(h) that require registered broker-dealers to make and preserve records and to file quarterly reports with the SEC concerning certain of their affiliated entities. [600]

Rules 17h-1T and 17h-2T require a registered broker-dealer to maintain and file with the SEC reports concerning each of its "material associated persons" ("MAPs"), [601] a term that includes any associated person (other than a natural person) of a broker-dealer whose "business activities are reasonably likely to have material impact on the financial and operational conditions of the broker-dealer." [602]

The required information concerning MAPs falls into two broad categories: (i) organizational and risk management policies and information and (ii) financial information. The first category of required information includes an organizational chart of the holding company structure (showing all MAPs, as well as other associated persons), records regarding material legal or arbitration proceedings and copies of written policies governing such matters as credit controls, sources of funding and trading risks. Required financial information includes, for each MAP, its aggregate securities and commodities positions, positions in certain financial instruments involving off-balance sheet risk, its short-term borrowing positions (which is an area of particular SEC concern) and its real estate activities. In addition, consolidating and consolidated balance sheets and income and cash flow statements are required for the broker-dealer and the broker-dealer's ultimate holding company parent. Entities using a set of accounting principles other than U.S. GAAP are required to disclose and explain the type of accounting principles employed, but do not need to reconcile their financials to U.S. GAAP. With respect to MAPs that are subject to regulation by a foreign financial regulatory authority, the broker-dealer is required to maintain and to file with the SEC only the reports that the MAP files with its foreign regulator. [603] With respect to certain MAPs that are themselves regulated by U.S. banking or insurance authorities or by the CFTC, broker-dealers are required to file with the SEC only certain of the reports that the MAP files with its U.S. regulator and are not required to generate any additional reports to satisfy the requirements of Rule 17h-1T or 17h-2T. [604] Information reported to the SEC pursuant to Rules 17h-1T and 17h-2T is not publicly available, but is available to Congress and to U.S. and foreign regulators.

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While the focus of § 17(h) of the Exchange Act and the rules thereunder has been the potential impact on registered broker-dealers of their affiliates' activities, the GAO has issued a report recommending that the SEC also use its authority under § 17(h) to gather any information necessary to determine whether regulation by the SEC of the unregulated affiliates of broker-dealers is warranted. [605] The GAO report notes, by way of example, that U.S. banking regulation applies not only to entities that are banks but to all of the companies in a bank holding company group. The SEC, in a letter responding to the GAO, said it did not believe that the SEC should expand its regulatory reach beyond broker-dealers, as this would impose unnecessary costs on broker-dealers and entangle the SEC in the regulation of nonsecurities activities. Nonetheless, the SEC stated that it would use the information that it gathers concerning broker-dealer affiliates to determine whether any such regulation might be useful. [606]

In 1999, Congress adopted § 17(i) of the Exchange Act to create a regulatory framework under which a holding company of a broker-dealer may voluntarily be supervised by the SEC as a "supervised investment bank holding company" ("SIBHC"). [607] In 2004, the SEC adopted rules implementing § 17(i). [608] Under these rules, an "investment bank holding company" that met certain requirements could have elected to become a SIBHC by filing a notice of intention with the SEC. [609] A SIBHC must comply with a number of requirements including requirements related to its group-wide internal risk management control system, recordkeeping and periodic reporting. The reporting requirements include a requirement to report consolidated computations of allowable capital and risk allowances consistent with the standards published by the Basel Committee on Banking Supervision. Because certain of the SIBHC requirements would duplicate requirements under the risk assessment rules, the SEC provided

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an exemption from Rules 17h-1T and 17h-2T for a broker-dealer that is affiliated with a SIBHC. [610]

In 2010, the Dodd-Frank Act deleted § 17(i) of the Exchange Act, terminating the SIBHC program and replacing it with a new regulatory framework for voluntary supervision of securities holding companies (*i.e.*, nonbank companies owning one or more registered broker-dealers) by the Board. This supervisory framework is intended to satisfy requirements that securities holding companies be subject to comprehensive consolidated supervision in the United States. [611] Consequently, the SEC rescinded its rules implementing § 17(i) of the Exchange Act and providing exemptions from Rules 17h-1T and 17h-2T. [612] Upon registering with the Board, the supervised securities holding companies ("SSHCs") would become subject to all of the examination, supervision and enforcement regulations applicable to registered bank holding companies, other than the restrictions on nonbanking activities set forth in § 4 of the Bank Holding Company Act.

In June 2012, the Board issued a final rule implementing the new SSHC regime and, in particular, outlining the requirements that an SSHC must satisfy to make an effective registration. [613] The rule requires a company electing to be a "securities holding company" [614] to submit a form containing organizational information, financial reports and income statements, a description of the methods used to monitor and control its operations, a description of the bank regulatory systems existing in the home country of any of its foreign bank subsidiaries and a description of any other regulatory capital framework to which

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the company is subject. [615] Upon effective registration, an SSHC is supervised and regulated as if it were a bank holding company (*e.g.*, submitting the same reports and subject to the same examination procedures, supervisory guidance and capital standards), except that the nonbanking restrictions contained in § 4 of the Bank Holding Company Act will not apply to SSHCs. [616]

[c] Large Trader Reporting Rules and Electronic Submission of Trading Data

In 2000, the SEC adopted Rule 17a-25 under the Exchange Act, which is intended to codify the SEC's electronic submission requirements with respect to trading data and enhance the SEC's ability to monitor the securities activities of large traders. [617] Rule 17a-25 requires registered broker-dealers to submit electronically to the SEC, upon request, certain information with respect to customer and proprietary securities trading. Among other things, the rule requires that broker-dealers electronically provide information regarding prime brokerage identifiers, average price account identifiers and identifiers used by depository institutions in order to enable the SEC to identify double reporting and create uniformity in reporting.

In 2011, the SEC, in acknowledging the "increasingly prominent role in the securities markets" of large traders, declared Rule 17a-25 ineffective and inadequate at monitoring large trader activity, specifically faulting the current system for its time delays and inability to identify and track large traders, [618] and adopted Rule 13h-1 under the Exchange Act. Among other things, Rule 13h-1 requires a U.S.-registered broker-dealer to maintain specified account and transaction records for persons (including foreign entities) who have identified themselves as "large traders" or persons whom the broker-dealer has "reason to know" are large traders based upon the aggregate transactions that the trader has effected through the broker-dealer. [619] Rule 13h-1 is intended to enable the SEC to collect market information necessary to reconstruct the activities of large traders during

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periods of market stress, such as the rapid declines in the U.S. securities markets during October of 1987 and 1989 and to support the SEC's investigative and enforcement activities. [620]

The rule requires U.S.-registered broker-dealers to record and report electronically to the SEC all transactions effected directly or indirectly by or through accounts of large traders if the trading activity for a particular day equals or exceeds the "reporting activity level" of 100 shares. [621] In addition, broker-dealers must monitor each person whom the broker-dealer "knows or has reason to know" is a large trader where such person has not identified itself as such to the SEC in compliance with the large trader requirements of Rule 13h-1. Such a determination may be based solely by taking into account the transactions of such person in NMS securities effected by or through such broker-dealer. A broker-dealer may rely on its conclusion that it does not know or have reason to know that person is a large trader so long as the broker-dealer (i) has no reason to expect that any of its customers' transactions approach the identifying activity level or does not have actual knowledge that a person is a large trader and (ii) has implemented policies and procedures "reasonably designed to identify customers whose transactions at the broker-dealer equal or exceed the identifying activity level." Absent these circumstances, the broker-dealer is obligated to notify such person that it may be a large trader and its potential reporting obligations under the rule. [622]

Footnotes

551 *See*, *e.g.*, § 14.07[1][b] regarding the special procedures broker-dealers are required to establish to prevent insider trading. SEC-registered broker-dealers must also have detailed anti-money laundering compliance procedures. *See* § 14.07[4].

552 Although, for convenience, the term "employee" is sometimes used in this section, the Exchange Act and FINRA rules generally use the term "associated persons." Persons who are not employees in the labor law sense of that term (such as independent contractors) may be deemed "employees" or "associated persons" of a broker-dealer. *See*, *e.g.*, NASD Membership and Registration Rules, Rules 1021 and 1031, FINRA MANUAL.

553 *See* § 14.07[3][b]. In addition, Rule 17f-2 under the Exchange Act contains a requirement, subject to certain exceptions, that employees of a broker-dealer be fingerprinted and their fingerprints submitted to the U.S. Attorney General.

554 *See*, *e.g.*, SEC Release No. 34-6872 (Aug. 8, 1962) (casual interviews and a perfunctory telephone call to a former employer are not evidence of "reasonable care" in hiring); *see also* Remarks of Mary L. Schapiro, then-Commissioner of the SEC, Investor Protection: The Role of the SEC, the SROs, and the Industry in Preventing Sales Practice Abuses (Oct. 9, 1992) (broker-dealer hiring procedures "should be designed to uncover and disqualify from employment" individuals having a bad disciplinary history).

555 *See* SEC Release No. 34-32261 (May 4, 1993).

556 *See* SEC, Division of Market Regulation and Division of Enforcement, REPORT ON THE STATUS OF THE RECOMMENDATIONS FROM THE LARGE FIRM PROJECT REPORT (1994) (hereinafter "Large Firm Project Recommendations").

557 *See* Large Firm Project Recommendations. FINRA Rule 4530 requires each FINRA member to report to FINRA the occurrence of certain specified events (such as criminal or administrative proceedings, or customer complaints) that suggest that the member or an associated person may have engaged in a violation of the securities laws. FINRA Rule 4530, FINRA MANUAL. FINRA Rule 4530 also requires each member firm to file quarterly summary statistics concerning written customer complaints it has received relating to the firm or its associated persons. The rule is closely patterned after former NASD Rule 3070 and NYSE Rule 351.

558 *See* Appendix B to Large Firm Project Recommendations.

559 *See* Appendix B to Large Firm Project Recommendations.

560 *See* Appendix B to Large Firm Project Recommendations.

561 *See* § 15(b)(4)(E) of the Exchange Act; *see also* § 14.07[1][b]; *See*, *e.g.*, *Hollinger v. Titan Capital Corporation*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 975 (1991) (to establish defense to controlling person liability, broker-dealer must prove it maintained and enforced proper system of supervision and internal control); *Paul F. Newton v. Texas Commerce*, 630 F.2d 1111 (5th Cir. 1980) (evidence of supervision was insufficient to establish that broker-dealer diligently enforced a proper system of supervision and control).

Broker-dealers are responsible not only for establishing procedures for the supervision of their employees, but may under certain circumstances also be held responsible for establishing procedures to ensure that they are not facilitating illegal actions by their clients. *In re Goldman Sachs Execution & Clearing, L.P.*, SEC Release No. 34-55465 (Mar. 14, 2007) ("Had Goldman Clearing instituted and maintained procedures reasonably designed to detect any significant disparity between its customers' pattern of trading and the manner in which they marked their orders to sell, it could have discovered that its trading and clearance records revealed the pattern of unlawful trades effected by its customers.…Accordingly, Goldman Clearing did not have a reasonable basis to believe its customers' representations that they were 'long' the securities they were selling and, therefore, violated the Commission's short sale rules and was a cause of its customers' violations of the rules.…").

562 *See Section 21(a) Report of Investigation: In re Gutfreund*, SEC Release No. 34-31554 (Dec. 3, 1992)

(hereinafter "Supervisory Release").

563 *See* Remarks of then-Chairman of the SEC Richard Breeden to the SIA (Dec. 3, 1992).

564 *See* Supervisory Release.

565 *See* Supervisory Release.

566 FINRA Rule 3110, FINRA MANUAL. For example, a FINRA member must designate a senior representative responsible for ensuring that any delegated authority and responsibility is properly exercised. *Cf*. *In re Shearson, Hammil*, 42 S.E.C. 811, 843 (1965) (excessive reliance upon subordinates constitutes improper abdication of supervisory responsibility). FINRA also requires that only duly qualified persons be in charge of member firm offices or departments. *See*, *e.g.*, SEC Release No. 34-18429 (Jan. 19, 1982) (disciplining broker-dealer for not having a registered options principal in branch office).

567 FINRA Rule 3110, FINRA MANUAL.

568 FINRA Rule 3110(c), FINRA MANUAL.

569 FINRA Rule 3120, FINRA MANUAL.

570 FINRA Rule 3130(a), FINRA MANUAL.

571 FINRA Rule 3130(b), FINRA MANUAL.

572 Certain of these requirements may not apply to FCMs that have notice-registered as broker-dealers for the limited purpose of trading security futures products. *See* §§ 15(b)(11)(B) and 17(b)(4) of the Exchange Act; U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[2].

573 The SEC may prescribe the books and records that a broker-dealer is required to keep. *See* § 17(a) of the Exchange Act. The recordkeeping, record preservation and financial reporting requirements of registered government securities broker-dealers are generally identical to those imposed upon registered broker-dealers. *See* Treas. Reg. § 404.2. Financial institutions registered as government securities broker-dealers by notice to an appropriate regulatory agency are, subject to certain conditions, generally exempted from the Exchange Act's recordkeeping requirements. Notwithstanding this general exemption, such government-noticed financial institutions must keep customer and securities positions ledgers and must make a record of periodic securities count differences. *See* Treas. Reg. § 404.4(a)(1).

574 *See*, *e.g.*, Rule 17a-3 of the Exchange Act (requiring the maintenance of a transaction blotter); Rule 17a-13 (requiring quarterly securities counts and verification of accuracy of records as against physical counts); *see also* SEC Litigation Release No. 34-13533 (Feb. 25, 1993) (disciplining U.S. broker-dealer subsidiary of a foreign broker-dealer for failure to keep adequate financial records, which failure permitted the U.S. broker-dealer to conceal its capital deficiency).

575 *See*, *e.g.*, SEC Release No. 34-25125 (Nov. 16, 1987) (suspending a broker-dealer for failure to comply with, among other things, Rule 17a-3 of the Exchange Act, which made it impossible for the SEC to reconstruct the broker-dealer's activities).

576 *See generally* American Institute of Certified Public Accountants, Brokers and Dealers in Securities: Audit and Accounting Guide (2015) (description of the records required by Rules 17a-3 and 17a-4 under the Exchange Act); SEC Release No. 34-11935 (Dec. 17, 1975).

577 The term "blotter" is used in the securities industry as the term "journal" is more commonly used in accounting for other industries.

578 *See* SEC Release Nos. 34-51200 (Feb. 14, 2005) and 34-46937 (Dec. 3, 2002) (imposing penalties against various broker-dealers for failure to preserve electronic mail communications including inter-office memoranda and communications). The SEC has stated that for purposes of Rule 17a-4 under the Exchange Act, "broker-dealers must retain only those e-mail and Internet communications (including inter-office communications) which relate to the broker-dealer's 'business as such.'" SEC Release No. 34-38245 (Feb. 5, 1997). The reference to "inter-office memoranda and communications" in Rule 17a-4(b)(4) is deemed also to refer to "intra-office" memoranda and communications.

In 2006, the SEC brought a settled civil action against Morgan Stanley & Co. Inc. for repeated failures to produce e-mails during the IPO and research analyst investigations conducted by the SEC from December 11, 2000 through at least July 2005. The SEC complaint alleged that (i) Morgan Stanley did not diligently search for back-up tapes containing responsive e-mails until 2005, (ii) failed to produce responsive e-mails because the company over-wrote back-up tapes, and (iii) made numerous misstatements regarding the status and completeness of its productions, the unavailability of certain documents, and its efforts to preserve requested e-mails. Morgan Stanley consented to a permanent injunction and a $15 million civil penalty, and agreed to adopt and implement policies, procedures and training on the preservation and production of e-mail communications. *See SEC v. Morgan Stanley & Co.*, SEC Litigation Release No. 19693 (May 10, 2006).

579 The SEC has adopted several amendments to Rules 17a-3 and 17a-4 designed to require retention of certain records of value to state regulators. Under the amendments, which became effective in 2003, broker-dealers are required, among other things, to make certain records available in local offices or to produce the records promptly at the request of a securities regulatory authority. *See* SEC Release No. 34-44992 (Sept. 26, 2001); *see also* SEC Release No. 34-47910 (May 22, 2003) (clarifying certain issues relating to broker-dealer books and records rules, some of which have been raised as a result of the amendments that were adopted on September 26, 2001).

580 *See generally* SEC Release No. 34-11935 (Dec. 17, 1975); SEC Release No. 34-70073 (July 31, 2013).

581 The annual audited financial statements, prepared in accordance with U.S. GAAP applicable to broker-dealers, had to be filed with the SEC within 60 days after the end of a fiscal year. Copies of such statements generally had to be provided to SROs of which the broker-dealer was a member and to state regulatory agencies in states in which the broker-dealer was registered.

582 *See generally* SEC Release No. 34-70073 (July 31, 2013).

583 Rule 17a-5(d)(2) under the Exchange Act.

584 Rule 17a-5(e) under the Exchange Act.

585 Rule 17a-5(d)(3) and (4) under the Exchange Act.

586 Rule 17a-5(d)(6) under the Exchange Act. In addition, copies must be made for any SRO of which the broker-dealer is a member, unless the SRO waives this requirement. Rule 17a-5(d)(6) under the Exchange Act.

587 Rule 17a-5(e)(4) under the Exchange Act.

588 A broker-dealer will be unable to conclude that the controls were effective if there were one or more material weaknesses (*i.e.*, deficiencies such that there is a reasonable possibility that non-compliance with (1) Rule 15c3-1 or Rule 15c3-3(e) will not be prevented or detected on a timely basis, or (2) Rule 17a-13 or any account statement rule will not be prevented or detected on a timely basis).

589 Rule 17a-5(d)(3) under the Exchange Act.

590 Rule 17a-5(d)(4) under the Exchange Act.

591 Rule 17a-5(h) under the Exchange Act.

592 Rule 17a-5(a)(4) under the Exchange Act.

593 17 C.F.R. 249.639.

594 Rule 17a-5(a) under the Exchange Act.

595 Rule 17a-5(c)(2) under the Exchange Act.

596 The SEC has adopted amendments to Rule 17a-5 that provide a conditional exemption to the requirement that a broker-dealer send its full balance sheet and certain other financial information to each of its customers twice a year. Under the amendments, a broker-dealer may send its customers only certain information regarding its net capital so long as it also provides customers with a toll-free number to call for a free copy of its full balance sheet and makes its full balance sheet available to customers over the Internet. The amendments codify relief the SEC has provided under a voluntary pilot program that began in 1999.

SEC Release No. 34-48272 (Aug. 1, 2003).

597 Rule 17a-5(c)(2)(iv) under the Exchange Act.

598 *See* § 14.07[3][b].

599 Market Reform Act of 1990, Pub. L. No. 101-432; 104 Stat. 963 (1990).

600 *See* Rules 17h-1T and 17h-2T under the Exchange Act; *see also* SEC Release No. 34-30929 (July 16, 1992); SEC Release No. 34-29635 (Aug. 30, 1991) (solicitation of public comment). The rules provide limited exemptions for broker-dealers that are permitted to maintain net capital of less than $250,000 or that do not carry customer accounts and that are permitted to have capital of less than $20 million. *See* Rules 17h-1T(d) and 17h-2T(b). Like the SEC's net capital rule amendments instituted in 1991 that prevent sudden withdrawals of capital from a broker-dealer, *see* § 14.07[2][b][ii], these disclosure requirements, which originally were considered by Congress and the SEC as a reaction to the impact of the financial difficulty of the parent holding corporation on its registered broker-dealer subsidiary Drexel and the rapid collapse of Drexel immediately following the bankruptcy of its parent, also now in part reflect a more generalized concern regarding the financial condition of a broker-dealer's affiliates and the material impact that activities of those affiliates could have on the broker-dealer. *See* SEC Release No. 34-29635 (Aug. 30, 1991). For a discussion of other regulatory developments as a result of Drexel's failure, *see* § 14.07[2][b][ii].

601 A broker-dealer that receives SEC approval to calculate market and derivatives-related credit risk deductions in accordance with Appendix E of the SEC's net capital rule, Rule 15c3-1(e) under the Exchange Act, and that is affiliated with an ultimate holding company that has a principal regulator is exempt from Rules 17h-1T and 17h-2T. Rules 17h-1T(d)(4) and 17h-2T(b)(4) under the Exchange Act. For a discussion of the requirements applicable to broker-dealers authorized to use risk-based capital deductions, *see* § 14.07[2][b][iii].

602 *See* SEC Release No. 34-30929 (July 16, 1992), 57 Fed. Reg. 32,159, 32,161 (July 21, 1992). Factors to be considered in determining whether a particular associated person is a "MAP" include: (i) the legal relationship between it and the broker-dealer, (ii) its and the broker-dealer's financing requirements and the degree, if any, to which they are financially interdependent, (iii) the degree, if any, to which the broker-dealer relies on the associated person for operational support or services, (iv) the riskiness of its activities, and (v) the extent to which the associated person has the authority or the ability to cause a withdrawal of capital from the broker-dealer. *See* Rule 17h-1T(a)(2) under the Exchange Act.

603 *See* Rules 17h-1T(c) and 17h-2T(d). The SEC staff has informally indicated that it does not wish to be deluged with reports filed with foreign regulators and that broker-dealers should file only reports in the nature of FOCUS Reports (*see* § 14.08[3][a]) that will allow the SEC to determine the financial condition of the foreign entity. Any such reports must be translated into English.

604 *See* Rules 17h-1T(b) and 17h-2T(c); *see also Institute of International Bankers* (avail. Sept. 25, 1992) (providing that certain reports filed by foreign banking groups with U.S. banking regulators need not be filed with the SEC, although the SEC will have access through the banking regulator to the report).

605 *See* GAO/GGD-92-70, SECURITIES FIRMS: ASSESSING THE NEED TO REGULATE ADDITIONAL FINANCIAL ACTIVITIES at 5-6 (Apr. 21, 1992).

606 *See* Letter, from William H. Heyman, Director of the Division of Market Regulation, SEC, to Mr. Richard L. Fogel, Assistant Comptroller General, GAO (Feb. 26, 1992).

607 *See* § 231 of the GLB Act.

608 *See* SEC Release No. 34-49831 (June 8, 2004).

609 Section 17(i)(5)(A) of the Exchange Act defined "investment bank holding company" to mean any person other than a natural person that owns or controls one or more brokers or dealers and the associated persons of the investment bank holding company. Section 17(i)(1)(A) of the Exchange Act provided that an investment bank holding company could only have elected to become supervised as a SIBHC if it were *not* an affiliate of an insured bank (with certain exceptions) or a savings association; a foreign bank, foreign company, foreign bank branch agency, or a state-chartered commercial lending company; or a foreign bank

that controls an Edge Act Corporation. Given the limitations on the types of entities with which an investment bank holding company could have been affiliated, the SIBHC regime was expected to have little practical utility.

610 *See* Former Rules 17h-1(d)(5) and 17h-2(d)(5) under the Exchange Act.

611 § 618 of the Dodd-Frank Act; *see also* SEC, Rescission of Supervised Investment Bank Holding Company Rules, 78 Fed. Reg. 42,863 (July 18, 2013).

612 *See* SEC, Release No. 34-69979 (July 12, 2013).

613 Federal Reserve System, Supervised Securities Holding Company Registration, 77 Fed. Reg. 32,881 (June 4, 2012).

614 "Securities holding company" is defined in the rule as:

> (i) [a]ny company that directly or indirectly owns or controls, is controlled by, or is under common control with, one or more brokers or dealers registered with the [SEC]; and (ii) [i]s required by a foreign regulator or provision of foreign law to be subject to comprehensive consolidated supervision.…A securities holding company does not include a company that is—(i) A nonbank financial company supervised by the Board pursuant to title I of the [Dodd-Frank Act]; (ii) An insured bank (other than an institution described in subparagraphs (D), (F), or (H) of section 2(c)(2) of the [Bank Holding Company Act]) or a savings association; (iii) [a]n affiliate of an insured bank (other than an institution described in subparagraphs (D), (F), or (H) of section 2(c)(2) of the [Bank Holding Company Act]) or an affiliate of a savings association; (iv) [a] foreign bank, foreign company, or company that is described in section 8(a) of the [International Banking Act]; (v) [a] foreign bank that controls, directly or indirectly, a corporation chartered under section 25A of the Federal Reserve Act; or (vi) [c]urrently subject to comprehensive consolidated supervision by a foreign regulator.

12 C.F.R. § 241.2(a).

615 77 Fed. Reg. 32,881, 32,882 (June 4, 2012).

616 *See* 12 C.F.R. § 241.3(b)(3).

617 SEC Release No. 34-44494 (June 29, 2001).

618 *See* SEC Release No. 34-64976 (July 27, 2011), 76 Fed. Reg. 46,960, 46,963 (Aug. 3, 2011).

619 *See* SEC Release No. 34-64976 (July 27, 2011). As defined in Rule 13h-1 under the Exchange Act, a "large trader" is any person (including any foreign person other than a foreign central bank) who directly or indirectly exercises investment discretion over and effects transactions for or on behalf of its own accounts or accounts that it controls in NMS securities by or through a registered broker-dealer in an amount of at least 2,000,000 shares or $20 million during any calendar day, or at least 20,000,000 shares or $200 million during any calendar month. (The transactions of affiliated entities in some instances would be required to be aggregated to determine whether these limits had been reached.) In addition, persons engaged in program trading to any extent would be deemed large traders.

The Treasury has adopted large position rules that establish recordkeeping and reporting requirements for foreign and domestic entities that control large positions (*i.e.*, above $2 billion) in certain Treasury securities. 61 Fed. Reg. 48,338 (Sept. 12, 1996), codified at Treas. Reg. § 420. In 2002, the Treasury adopted amendments to its large position rules to increase reporting about these positions. *See* 67 Fed. Reg. 77,411 (Dec. 18, 2002).

620 SEC Release No. 34-64976 (July 27, 2011).

621 The "reporting activity level" is defined as "(i) [e]ach transaction in NMS securities, effected in a single account during a calendar day, that is equal to or greater than 100 shares; (ii) any other transaction in NMS securities, effected in a single account during a calendar day, that a registered broker-dealer may deem appropriate; or (iii) such other amount that may be established by order of the [SEC] from time to time." Rule 13h-1(a)(8) under the Exchange Act.

622 *See* SEC Release No. 34-64976 (July 27, 2011), 76 Fed. Reg. 46,960, 46,981 (Aug. 3, 2011) ("The Rule does not require broker-dealers to definitively determine who is, in fact, a large trader.").

U.S. Regulation of the International Securities and Derivatives Markets, § 14.09, OTC DERIVATIVES DEALERS AND TRANSACTIONS IN SECURITY FUTURES PRODUCTS

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 § 14.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] OTC Derivatives Dealers

Prior to the Dodd-Frank Act, the SEC had adopted a series of rules in 1998 that established a limited purpose broker-dealer registration category for entities (referred to as "OTC derivatives dealers") that engage in over-the-counter

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derivative instruments that are securities, but that do not engage in the broad range of securities activities typically associated with full purpose broker-dealers. [623] Due to the Dodd-Frank Act's creation of a comprehensive regulatory scheme for swaps and security-based swaps, the SEC may repeal or significantly modify this category. However, as of the date of publication, the SEC has not done so.

In adopting the series of rules that established the limited purpose broker-dealer registration category for OTC derivatives dealers, the SEC noted that the "traditional" broker-dealer regulatory structure under the Exchange Act has not permitted U.S. securities firms to operate a consolidated OTC derivatives business in the United States, involving both securities and nonsecurities instruments, on terms that are competitive with those offered by U.S. banks and foreign derivatives dealers. [624] Instead, current regulatory inefficiencies have, in many instances, caused U.S. securities firms to separate their securities derivatives activities (which they often conduct from abroad) from their nonsecurities derivatives activities (which they often place in unregistered U.S. affiliates), hindering their ability to manage risk and compete effectively in the global OTC derivatives markets.

The rules are intended to create a more practical and flexible commercial and regulatory framework under which U.S. securities firms may establish separately capitalized entities within the United States that engage in dealer activities in both securities and nonsecurities derivative instruments subject to specially tailored capital, margin and other requirements.

Registration as an OTC derivatives dealer is available to firms that are affiliated with a full purpose broker-dealer and that limit their securities derivatives activities to:

- engaging in dealer activities in "eligible OTC derivative instruments" that are securities;
- issuing and reacquiring securities that are issued by the dealer, including warrants on securities, hybrid securities and structured notes;
- engaging in "cash management securities activities";
- engaging in "ancillary portfolio management securities activities"; and
- engaging in such other securities activities as the SEC may designate by order. [625]

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Registration as an OTC derivatives dealer is effected under § 15(b) of the Exchange Act by the filing of Form BD with the SEC.

An OTC derivatives dealer generally must effect its securities transactions through an affiliated full-purpose broker-dealer that is subject to applicable SRO sales practice requirements, except in the case of transactions with certain types of professional counterparties. [626] In addition, subject to certain enumerated exceptions, the rules require contacts with customers on behalf of the OTC derivatives dealer to be conducted by registered representatives of its affiliated full purpose broker-dealer.

OTC derivatives dealers are able to calculate their regulatory capital under Appendix F to Rule 15c3-1 under the Exchange Act rather than using the securities haircut provisions otherwise applicable to full purpose broker-dealers. [627] Extensions of credit by an OTC derivatives dealer are exempt from Regulation T (governing extensions of credit by broker-dealers), provided that the OTC derivatives dealer complies with the requirements of Regulation U (governing extensions of credit by banks and other nonbroker-dealers). In addition, OTC derivatives dealers are exempt from the provisions of SIPA, are not required to become members of an SRO and are exempted from a number of other regulatory requirements applicable to full-purpose broker-dealers. [628]

[2] Broker-Dealer Transactions in Security Futures Products

Transactions in security futures products are subject to a unique dual regulatory structure under the Exchange Act and the CEA. As part of this regime, intermediaries that engage in brokerage or dealing activities with respect to these

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products are generally required to register both as a broker-dealer under the Exchange Act and as an FCM or introducing broker under the CEA. [629]

Footnotes

623 SEC Release No. 34-40594 (Oct. 23, 1998), *as amended by* SEC Release No. 34-40594A (Nov. 5, 1998) (containing minor corrections). The OTC derivatives dealers regulatory regime is commonly referred to as "BD Lite."

624 *See* SEC Release No. 34-40594 (Oct. 23, 1998).

625 *See* SEC Release No. 34-40594 (Oct. 23, 1998).

626 Because of this requirement, FINRA member broker-dealers that execute OTC options transactions for OTC derivatives dealers must comply with the option position limit and exercise requirements of FINRA Rule 2360 (the "position limit rules") with respect to such transactions. In its release adopting the OTC derivatives dealer regime, the SEC indicated that the NASD should consider an exemption from the position limit rules for those types of transactions. *See* SEC Release No. 34-40594 (Oct. 23, 1998). On October 12, 2004, the NASD (responding to a request from five broker-dealer affiliates of OTC derivatives dealers) submitted a proposed amendment to NASD Rule 2860 to provide a delta hedging exemption from the position limit rules for OTC derivatives dealers affiliated with NASD member broker-dealers if certain conditions are satisfied. The proposal was approved by the SEC on November 29, 2004, *see* SEC Release No. 34-50748 (Nov. 29, 2004), and subsequently adopted as part of the consolidated FINRA rulebook as FINRA Rule 2360, effective February 17, 2009. FINRA Regulatory Notice 08-78 (Dec. 2008).

627 Appendix F permits OTC derivatives dealers to calculate market risk capital charges using proprietary value-at-risk models with respect to certain asset categories and to take certain specified credit risk capital charges. Appendix F is generally consistent with the Basel Capital Accord and the capital rules of U.S. banking regulators. *Cf.* § 14.07[2][b] for a discussion of how net capital is calculated for full purpose broker-dealers.

628 To date, only a few firms have elected to register as OTC derivatives dealers. *See* SEC Release No. 34-47570 (Mar. 26, 2003), 68 Fed. Reg. 15,488, 15,489 n.7 (Mar. 31, 2003).

629 For a discussion of this dual regulatory structure, *see* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07[3].

U.S. Regulation of the International Securities and Derivatives Markets, § 14.10, ELECTRONIC TRADING SYSTEMS

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 § 14.10 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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In 1998, the SEC significantly revised the framework for the regulation of electronic trading systems. In particular, the SEC adopted new rules and rule amendments permitting certain "alternative trading systems" either to register as a national securities exchange or to register as a broker-dealer and comply with the requirements of Regulation ATS. [630] The SEC also adopted new recordkeeping requirements for "internal broker-dealer systems."

[1] Alternative Trading Systems

In the ATS Release, the SEC expanded its interpretation of an "exchange" under the Exchange Act to include a broad range of electronic trading systems, [631] while permitting certain "alternative trading systems" to continue to be regulated as broker-dealers, subject to compliance with a number of additional requirements imposed by Regulation ATS based on their activities and trading volume. [632]

Under Regulation ATS, an "alternative trading system" is defined to mean any organization, association, person, group of persons, or system that

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(i) constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing the functions commonly performed by a stock exchange (within the meaning of Rule 3b-16 under the Exchange Act) and (ii) does not (a) set rules governing the conduct of subscribers (other than the conduct of subscribers' trading on the system) or (b) discipline subscribers (other than by exclusion from trading). [633]

An alternative trading system subject to Regulation ATS must:

- register with the SEC as a broker-dealer;
- file with the SEC a notice of initial operation on Form ATS and quarterly transaction reports on Form ATS-R, as well as reports of any material changes to the operation of its system;
- maintain certain records, including detailed information about all orders and transactions;
- establish adequate safeguards and procedures to protect its subscribers' confidential trading information;
- cooperate with SEC and SRO examinations, inspections and investigations, including any examination, inspection or investigation of its subscribers; and
- refrain from using the words "exchange," "stock market" or similar terms in its name.

In addition to these basic requirements, Regulation ATS imposes certain additional requirements on alternative trading systems with significant trading volume. An alternative trading system that displays subscriber orders and has 5% or more of the average daily trading volume in certain equity securities during four of the six preceding calendar months must arrange with a registered securities exchange or FINRA to disseminate its best priced orders in those securities through the public quote stream and provide broker-dealers who have access to such exchange or FINRA with the ability to effect transactions with respect to those orders. [634] An alternative trading system that displays subscriber orders and has 5% or more of the average daily trading volume in certain equity securities or categories of debt securities during four of the six preceding calendar months must establish written standards for granting access to trading, not unreasonably prohibit or limit access by applying such standards in an unfair or discriminatory

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manner, and make records and reports regarding grants and denials of access. [635] An alternative trading system with 20% or more of the average daily trading volume of certain equity securities or categories of debt securities must also satisfy certain system capacity, integrity and security requirements of Regulation ATS. [636]

Trading systems (i) whose activities are limited to routing orders to a registered securities exchange, market operated by FINRA or a broker-dealer for execution, or (ii) that automate the order routing and execution mechanisms of a single dealer or market maker, are expressly excluded from the revised interpretation of the term "exchange" and are not subject to Regulation ATS. [637]

In 2010, the SEC adopted Rule 15c3-5, under which broker-dealers that are able to trade securities on an exchange or ATS as members or subscribers, as well as broker-dealer operators of an ATS that provide access to the ATS to a nonbroker-dealer, generally are required to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed both to systemically limit the financial exposure of the broker-dealer that could arise as a result of market access and to ensure compliance with all regulatory requirements applicable in connection with market access. [638] Specifically, the required controls and procedures

- must prevent the entry of orders unless there has been compliance with all regulatory requirements applicable prior to order entry;
- must prevent the entry of orders that (a) exceed appropriate pre-set credit or capital thresholds, (b) appear to be erroneous, or (c) the broker-dealer or customer is restricted from trading;
- must restrict market access technology and systems to authorized persons;
- must assure appropriate surveillance personnel receive immediate post-trade execution reports; and

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- must be under the direct and exclusive control of the broker-dealer with market access (unless the requirements of certain limited exceptions applicable when the customer is a broker-dealer are satisfied).

In addition, broker-dealers with market access must establish, document, and maintain a system for regularly reviewing the effectiveness of the required controls and procedures; the system must include, among other things, an annual review of the broker-dealer's business activity in connection with market access and an annual certification by the broker-dealer's CEO that the required review has been conducted and the required controls and procedures comply with Rule 15c3-5. A limited exception to Rule 15c3-5 applies to broker-dealers that provide outbound routing services to an exchange or ATS to prevent "trade-throughs" pursuant to Regulation NMS Rule 611, discussed below.

[2] Online Brokerage and Electronic Communications

The growth of electronic trading systems has led to regulatory concern regarding the actions of broker-dealers who participate in and conduct business over such systems and on the Internet. While all rules of the SEC and the SROs apply to such online broker-dealers, regulators have expressed concerns regarding how the rules can be enforced and monitored given the lack of paper records, the speed of transactions and the transitory nature of many online businesses. In light of the use of the Internet to facilitate communications with customers, the SEC has provided guidance with respect to specific online issues including the provision of electronic confirmations of trades and the delivery of prospectuses and other materials over the Internet and through electronic mail. [639]

In 1999, the SEC issued a report [640] with respect to the subject of technology and its impact on retail brokerage. The report consists of an overview of the issues raised by online brokerage for investors and the SEC and explores how online brokerage impacts the SEC's traditional regulatory scheme. It details the findings from three roundtables conducted with participants from full-service and discount, online and offline brokerage industry representatives, securities practitioners, academics, regulators, market participants and investors. The report recommends that the SEC examine information from broker-dealers

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regarding how they conduct research and how they then customize information for customers in reference to suitability of investments. The report further recommends that the SEC take steps to require that broker-dealers ensure more adequate systems capacity, including contingency plans, keep records of significant systems outages, testing and evaluation and provide plain English disclosure of the risks of systems delays or outages in new account documentation. Also, the report makes recommendations regarding best execution, dissemination of real-time market data, investor education, online discussion forums, privacy and compensation for entities that are not registered as broker-dealers. [641]

In addition, as part of its continuing focus on electronic trading systems, the SEC's Office of Compliance Inspections and Examinations published a summary of its findings and recommendations resulting from its examination of broker-dealers who offer online trading. [642] The report provides examples of sound practices, as well as areas where some online broker-dealers could, through self-evaluation in line with the report, enhance their practices. In the report, the SEC staff recommends that broker-dealers offering online trading consider:

- the information provided to customers online about how orders are executed, how margin works and the possibility of system delays;
- the objectivity of their advertising;
- procedures for ensuring that customers receive best execution;
- procedures for ensuring adequate operational capability to handle customer trading volume;
- security measures to protect customer privacy and funds; and
- procedures to supervise employees' use of Internet communications. [643]

In 2014, the SEC began to emphasize cybersecurity, conducting examinations of broker-dealers and investment advisers. [644] In 2015, the SEC published the results of examinations of 57 registered broker-dealers and 49 registered investment advisers, and determined that examining these firms will be a central function of the SEC's cybersecurity initiative moving forward. [645]

[3] Internal Broker-Dealer Systems

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In 1998, the SEC adopted recordkeeping requirements for "internal broker-dealer systems" that are sponsored by a registered broker-dealer. [646] Under the rules, an "internal broker-dealer system" is defined to mean any facility (other than a national securities exchange, an exempt exchange or an alternative trading system) that provides a mechanism, automated in full or in part, for collecting, receiving, disseminating or displaying system orders and facilitating agreement to the basic terms of a purchase or sale of a security between a customer and the sponsor, or between two customers of the sponsor, through use of the internal broker-dealer system or through the broker-dealer sponsor of the system. [647] Sponsors of such systems must maintain a record of the system's customers, daily summaries of trading in the system and time-sequenced records of each transaction effected through the system. Unlike former Rule 17a-23, these rules do not require "internal broker-dealer systems" to file reports with the SEC. [648]

[4] Day Trading

Day trading is a strategy employed by retail investors who are not registered as broker-dealers or as registered representatives who trade stock at a firm (a "day trading firm") that allows the investor real time access to the major stock exchanges. Day trading is characterized by multiple intra-day trades executed to take advantage of small price movements in stocks. Stocks are generally held for seconds or hours and generally positions are closed out overnight for small profits or losses. In 2000, the SEC released a study that reported the findings of a year-long investigation by the SEC's Office of Compliance Inspections and Examinations (in cooperation with the NASD and NYSE) of 47 registered broker-dealers providing day trading facilities to the general public (the "day trading study"). [649] The purpose of the examination was to review each firm's compliance with federal securities laws and SRO rules. In addition, examiners reviewed how day trading activities fit within the existing securities regulatory structure and identified regulatory issues that might require further consideration. The examination revealed that many firms need to take steps to improve

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compliance with net capital, short selling and supervision rules. The day trading study focused in particular on the lack of information provided to customers concerning the risks of day trading. FINRA, in part in response to the day trading study, requires that prior to opening a day trading account a broker-dealer furnish to the customer a risk disclosure statement and approve the customer for day trading only after analyzing the customer's investment objectives; trading experience and knowledge; financial situation; marital, tax and employment status; and age to ensure that a day trading strategy is appropriate for the customer. [650] FINRA also has special day trading margin requirements designed to protect broker-dealers against their intra-day exposures to day traders. [651]

[5] National Market System

Section 11A(a) of the Exchange Act, enacted in 1975, directs the SEC to facilitate the development of a national market system for securities in accordance with Congressional findings and objectives set forth therein and with due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets. [652] The Congressional findings and objectives include that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure:

1. economically efficient execution of securities transactions;
2. fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

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3. the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
4. the practicability of brokers executing investors' orders in the best market; and
5. an opportunity, consistent with the provisions of clauses (i) and (iv), for investors' orders to be executed without the participation of a dealer.

The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders. [653]

Over the decades since the enactment of § 11A, the SEC has taken numerous steps to carry out Congress's instruction to facilitate the development of the national market system, including: requiring the SROs to adopt plans for the collection, consolidation and dissemination of last sale reports and quotations in certain securities and approving such plans; approving a plan linking the markets trading exchange-listed securities and SRO rules generally requiring participants in that plan to avoid execution of trades at a price worse than the best price displayed on another participant market ("trade-throughs"); requiring certain specialists and OTC market-makers to publicly display customer limit orders that better the dealer's displayed price or size; and requiring any specialist or OTC market-maker responsible for more than 1% of the volume of trading in a listed security to display their best-priced quotations and customer limit orders for that security. [654]

In 2005, the SEC published Regulation NMS, the most significant overhaul of its rules regarding the national market system since the enactment of § 11A. [655] Regulation NMS generally applies to stocks traded on a national exchange. FINRA has since adopted rules that apply Regulation NMS-style rules to the market for OTC Equity Securities as well. [656] In addition to modernizing its earlier national market system rules and consolidating them into a single regulation, Regulation NMS addresses three substantive topics:

Order Protection. Rule 611 of Regulation NMS (the "Order Protection Rule") requires "trading centers" to establish, maintain, and enforce written policies and procedures reasonably designed to prevent trade-throughs on such trading center of "protected quotations" for NMS stocks [657] displayed by other trading centers. [658] For this purpose, "trading centers" include national securities exchanges, SRO trading facilities, ATSs, exchange and over-the-counter market makers and any other broker-dealer that executes orders internally by trading as principal or crossing orders as agent. [659] The "protected quotations" covered by Rule 611 include the best bids and offers of a national securities exchange and FINRA's alternative display facility ("ADF"), provided that it is an automated quotation of an automated trading center and disseminated pursuant to an effective national market system plan. [660] To qualify quotations as "automated quotations" of an "automated trading center," the trading center displaying the quotation must (among other things) immediately and automatically execute certain orders against its displayed quotations and immediately and automatically update its displayed quotations. [661] The Order Protection Rule includes exceptions for intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and "flickering" quotations with multiple prices displayed in a single second.

Intermarket Access. Rule 610 of Regulation NMS requires SRO trading centers to allow access to their quotations in NMS stocks on a nondiscriminatory basis and limits the fees that may be charged for access to quotations. Rule 610 also requires SROs to establish rules to prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross [662] the protected

quotations of other trading centers rather than executing against the protected quotation. [663] In addition, FINRA limits the fees that a member can impose for access to a published quotation in any OTC Equity Security and requires its members to implement policies and procedures that avoid the display of locking or crossing quotations in any OTC Equity Security. [664]

Sub-Penny Pricing. Rule 612 of Regulation NMS prohibits market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment of less than $0.01 (or $0.0001 if the price of the quotation is less than $1.00). [665] This rule is intended to enhance the protection of customer limit orders by preventing sub-penny pricing from being used to "step-ahead" of such orders by an economically insignificant amount. FINRA applies the same rule to the displaying, ranking, or accepting of quotations in any OTC Equity Security. [666]

In 2010, the SEC began a broad review of the current structure of the national market system and published a concept release, seeking public feedback on, among others, the following issues: (i) how well the current market structure performs its functions, (ii) the strategies and tools used by firms in the current market structure, (iii) whether high volume trading poses a risk to the current market structure, (iv) the effects of undisplayed liquidity, and (v) any other notable aspects of the current market structure. The SEC intended to use the public comments received to determine whether further regulatory action is needed to improve the current equity market structure. [667]

In 2015, the SEC created an Equity Market Structure Advisory Committee to focus on the structure and operations of the U.S. equity markets. This committee is expected to discuss issues relating to the review of Regulation NMS, the role of exchanges in the current market structure and the presence and effect of conflicts in the routing and execution or equity orders. This committee has recommended a pilot program to adjust the cap that Rule 610 sets on fees that trading venues can charge to access published quotations, but as of the date of publication, the SEC has not taken any action on this recommendation. [668]

In 2016, FINRA and a group of national securities exchanges began a two-year pilot program to test the effect of widening the minimum quotation and

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trading increment ("tick size") for stocks of some smaller companies from a penny to five cents. [669]

Footnotes

630 SEC Release No. 34-40760 (Dec. 8, 1998) (the "ATS Release"). The rules and rule amendments generally took effect on April 21, 1999, except as otherwise noted.

Prior to the adoption of Regulation ATS and related rules under the Exchange Act, electronic trading systems sponsored by registered broker-dealers operated pursuant to no-action relief granted by the SEC. *See*, *e.g.*, *Instinet Corp*. (avail. Sept. 8, 1986) (granting no-action relief from the exchange registration requirement of § 5 of the Exchange Act).

631 Pursuant to Rule 3b-16 under the Exchange Act, an organization, association or group of persons is considered to constitute, maintain or provide "a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing the functions commonly performed by a stock exchange" if it (i) brings together the orders for securities of multiple buyers and sellers, and (ii) uses established, nondiscretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. *See* Rule 3b-16(a) under the Exchange Act.

632 An alternative trading system that limits its securities activities to government securities or commercial paper and certain related instruments (*e.g.*, repurchase and reverse repurchase agreements involving government securities or commercial paper, or unlisted options on government securities) is not required to comply with the requirements of Regulation ATS, provided that it is registered as a broker-dealer under § 15 of the Exchange Act or as a government securities broker-dealer under § 15C of the Exchange Act. *See* Rule 301(a)(4) of Regulation ATS.

Alternative trading systems that permit the trading of security futures products are required under the CEA to become limited-purpose contract markets pursuant to the CEA's notice registration provisions. CEA § 5f.

633 Rule 300(a) of Regulation ATS.

634 Rule 301(b)(3) of Regulation ATS. In 2009, the SEC proposed several amendments to Regulation ATS, one of which would have lowered the average trading volume threshold from 5% to 0.25%. The amendments would also have extended display requirements to all orders displayed to more than one person, regardless of that person's membership in the ATS. *See* SEC Release No. 34-60997 (Nov. 23, 2009). The SEC's proposal was withdrawn in 2013.

635 Rule 301(b)(5) of Regulation ATS; FINRA Rule 4552, FINRA MANUAL.

636 Rule 301(b)(6) of Regulation ATS. As of November 4, 2016, 82 entities have a current Form ATS on file with the SEC. *See* SEC, Frequently Requested FOIA Document: Alternative Trading System ("ATS") List (Nov. 4, 2016), *available at* https://www.sec.gov/foia/docs/atslist.htm (last visited Nov. 11, 2016).

637 *See* Rule 3b-16(b)(1) under the Exchange Act.

638 *See* SEC Release No. 34-63241 (Nov. 3, 2010); *see also* Press Release, SEC, SEC Adopts New Rule Preventing Unfiltered Market Access (Nov. 3, 2010).

639 *See*, *e.g.*, SEC Release No. 34-42728 (Apr. 28, 2000) (providing guidance on the use of electronic media by issuers of all types, including the use of electronic media to deliver documents, issuers' liability for website content and basic legal principles that issuers and market intermediaries should consider in conducting online offerings); SEC, ON-LINE BROKERAGE: KEEPING APACE OF CYBERSPACE (Nov. 1999); SEC Release No. 34-37182 (May 29, 1996); SEC Release No. 34-36345 (Oct. 6, 1995); *Lamp Technologies* (avail. May 29, 1998); *Thomson Financial Inc.* (avail. July 10, 2002).

640 SEC, ON- LINE BROKERAGE: KEEPING APACE of CYBERSPACE (Nov. 1999).

641 *See* SEC, ON- LINE BROKERAGE: KEEPING APACE of CYBERSPACE (Nov. 1999).

642 SEC, Office of Compliance Inspections and Examinations, EXAMINATIONS of BROKER- DEALERS OFFERING ONLINE TRADING: SUMMARY of FINDINGS and RECOMMENDATIONS (Jan. 25, 2001).

643 *See* SEC, Office of Compliance Inspections and Examinations, EXAMINATIONS of BROKER- DEALERS OFFERING ONLINE TRADING: SUMMARY of FINDINGS and RECOMMENDATIONS (Jan. 25, 2001).

644 SEC, Office of Compliance Inspections and Examinations, OCIE Cybersecurity Initiative (Apr. 15, 2014).

645 SEC, Office of Compliance Inspections and Examinations, OCIE's 2015 Cybersecurity Examination Initiative (Sept. 15, 2015).

646 Rule 17a-3(a)(16) under the Exchange Act; the ATS Release.

647 *See* Rule 17a-3(a)(16) under the Exchange Act.

648 Rule 17a-23 under the Exchange Act was repealed as of the effective date of Rule 17a-3(a)(16) under the Exchange Act.

649 SEC, Office of Compliance Inspections and Examinations, REPORT OF EXAMINATIONS OF DAY-TRADING BROKER-DEALERS (Feb. 25, 2000, revised Oct. 23, 2003). In the day trading study, a "day trader" is described as "an individual who conducts intra-day trading in a focused and consistent manner, with the primary goal of earning a living through the profits derived from this trading strategy."

650 FINRA Rule 2130, FINRA MANUAL.

Certain firms have also been the subject of enforcement actions involving day trading activities that resulted in violations of Regulation T. *See*, *e.g.*, News Release, FINRA, FINRA Fines Scottrade $200,000 for Pattern Day Trading Violations (Apr. 1, 2010); Press Release, NASD, NASD Fines Scottrade, Inc. $250,000 for Improperly Extending Credit to Cash Account Customers (Jan. 21, 2005). Similar actions were brought by the NASD against Ameritrade, Datek and iClearing in March 2004. *See* Press Release, NASD, NASD Fines Ameritrade, Datek and iClearing $10 Million For Improperly Extending Credit and Allowing Trades That Avoided NASD Day Trading Margin Rules (Mar. 11, 2004).

651 *See* FINRA Rule 4210(f)(8)(B), FINRA MANUAL. Because the Regulation T initial margin requirements and standard SRO maintenance margin requirements are calculated only at the end of each day, a day trader that has no positions in its account at the end of the day would have no initial or maintenance margin requirements (except to the extent of any trading losses during the day). The day trader's broker-dealer, however, is exposed to any losses the day trader may incur during the trading day, as well as the possibility that the day trader would be unable to close out its positions before the end of the trading day. Among other things, the special day trading margin requirements require day traders to provide margin based on the largest positions held during the trading day and limit the size of the intra-day positions of "pattern day traders."

652 § 11A(a)(1) of the Exchange Act.

653 § 11A(a)(1) of the Exchange Act.

654 For some of the history of SEC regulation of the national market system, *see* SEC Release No. 34-49325 (Feb. 26, 2004), Regulation NMS, Proposed Rule, 69 Fed. Reg. 11,126, 11,130–33 (Mar. 9, 2004).

655 *See* SEC Release No. 34-51808 (June 9, 2005), Regulation NMS, Final Rule, 70 Fed. Reg. 37,496 (June 29, 2005).

656 *See* FINRA Rules 6410-90, FINRA MANUAL; *see also* FINRA Regulatory Notice 10-42 (Sept. 2010).

657 "NMS stocks" are all securities, other than options, for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan. They include all equity securities traded on national securities exchanges. Rule 600(46) and (47) of Regulation NMS under the Exchange Act.

658 Rule 611 of Regulation NMS under the Exchange Act.

659 Rule 600(b)(78) of Regulation NMS under the Exchange Act.

660 Rule 600(b)(57) and (58) of Regulation NMS under the Exchange Act.

661 Rule 600(b)(3) and (4) of Regulation NMS under the Exchange Act.

One significant effect of Regulation NMS was initiatives by the NYSE to modernize its method of operations so that it is an "automated trading center" and some of its quotations are "automated quotations." In 2006, the SEC approved the NYSE's Hybrid Market proposal to integrate the NYSE's traditional floor-based auction market with enhanced automated trading functionality. The approved rule changes: (i) expanded the NYSE's automatic execution facility, Direct+, so that it may accept more order types and allow executions to occur against liquidity that is priced outside the NYSE's best bid or offer, (ii) automated participation by NYSE floor members so that they can electronically provide liquidity available for automatic executions, and (iii) allowed specialists to create proprietary algorithms so that they can quote and trade electronically. *See* SEC Release No. 34-53539 (Mar. 22, 2006).

662 Quotations are "locked" when the bid and offer are equal and "crossed" when the bid is higher than the offer.

663 Rule 610 of Regulation NMS under the Exchange Act.

664 FINRA Rules 6450 and 6437, FINRA MANUAL.

665 Rule 612 of Regulation NMS under the Exchange Act.

666 FINRA Rule 6434, FINRA MANUAL.

667 SEC Release No. 34-61358 (Jan. 14, 2010).

668 For one perspective on how the SEC should proceed in this regard, *see* COMMITTEE ON CAPITAL MARKETS REGULATION, THE U.S. EQUITY MARKETS: A PLAN FOR REGULATORY REFORM (July 2016), http://www.capmktsreg.org/wp-content/uploads/2016/10/08_08_FINAL_DRAFT_EMS_REPORT-1.pdf.

669 Press Release, SEC Approves Pilot to Access Tick Size Impact for Smaller Companies (May 6, 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.11, ENFORCEMENT

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 § 14.11 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The SEC and SROs are charged with responsibility for overseeing and enforcing, through their respective inspection and sanction powers, broker-dealer compliance with U.S. securities laws, the rules and regulations thereunder and the rules of the SROs.

[1] Inspection

The Exchange Act gives the SEC broad powers to inspect broker-dealers. Section 17(b) of the Exchange Act provides that all records kept by a registered broker-dealer are subject "at any time … [to] reasonable periodic, special, or other examinations" by the SEC. [670] Under § 21(a) of the Exchange Act, the SEC has a power of "original inquiry" to make investigations as it deems necessary to determine whether any person is violating the U.S. securities laws, the rules and regulations thereunder or the rules of the SROs. [671] The SEC may also conduct investigations on the request of a foreign securities authority, even though no violation of U.S. law has been committed or is suspected. [672]

SROs, including FINRA, maintain the right to inspect all books, records and accounts of their members, as well as to require any member to submit

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written reports concerning its business practices. [673] A member that does not permit an investigation or refuses a request for information is subject to sanction by the relevant SRO.

Foreign branch offices (including perhaps any offices where "dual employees" of a U.S. broker-dealer and a foreign broker-dealer work) [674] are subject to examination and to the requirement that they make their records available for inspection by U.S. regulators as would be any U.S. office. In a disciplinary action instituted against the Swiss branch of a registered broker-dealer that had failed to provide its records for inspection on a timely basis, the SEC rejected out of hand the broker-dealer's defense that Swiss secrecy laws had prevented it from making customer records promptly available to the SEC. [675]

[2] Sanctions

[a] By SROs

FINRA and the other SROs have the authority to discipline members and their associated persons with a censure, fine, suspension or expulsion from membership or "any other fitting sanction." [676] Any disciplinary action taken by an SRO is subject to review by the SEC. [677]

[b] By the SEC

The SEC has the authority to sanction broker-dealers for any violation of the U.S. securities laws or the rules and regulations thereunder. Under § 15(b)(4) of the Exchange Act, the SEC is required to "censure, place limitations on the activities, functions or operations of, suspend for [not more than]… twelve months or revoke the registration of [a broker-dealer]" if it finds that the broker-dealer has committed one of a number of enumerated offenses and the disciplinary action is in the "public interest." No disciplinary action may be taken without "notice and opportunity for hearing." [678] Suspension may be too harsh for many

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infractions, while a censure has been described by the SEC as a "slap on the wrist." [679]

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("SERPSA") [680] significantly expanded the range of penalties that the SEC could impose upon broker-dealers. Pursuant to SERPSA, the SEC may now seek money penalties of up to $100,000 against a natural person or up to $500,000 against any entity for violations of the U.S. securities laws. [681] Further, SERPSA authorizes the SEC to order respondents to "cease and desist" any violation of U.S. securities laws or "to take steps to effect compliance" with such laws. [682] Notice and opportunity for hearing are generally required in connection with SEC proceedings; however, in certain emergency situations, the SEC may issue temporary orders to regulated persons, such as broker-dealers, without a hearing. [683]

[c] Private Rights of Action

The civil actions for fraud that may be brought, for example, under § 10(b) of the Exchange Act and Rule 10b-5 thereunder may be brought against broker-dealers as well as other persons. The Private Securities Litigation Reform Act of 1995, [684] among other provisions, raises the pleading standards for fraud actions under the securities laws and prohibits broker-dealers from accepting referral fees from attorneys in connection with class actions for securities law violations.

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Broker-dealers may also be liable for fraud under other provisions of federal and state law. [685]

In addition, under § 29(b) of the Exchange Act, any contract made in violation of the Exchange Act is void. Accordingly, § 29(b) might be used, for example, as a defense by a customer of an unregistered broker-dealer that did not wish to perform an agreed-upon transaction or in an action to seek rescission. [686] Further, it is possible that this provision of the Exchange Act could also serve as the basis for a rescission action where a customer did business with a broker-dealer's employee who was not properly registered with FINRA or other SRO, even though the broker-dealer was itself properly registered and the transaction was not otherwise improper. [687]

Footnotes

670 The CFMA imposes certain limitations on the SEC's examination authority over FCMs that are notice-registered as broker-dealers, such as requiring the SEC to coordinate with the CFTC and, where possible, to use reports of examination by the CFTC. *See* §§ 17(b)(1)(B) and 17(b)(2)-(4) of the Exchange Act.

671 *See*, *e.g.*, *United States v. Morton Salt*, 338 U.S. 632 (1950). To conduct an inspection, the SEC is required to demonstrate only that any investigation is for a lawfully authorized purpose and that any documents it is seeking are reasonably relevant to its inquiry; the SEC is not required to establish "probable" or "reasonable" cause. *See*, *e.g.*, *SEC v. Howatt*, 525 F.2d 226, 229 (1st Cir. 1975); *SEC v. Brigadoon Scotch Distributing*, 480 F.2d 1047, 1054 (2d Cir. 1973), *cert. denied*, 415 U.S. 915 (1974); *SEC v. Blackfoot Bituminous*, 622 F.2d 512, 514 (10th Cir.), *cert. denied*, 449 U.S. 955 (1980); *SEC v. Kaplan*, 397 F. Supp. 564 (E.D.N.Y. 1975).

Section 15C(d) of the Exchange Act provides that the appropriate regulatory agency for a government securities broker-dealer has authority to inspect its records. Although § 21(a) of the Exchange Act gives the SEC power to inspect "any person" who has violated the act, § 15C(g)(2) of the Exchange Act provides that the SEC generally may inspect only the government securities broker-dealers for which it is the appropriate regulatory agency.

672 § 21(a)(2) of the Exchange Act; *see also* § 14.03[3][i].

673 *See*, *e.g.*, FINRA Rule 8210, FINRA MANUAL; NYSE Rule 476(a)(11), NYSE GUIDE (CCH) ¶2476 (failure to

comply with a request by the NYSE for information or testimony is cause for disciplinary action). Such information and reports may be shared with other domestic or foreign SROs with whom FINRA or the NYSE has entered into an agreement for the exchange of information or mutual assistance.

674 *See* § 14.04[2].

675 *See* SEC Release No. 34-29243 (May 29, 1991).

676 *See*, *e.g.*, FINRA Rule 8310, FINRA MANUAL; NYSE Rule 476, NYSE GUIDE (CCH) ¶2476.

677 *See* § 19(d) and (e) of the Exchange Act and Rule 19d-3 thereunder.

678 *See* § 15(b)(4) of the Exchange Act.

679 *See generally* written testimony of Richard Breeden, then-Chairman of the SEC, before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, United States Senate (1990).

680 Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

681 *See* §§ 21(d)(3) and 21B of the Exchange Act. If the gross pecuniary gain to the defendant exceeds the maximum penalties listed in the text, the SEC can seek a penalty in court up to the amount of such gain under § 21(d)(3) of the Exchange Act. The relevant provisions provide for lower maximum penalties for first and second time offenders, unless the violation involved fraud or reckless disregard and resulted in substantial loss or created a risk of substantial loss to other persons. Note that violations of insider trading prohibitions are subject to the provisions of Exchange Act § 21A. *See* §§ 11.05[2][c] and 14.07[1][b].

682 § 21C(a) of the Exchange Act; *see also* § 21(d) of the Exchange Act (authorizing the SEC to seek injunctions in federal court). In connection with any cease and desist proceeding, the SEC may require an accounting and disgorgement. § 21C(e) of the Exchange Act. The SEC's second use of its § 21C injunctive power was in connection with a disciplinary action taken against the foreign branch of a U.S. broker-dealer that failed to make its records available for inspection on a timely basis. *See* SEC Release No. 34-29243 (May 29, 1991).

683 § 21C(c) of the Exchange Act.

684 Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995); *see* § 11.03[c].

685 *See generally* Chapter 11.

686 *See*, *e.g.*, *Regional Properties, Inc. v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 558 (5th Cir. 1982), *aff'd on other grounds*, 752 F.2d 178 (5th Cir. 1985) (later appeal); *Eastside Church of Christ v. National Plan, Inc.*, 391 F.2d 357 (5th Cir.), *cert. denied*, 393 U.S. 913 (1968) (allowing investors to rescind transactions with unregistered broker-dealer); *see also* Samuel H. Gruenbaum and Marc I. Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 GEO. WASH. L. REV. 1 (1979).

687 Violation of the rules of FINRA or other SROs generally does not give rise to a private right of action. *See*, *e.g.*, *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980) (holding that there is no private right of action under the NYSE's "know your customer" rule or the NASD's suitability rule); *Emmons v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 532 F. Supp. 480 (S.D. Ohio 1982) (explaining that under the Supreme Court's test established in *Cort v. Ash*, 422 U.S. 66 (1975), there is no implied private right of action under NYSE or NASD rules); *Klitzman v. Bache Halsey Stuart Shields, Inc.*, 499 F. Supp. 255 (S.D.N.Y. 1980) (holding that there is no private right of action under NASD rules).

U.S. Regulation of the International Securities and Derivatives Markets, § 14.12, STATE REGISTRATION OF BROKER-DEALERS

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 § 14.12 (11th and 12th Editions 2014-2017)
11th and 12th Editions

A great complication for broker-dealers doing an international, or even a national, securities business in the United States is that they must contend both with the federal securities law registration and compliance requirements and with those contained in the securities laws of the various states ("blue sky" laws). [688] The state blue sky laws may be not only different from the federal laws but also different from each other; in addition, the various states' interpretation of the same written language may be inconsistent. It is thus essential for a broker-dealer to be aware of local securities law in each state in which it transacts business.

The North American Securities Administrators Association ("NASAA") is a coordinating agency of state securities administrators that attempts to minimize duplication and irregularity between the various jurisdictions. One result of

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this coordination is that a broker-dealer may register with the securities authority in every state by filing Form BD.

Most states have adopted the same version of the Uniform Securities Act, although they may differ in their respective implementations or interpretations of the act. [689] Section 201(a) of the Uniform Securities Act provides that "a person may not transact business in [a] state as a broker-dealer or sales representative unless licensed or exempt from licensing under …" the securities law of that state. A broker-dealer is defined by the Uniform Securities Act as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account." [690] Excluded from this definition are, among others,

> a person who has no place of business in [the] state if (a) his only clients in [the] state are other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pensions or profit-sharing trust[s], or other financial institutions or institutional buyers, whether acting for themselves or as trustees, or (b) during any period of twelve consecutive months he does not direct more than fifteen offers to sell or buy into [the] state in any manner to persons other than those specified in clause (a), whether or not he or any of the persons to whom the communications are directed is then present in [the] state. [691]

The Rule 15a-6 exemption from registration for foreign broker-dealers under the Exchange Act does not affect state registration requirements as such, although the above exclusions from the Uniform Securities Act definition of a broker-dealer to a certain extent overlap the Rule 15a-6 exemption from Exchange Act registration. [692] In particular, the Uniform Securities Act exclusion covers a foreign broker-dealer's transactions with registered broker-dealers,

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banks and certain institutional investors. [693] However, the institutional investors whom an unregistered broker-dealer may contact in a particular state may not overlap precisely with the Rule 15a-6 definition of "U.S. institutional investors." Further, the Uniform Securities Act, unlike Rule 15a-6, does not provide a general exclusion for purchases and sales that are "unsolicited." [694] It is also important to note that certain states (including, *e.g.*, California) do not have an applicable exemption from registration for an out-of-state broker-dealer effecting securities transactions with only institutional investors unless the broker-dealer is registered under the Exchange Act.

The NSMIA largely preempts state securities broker-dealer qualification requirements that differ from or are duplicative of federal requirements. [695] On its face, the NSMIA would appear to eliminate state regulation of federally exempted foreign broker-dealers except for the bare requirements that such broker-dealers register and pay registration fees. Nonetheless, individual states continue to require certain documentation in addition to the Form BD, including, among other things, affidavits with respect to any previous sales activities in the state.

Accordingly, foreign broker-dealers need to consider carefully the potential applicability of state, as well as federal, registration requirements to their U.S. securities activities. This is particularly the case as state securities regulatory authorities may be quite aggressive in seeking fines or other disciplinary actions against a foreign broker-dealer. For example, the Commonwealth of Massachusetts not only imposed a substantial fine against, but also permitted Massachusetts investors to rescind individual transactions with, Midland Walwyn, a Canadian broker-dealer that was improperly doing business with former Canadians who had moved to Massachusetts. [696]

Footnotes

688 Section 28(a) of the Exchange Act preserves state law insofar as such law does not "conflict" with the provisions of the Exchange Act. *See generally* Joseph C. Long, BLUE SKY LAW (Chap. 8: Broker-Dealers, Agents & Investment Advisers) (2016).

689 Most state regulation derives from the Uniform Securities Act (1956), adopted by 37 jurisdictions, and its successor, the Revised Uniform Securities Act (published in 1985). After both of these acts were preempted in part by NSMIA, the Uniform Securities Act (2002) was drafted and approved by the National Conference of Commissioners on Uniform State Laws as a "new" Uniform Securities Act. The Uniform Securities Act (2002) has been adopted by Georgia, Hawaii, Idaho, Indiana, Idaho, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Hampshire, New Mexico, Oklahoma, South Carolina, South Dakota, Vermont, Wisconsin, Wyoming and the U.S. Virgin Islands.

690 § 401(c) of the Uniform Securities Act.

691 § 401(c)(4) of the Uniform Securities Act.

692 *See* § 14.03[3].

693 Similar to the exclusion from the definition of "broker-dealer" under the Uniform Securities Act (1956), § 401(b) of the Uniform Securities Act (2002) provides an exemption from registration for a broker-dealer without a place of business in the relevant state if its only transactions effected in the state are with "institutional investors" (a term defined in the Uniform Securities Act to include other registered broker-dealers, banks and certain types of other institutions).

694 *See* § 14.03[3][b][i].

695 In addition, § 28(a) of the Exchange Act (as amended by the CFMA) preempts the application of state laws with respect to the offer, sale or distribution of securities (other than generally applicable antifraud provisions) to transactions in security futures products.

696 *See In re Midland Walwyn Capital Corp.*, Commonwealth of Massachusetts, Docket No. E-92-148, 1993 Mass. Sec . LEXIS 2 (Dec. 3, 1993). In part in response to this case, NASAA has added § 201(a) to the Uniform Securities Act, providing for limited registration of Canadian broker-dealers. NASAA REPORTS (CCH) ¶1211. A similar limited registration regime has been adopted by Canadian securities regulatory authorities.

U.S. Regulation of the International Securities and Derivatives Markets, § 15.01, 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 § 15.01 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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The Investment Company Act, the primary source of U.S. regulation of collective investment vehicles, [1] was adopted to curtail the securities fraud that existed in the 1930s and earlier in pooled investment funds offered in the U.S. retail market. The Investment Company Act is designed to provide a detailed regulatory scheme addressed at specific industry ills through a combination of registration and disclosure requirements and ongoing substantive regulation.

The Investment Company Act regulates companies identified as investment companies either by their purpose or by virtue of the makeup of their assets. As a result, companies, including operating companies, that are not funds (so-called "inadvertent investment companies") may fall within the Investment Company Act's definition of investment company. Companies that hold minority interests and other investment securities that account for as little as 40% of the value of their assets may be required to register as investment companies and become subject to substantive regulation. The regulatory requirements for companies registered under the Investment Company Act are extremely restrictive and, as a practical matter, are impossible for foreign companies to meet. The critical areas of inquiry for a foreign company therefore are whether it (or the affiliate, subsidiary or parent company involved in a particular transaction) falls within the definition of investment company, and, if so, whether it can avail itself of any of the provisions of the Investment Company Act or the rules thereunder, or obtain a specific order of the SEC, excluding it from the definition of investment company or exempting it from regulation.

In the early 1990s, the Investment Company Act was the subject of special scrutiny by the SEC staff and market participants. This scrutiny was largely directed at the criteria used to determine whether registration was required under the Act and the scope and limited number of exemptions from registration that were available. A 1990 SEC "concept release" (the "Concept Release") [2] soliciting public comment regarding the continued workability of the Investment Company Act generated significant commentary by professionals active on both the "buy" and "sell" sides of the industry, regulatory and self-regulatory authorities, the private bar and academics. The staff subsequently issued a major evaluation of the Investment Company Act entitled PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (the "1992 Report") [3] that included

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recommendations for various rulemaking and legislative initiatives. Although some of these proposals were implemented, action has not been taken with respect to many others, including, notably, certain of the staff's recommendations regarding the treatment of both private and public investment funds organized outside the United States. [4]

Before the SEC could act further, the National Securities Markets Improvements Act of 1996 (the "NSMIA") [5] very significantly amended the Investment Company Act. The changes made by the NSMIA included the addition of a new exemption from registration under the Investment Company Act for investment companies whose securities are offered and sold privately only to institutions and individuals with high net worth and significant investments, the addition of an exemption for dealers principally in derivative instruments, the substantial reduction of state regulation of SEC-registered public investment companies and the relaxation of restrictions on investments by one investment company in securities of another investment company. Although none of the amendments was targeted at international markets or international activities, several of the changes, including in particular the first two mentioned above, have had a significant impact on the operation of the Investment Company Act in the international context.

Even after these changes, however, the efficacy of the Investment Company Act continues to be scrutinized by Congress and other market participants with a special focus on open-end investment companies, better known as mutual funds. In late 2002, attention focused on the failure of many mutual funds and brokers to provide promised volume-based discounts (so-called "breakpoints") on sales fees charged to qualifying investors who acquired fund shares. More significantly, during the second half of 2003, a series of abuses involving mutual funds and their investment advisers came to light as a result of an investigation by the New York Attorney General, prompting the SEC to initiate numerous enforcement proceedings. [6] In general, investors are able to purchase or redeem the shares of a mutual fund that they hold at a price based on the fund's net asset value determined as of a specified time after the order is submitted. It was discovered, however, that certain mutual funds, their advisers or dealers were permitting favored investors to engage in "late trading," whereby the investors would purchase or redeem mutual fund shares based on the fund's old net asset value after the time on each day as of which the fund's new net asset value would

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have been applicable. [7] This late trading permitted the favored investors to take advantage of market events that occurred after the fund's net asset value had been determined by, for example, purchasing shares at the old net asset value if subsequent events would cause the new net asset value to be higher or redeeming shares at the old net asset value if subsequent events would cause the new net asset value to be lower. [8] Cases also arose where investment advisers or dealers allowed investors to engage in or facilitated short-term trading in mutual fund securities in violation of stated fund policies to the detriment of other fund investors and in breach of the fiduciary duties owed by the adviser to the fund and its shareholders. [9] These so-called "market timing" practices were especially pronounced in funds that invested in non-U.S. securities, where investors would seek to take advantage of time-zone differences between the markets where the fund's portfolio securities traded and the specified time in the United States as of which the fund's net asset value was determined. There were also allegations that certain investment advisers selectively disclosed the content of fund portfolios to attract investments from large investors, potentially allowing those investors to trade against the fund. [10]

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In addition to instituting numerous enforcement proceedings, the SEC engaged in a flurry of rulemaking, ranging from mutual fund governance reforms [11] and mandating or prohibiting certain pricing and payment arrangements [12] to enhanced disclosure of fund fee structures, trading policies and conflicts of interest. [13]

Most of the Investment Company Act's provisions address the operation of funds offered to the U.S. public. Hedge funds, however, which generally are

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private funds, have also attracted Congressional and regulatory attention. [14] These funds, which are often organized outside the United States, rely substantially on leverage (directly and through the use of complex derivative instruments) to increase potential investment returns. The investment strategy of hedge funds, which are offered to sophisticated high net worth individuals and institutions worldwide under exemptions from regulation under the Investment Company Act, may also present a significant risk of loss. In one case involving a U.S.-based hedge fund, Long-Term Capital Management, Inc., the losses incurred were of sufficient size to have a potential systemic impact on the global financial markets and necessitated a rescue that was coordinated by the Federal Reserve Bank of New York. [15] A 2003 study by the SEC staff that examined hedge fund operations and the role that hedge funds played in the late trading and market-timing cases involving mutual funds intensified this scrutiny. [16] SEC concerns over the growth in assets managed by hedge funds, an increasing number of cases involving fraud at hedge funds and the rise in the number of retail investors exposed to hedge funds resulted in a rule that required hedge fund advisers to register under the Investment Advisers Act of 1940, [17] although this rule was later vacated by the U.S. Court of Appeals for the District of Columbia Circuit.

More recently, the SEC has adopted regulatory reforms aimed at addressing the trouble that money market mutual funds experienced during the financial crisis of 2008. For the first time, a money market mutual fund "broke the buck" (allowed its net asset value per share ("NAV") to fall below $1.00), [18] leading to a temporary loss of confidence in such funds generally and necessitating a federal rescue program to preserve liquidity and stability in the money market mutual fund market. [19] In July 2014, however, the SEC adopted new rules applicable to money market funds that require institutional money market funds that do not principally invest in U.S. government securities to transact at a floating

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NAV, [20] give money market funds the ability to impose liquidity fees and suspend redemptions in certain circumstances, govern valuation of such funds, and provide for new disclosure, stress testing, reporting and diversification requirements. [21] In October 2016, the SEC adopted rules to address risk management and liquidity requirements [22] and "swing pricing" for open-end funds and exchange-traded funds, [23] and to require enhanced disclosure. [24] Additionally, the SEC has proposed rules that would regulate the use of derivatives by registered investment companies. [25]

The Dodd-Frank Act made few modifications to the Investment Company Act. Most notably, the Investment Company Act was amended to remove any reliance on ratings provided by national registered statistical rating organizations ("NRSROs"). [26] The SEC has revised certain Investment Company Act rules to eliminate reliance on rating agencies, as mandated by the Dodd-Frank Act, [27] but has yet to take action with respect to other rules. [28] The other notable change made by the Dodd-Frank Act was to include aiding and abetting liability for persons assisting others in violating provisions of the Investment Company Act or the rules promulgated thereunder. [29]

Footnotes

1 Operators of funds that utilize commodity futures contracts and commodity options, including security futures products, even if only for hedging or other portfolio management purposes, may also be subject to regulation as commodity pool operators under the Commodity Exchange Act ("CEA"). The Investment Company Act, Pub. L. No. 76-768, was originally passed on August 22, 1940.

2 SEC Release No. IC-17534 (June 15, 1990).

3 SEC Division of Investment Management, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (May 1992) (the "1992 Report"). The 1992 Report also addressed various aspects of U.S. investment adviser regulation, which are discussed in Chapter 16.

4 *See* §§ 15.03, 15.06 and 15.08.

5 National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3426–27 (1996).

6 *See* SEC Release No. IC-26520 (July 27, 2004), 69 Fed. Reg. 46,378, 46,378 n.6 (Aug. 2, 2004) (collecting cases).

7 Rule 22c-1 under the Investment Company Act requires that a mutual fund sell and redeem shares at the net asset value next computed after the order is placed or the security is tendered. For example, if a mutual fund calculates its net asset value at 4:00 p.m., any orders to purchase or redeem shares in that mutual fund received after 4:00 P.M. should be satisfied using the net asset value calculated at 4:00 P.M. on the next day.

8 *See, e.g.*, *In the Matter of Bear, Stearns & Co. Inc.*, SEC Release No. IC-27262 (Mar. 16, 2006) (finding that, from 1999 through September 2003, Bear Stearns facilitated trading by certain of its prime brokerage customers and customers of certain correspondent broker-dealers to benefit those customers at the expense of mutual fund shareholders, and ordering $250 million in disgorgement and penalties); *In the Matter of Banc of America Capital Management, LLC*, SEC Release No. IC-26756 (Feb. 9, 2005) (finding that, from as early

as July 2000 through July 2003, certain Bank of America entities allowed favored large investors to engage in market timing and late trading activities with respect to mutual funds that they advised or distributed, and ordering payment of $375 million).

9 *See, e.g.*, *In the Matter of Bear, Stearns & Co. Inc.*, SEC Release No. IC-27262 (Mar. 16, 2006); *In the Matter of Banc of America Capital Management, LLC*, SEC Release No. IC-26756 (Feb. 9, 2005); *In the Matter of Massachusetts Financial Services Co.*, SEC Release No. IC-26347 (Feb. 5, 2004) (finding that, from at least late 1999 to October 2003, Massachusetts Financial Services allowed widespread market timing and late trading in certain of its funds, and ordering payment of $225 million). In some cases, advisors allowed "market timing" transactions by investors in exchange for placing long-term "sticky" assets in other funds managed by the adviser. *In the Matter of Columbia Management Advisors, Inc.*, SEC Release No. IC-26752 (Feb. 9, 2005) (finding that, from at least 1998 to October 2003, Columbia entities (i) allowed preferred customers to engage in market timing transactions with respect to certain Columbia funds in exchange for maintenance of "sticky" assets in other funds and (ii) disclosed material nonpublic portfolio holding information to various entities, and ordering payment of $140 million).

10 *See, e.g., In the Matter of Gary L. Pilgrim*, SEC Release No. IC-26655 (Nov. 17, 2004); *In the Matter of Harold J. Baxter*, SEC Release No. IC-26656 (Nov. 17, 2004); *In the Matter of Pilgrim Baxter & Associates, Ltd.*, SEC Release No. IC-26470 (June 21, 2004) (series of enforcement proceedings finding the existence of market timing and self-dealing practices with respect to funds advised by an investment adviser and its principals from at least June 1998 to December 2001, including disclosure of material nonpublic information regarding the composition of portfolio holdings to a certain broker, and ordering total payments of $250 million); *see also In the Matter of Alliance Capital Management, L.P.*, SEC Release No. IC-26312A (Jan. 15, 2004) (finding that an investment adviser permitted select investors to engage in market timing transactions in exchange for maintenance of "sticky" assets in other funds, finding further that the investment adviser divulged material nonpublic information about portfolio holdings, and ordering payment of $250 million).

11 *See* SEC Release No. IC-26520 (July 27, 2004) (adopting rules designed to increase the independence and effectiveness of the boards of directors of registered investment companies); SEC Release No. IC-26299 (Dec. 17, 2003) (requiring registered investment companies to adopt written compliance procedures and designate a chief compliance officer); *see also* SEC Release No. IC-26985 (June 30, 2005) (reconsidering certain aspects of fund governance reforms following remand from the U.S. Court of Appeals for the D.C. Circuit).

12 *See* SEC Release No. IC-27504 (Sept. 27, 2006) (adopting rule requiring mutual funds to, among other things, enter into shareholder information agreements with intermediaries, such as broker-dealers, that hold shares on behalf of other investors in so-called "omnibus accounts," whereby the intermediaries must provide the mutual funds access to information about transactions in such accounts to enable the mutual fund to enforce restrictions on market timing and similar abusive transactions); SEC Release No. IC-26782 (Mar. 11, 2005) (adopting rule requiring, with certain exceptions, a mutual fund's board of directors either to impose a redemption fee of up to 2% on mutual fund shares redeemed within seven or more calendar days of their purchase or determine that imposition of a redemption fee is not necessary or appropriate); SEC Release No. IC-26591 (Sept. 2, 2004) (adopting rules to prohibit open-end management investment companies from paying for the distribution of their shares with brokerage commissions).

13 *See* SEC Release No. IC-26533 (Aug. 23, 2004) (adopting amendments to forms under the Investment Company Act to enhance disclosure by registered management investment companies regarding their portfolio managers); SEC Release No. IC-26486 (June 23, 2004) (adopting rule and form amendments to enhance disclosure by registered management investment companies regarding investment advisory contracts); SEC Release No. IC-26464 (June 7, 2004) (adopting form amendments requiring disclosure of volume-based "breakpoint" discounts by mutual funds); SEC Release No. IC-26418 (Apr. 16, 2004) (adopting form amendments requiring disclosure with respect to policies regarding market timing and selective disclosure of portfolio holdings); SEC Release No. IC-26372 (Feb. 27, 2004) (adopting rule and form amendments requiring disclosure by registered management investment companies with respect to costs, portfolio investments and past performance); *see also* SEC Release No. IC-26778 (Feb. 28, 2005)

(reopening comment period on proposed rules that would require broker-dealers to provide customers information regarding the costs and conflicts of interest that arise from, among other things, the distribution of mutual fund shares).

14 *See, e.g.*, SEC Release No. IA-2333 (Dec. 2, 2004); The Long and Short of Hedge Funds: Effects of Strategies for Managing Market Risk: Hearing Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Committee on Financial Services, 108th Congress (2003); Recent Developments in Hedge Funds: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs, 108th Congress (2003).

15 *See, e.g.*, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of the President's Working Group on Financial Markets (Apr. 1999).

16 SEC, Staff Report to the SEC, *Implications of the Growth of Hedge Funds* (Sept. 2003).

17 *See* SEC Release No. IA-2333 (Dec. 2, 2004); *see also* § 15.03[3][a][i][A]; *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

18 Christopher Condon, *Reserve Primary Money Fund Falls Below $1 a Share*, Bloomberg News (Sept. 16, 2008).

19 From October 21, 2008 to October 30, 2009, the Federal Reserve Bank of New York's Money Market Investor Funding Facility temporarily provided senior secured funding to qualifying money market mutual funds in order to provide liquidity for investors. *See* the Federal Reserve Bank of New York's description of the program at http://www.federalreserve.gov/monetarypolicy/mmiff.htm.

20 Money market funds that invest at least 99.5% of their total assets in cash, government securities, and/or repurchase agreements that are ‘‘collateralized fully” (meaning collateralized by cash or government securities) are exempt from the requirement to transact at a floating NAV and the provisions regarding redemption fees and gates. *See* 79 Fed. Reg. 47,736, 47,791 (Aug. 14, 2014).

21 SEC Release No. IC-31166 (July 23, 2014).

22 SEC Release No. 33-10233 (Oct. 13, 2016).

23 SEC Release No. 33-10234 (Oct. 13, 2016).

24 SEC Release No. 33-10231 (Oct. 13, 2016).

25 SEC Release No. IC-31933 (Dec. 11, 2015).

26 § 939(c) of the Dodd-Frank Act.

27 § 939A of the Dodd-Frank Act (requiring the SEC to remove reliance on credit ratings from rules); SEC Release No. IC-30847 (Dec. 27, 2013) (Rule 5b-3 and forms for registration of investment companies under the Investment Company Act to eliminate reliance on credit ratings); SEC Release No. IC-31828 (Sept. 16, 2015) (adopting amendments to Rule 2a-7 (relating to money market mutual funds) SEC Release No. IC-30268 (Nov. 19, 2012) (adopting Rule 6a-5 (relating to business and industrial development companies).

28 *See infra* Notes 110 to 112 and surrounding text.

29 § 929M of the Dodd-Frank Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 15.02, DEFINITION OF "INVESTMENT COMPANY"

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 § 15.02 (11th and 12th Editions 2014-2017)
11th and 12th Editions

The Investment Company Act's definition of "investment company" encompasses any entity that:

> (A) [i]s or holds itself out as being engaged primarily … in the business of investing, reinvesting or trading in securities;
>
> … or
>
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>
> (B) [i]s engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. [30]

The definition does not require that a portfolio be managed, and the requirement of being in the "business" has been interpreted very expansively; it may, for example, be satisfied even by a completely passive trust that simply holds securities [31] or by a holding company.

The wide range of companies covered by the Investment Company Act was thought by Congress to be justified in light of the abuses sought to be eliminated. An investment company is thus defined not only in terms of its purpose, but also in terms of an objective asset-based test, in part to minimize the possibility that an entity could inappropriately escape regulation under the Act. [32]

The SEC and its staff have construed the Investment Company Act's definition of "security" expansively, in order to carry out the Act's remedial purposes, even though the textual definition is virtually identical to that found in the other U.S. securities laws under which the definition has not been so broadly construed. [33] They have consistently taken the position that instruments such as

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commercial bank loans, loans to affiliates, certain instruments issued by insurance companies, commercial and other ordinary-course credit arrangements and the like, constitute securities under the Investment Company Act, although none of these items would qualify as securities under the other securities laws. [34]

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"Investment securities" includes all securities other than (i) "government securities"; [35] (ii) securities issued by employees' securities companies [36] and (iii) securities issued by entities that are (x) majority-owned subsidiaries of the entity being tested and (y) are not themselves investment companies or relying on the exceptions from the definition of "investment company" included in §§ 3(c)(1) or 3(c)(7) of the Investment Company Act. [37] As a result of that definition, securities issued by a sister or parent entity (*e.g.*, notes representing an intercompany financing) are treated as "investment securities" when the lender's status under the Investment Company Act is being considered, regardless of whether borrower and lender are under common control. If a security is issued by a majority-owned subsidiary of the entity being tested (*e.g.*, equity in a direct or indirect subsidiary held by a parent), that majority-owned subsidiary's status under the Investment Company Act must be tested to determine if the securities it has isssued are "investment securities," often requiring that the Investment Company Act tests be applied iteratively to each entity in a corporate chain.

The Investment Company Act prescribes the methods to be used when making determinations of value. Securities for which market quotations are available are valued at their market value as of the end of the last quarter. Securities for which market quotations are not readily available and all other assets owned at the end of the last quarter are valued at "fair value at the end of such quarter, as determined in good faith by the board of directors." [38] Assets acquired after the end of the last quarter are valued at cost.

The requirement to value many assets at fair value and the requirement that the determination of fair value be made by the board of directors often creates difficulty for companies. Although in transactions, such as some acquisition financings, where a third-party valuation of assets is obtained, the value ascribed to assets in that valuation is generally adopted by the board of the directors for purposes of this analysis, difficult questions are often raised in other contexts, particularly when the fair value of shares in subsidiaries must be determined and where there may be a significant gap between the carrying value of assets recorded under generally accepted accounting principles and fair value.

There is no doubt that conventional mutual funds are intended to be the primary subjects of Investment Company Act regulation. But the combination of the asset-based definition of investment company and the expansive interpretation of

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the definition of security potentially subjects other entities, known to commentators and practitioners as "inadvertent investment companies," to regulation under the Investment Company Act. The appropriateness of Investment Company Act regulation for these entities is far less obvious, but the Act nonetheless fully applies to them. These companies include holding companies that own controlling, but less than majority, interests in other companies, foreign banks and insurance companies and their holding companies, and finance subsidiaries whose assets consist of loans to their parents and affiliates. [39] The Investment Company Act and the rules thereunder contain a number of provisions excluding or exempting particular types of entities either from the definition of investment company or from the operation of the Act. [40] In addition, the Act grants authority to the SEC to exempt entities from specific provisions or from its provisions generally where such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Act. [41]

Investment Company Act regulation can even be relevant in the context of individual account management services. Prior to the adoption of Rule 3a-4 under the Investment Company Act, the SEC staff took the position that, where an adviser manages accounts using the same or similar investment strategies, the accounts could be aggregated pursuant to the staff's "integration" policy, [42] resulting in the creation of an investment company. This issue arises in the context of so-called "wrap-fee" programs. These programs, typically sponsored by a broker-dealer or investment adviser, provide advisory clients with access to third-party money managers that are selected by the broker-dealer or adviser. [43] Rule 3a-4 provides a nonexclusive safe harbor from regulation of these programs under the Investment Company Act, subject to reporting obligations and other conditions, including that (i) each client's account will be managed according to

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the financial situation and investment objectives and restrictions of the client, and (ii) each client retains the right, as though his or her securities and funds were not held in the program, to vote those securities and withdraw them or cash. [44]

Complex issues must also be considered in evaluating new financial products such as basket-, index- and equity-linked notes and warrants under an act that long antedated and did not ever contemplate their existence. Basket-linked notes or warrants involve the issuance of securities that are linked to a specific basket of stocks, whereas equity-linked notes or warrants pass through to investors returns on either a registered fund or, increasingly, a synthetic portfolio comprising a registered fund or fund-of-funds and specific fixed-income securities that are dynamically hedged based on an objective fixed formula.

Footnotes

30 §§ 3(a)(1)(A) and 3(a)(1)(C) of the Investment Company Act. There is also a third type of entity that falls within the definition of investment company—the "face amount certificate company" described in § 3(a)(1)(B) of the Investment Company Act—which is not relevant for the purposes of the discussion provided in this book.

31 As long as the trust has an investment purpose in acquiring the securities it holds and engages in no other business that may be considered "primary," that trust may be considered to be engaged primarily in the business of investing in the securities. *Credit Suisse First Boston Corporation* (avail. Sept. 9, 1998); *see also SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3, 30–31 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970).

32 As stated by one observer, "[the SEC] conceived this objective [asset-based] standard, rejecting the descriptive approach theretofore advanced by text writers and others, because the existing definitions eliminated companies that exercised control or influence over their portfolio companies and because they contained indefinite terms." Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STANFORD L. REV. 29, 33 (1959).

It is not clear how the objective asset-based test will be applied to investments in security futures products, which, unlike other securities, are essentially a type of notional contract that has no inherent value once marked-to-market.

33 Section 2(a)(36) of the Investment Company Act defines "security" as:

> any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

See also § 12.01.

34 *See* § 12.01. The SEC and its staff's interpretations of the definition of "security" for purposes of the Investment Company Act are not, insofar as they are broader than those applied for purposes of the other U.S. securities laws, the subject of any published judicial or administrative decision.

The exclusions from the definitions of security under the Securities Act and the Exchange Act codified in the Commodity Futures Modernization Act of 2000 (the "CFMA"), Pub. L. No. 106-554, Appendix E, 114 Stat.

2763, 2763A–365 (2000), for qualifying swap agreements do not apply to the Investment Company Act. Title III of the CFMA contains a "savings clause" providing that nothing in the CFMA is to be construed as finding or implying that any swap agreement is or is not a security "for any purpose under the securities laws," including the Investment Company Act. § 304 of the CFMA. While interest rate and commodity swaps are unlikely to be considered securities for purposes of the Investment Company Act, the SEC staff has indicated in informal consultations that it would consider credit default swaps, which are linked or refer to defaults on specific securities or categories of securities of an issuer, to be securities for purposes of the Act. *See also MACRO Securities Depositor, LLC* (avail. Dec. 1, 2006) (granting no-action relief for trusts to enter into oil-linked OTC derivative instruments on a pre-determined formulaic basis and subject to certain other prescribed procedures, while noting that trusts using OTC derivative instruments linked to one or more securities or one or more securities indices may raise additional issues under the federal securities laws).

In 2007, the initial public offerings of several high-profile alternative asset managers, including Blackstone Group L.P. and Fortress Group LLC, attracted substantial attention, particularly with respect to their analysis of their holdings of investment securities. These entities hold principally general partnership and limited partnership interests in the private equity and hedge funds that they manage. Limited partnership interests count as securities for purposes of the Investment Company Act. General partnership interests, however, generally do not because they generate profits that result from the efforts of the general partner. Because of the high value attributed to their general partnership interests due to their entitlement to carried interest (*i.e.*, generally 20% of the profits realized by the underlying fund), investment securities comprised less than 40% of the total assets of these alternative asset managers, thereby exempting them from registration under the Investment Company Act at the time of their IPOs. *See* Andrew J. Donohue, Director, SEC Division of Investment Management, Testimony Concerning Initial Public Offerings of Investment Managers of Hedge and Private Equity Funds before the U.S. Senate Committee on Finance (July 11, 2007); *see also* Letter from Richard Trumka, AFL-CIO Secretary-Treasurer, to John White, Director, SEC Division of Corporation Finance, and Andrew Donohue, Director, SEC Division of Investment Management (May 15, 2007) (arguing that Blackstone should be viewed as an investment company because, among other things, the general partnership interests it holds are investment securities).

35 As defined in § 2(a)(16) of the Investment Company Act, "Government security" means any security issued or guaranteed as to principal or interest by the United States or its agencies or instrumentalities. Therefore, especially in the case of a foreign issuer, care should be taken to be sure that it has not categorized securities issued by a non-U.S. government as "Government securities" for this purpose.

An “employees' securities company” is an investment company all of the securities of which are owned by former and current employees of a single employer and certain other related parties.

36 § 2(a)(13) of the Investment Company Act.

37 § 3(a)(2) of the Investment Company Act.

38 § 2(a)(41) of the Investment Company Act.

39 Edmund H. Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STANFORD L. REV. 29 (1959); Edmund H. Kerr & Alan Appelbaum, *Inadvertent Investment Companies—Ten Years After*, 25 BUS. LAW. 887 (Apr. 1970). Certain of these entities have been exempted or excluded by rule from regulation under the Act, as discussed in §§ 15.05 and 15.06. *See also Xplornet Communications Inc.* (avail. Jan. 11, 2012) (granting no-action relief under § 7(d) of the Investment Company Act to a Canadian broadband Internet service provider ("XCI"), where XCI may have been deemed an investment company if loans it made to a data transmission company were determined to be "securities.")

40 *See* §§ 15.05 and 15.06 for discussion of certain of the provisions.

41 § 6(c) of the Investment Company Act.

42 *See* § 15.06[3][c].

43 Wrap-fee arrangements also raise issues under the Advisers Act. The Advisers Act was amended to require that registered investment advisers that are sponsors of wrap-fee programs provide certain disclosure to prospective clients in these programs in addition to the brochure required under Rule 204-3 under the

Advisers Act. Mutual fund asset allocation programs are specifically excluded from the definition of wrap-fee programs for these purposes. *See* SEC Release No. IA-1411 (Apr. 19, 1994); § 16.05; *see also* §§ 15.03[2][b] and 15.06.

44 Rule 3a-4 under the Investment Company Act. The introductory note to Rule 3a-4 also clarifies that there is no registration requirement under § 5 of the Securities Act for programs organized to comply with the rule. For those programs that do not comply, prior SEC no-action letters continue to apply and impose substantially similar conditions. *See, e.g.*, *Wall Street Preferred Money Managers Inc.* (avail. Apr. 10, 1992) (stating that the staff would no longer respond to inquiries concerning when a discretionary adviser and its accounts are not subject to the Investment Company Act unless the request presented novel or unusual issues). Some have complained that Rule 3a-4 is being taken advantage of to allow Internet-based portfolio accounts and advisory accounts to operate as unregistered investment companies, and the Investment Company Institute (the "ICI") asked the SEC to consider regulating such accounts. *See* Paul F. Roye, Director, SEC Division of Investment Management, Remarks at the Third Annual IA Compliance Summit (Mar. 26, 2001).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.03, REGISTRATION UNDER THE INVESTMENT COMPANY ACT

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 § 15.03 (11th and 12th Editions 2014-2017)
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An investment company required to register with the SEC must operate as one of the three types of investment companies enumerated in the statute: a unit investment trust, a management company or a face amount certificate company. Management companies are in turn divided into open-end and closed-end companies. Unit investment trusts are defined as entities organized under trust indentures or similar instruments without boards of directors or similar bodies that issue only securities redeemable at any time at the option of the holder, each of which represents an undivided interest in a pool of specified securities. [45] Unit investment trusts are therefore generally fixed and unmanaged pools of assets. Face-amount certificate companies have been pushed out of the marketplace by other products; they are now extremely rare [46] and will not be considered further in our discussion. Management companies comprise all other investment companies. Open-end companies, the entities commonly referred to as "mutual funds" in the U.S. market, are defined as those having securities outstanding that are redeemable at any time at the option of the holder. [47] Closed-end companies, which do not issue securities redeemable by the holder at will and are traded in the secondary market, include all other management companies. [48] The requirements applicable to a registered investment company depend in part on its type. [49]

Although the system of classification contained in the Investment Company Act might have been an accurate reflection of the types of investment companies that were in existence when the Investment Company Act was adopted over 70 years ago, requiring an investment company to fit into one of these classifications now may be inconsistent with legitimate business objectives. One of the most popular investment vehicles introduced in recent years is the exchange-traded fund or "ETF." ETFs are a hybrid of open-end and closed-end funds—they are traded on the secondary market like shares of stock and their shares are redeemable, although only in very large blocks, which provides certain efficiencies in the operation of the funds. Because the innovative structure of ETFs was not contemplated by the drafters of the Investment Company Act, they do not fit neatly within the typology prescribed by the Act and, to date, have been able to operate only under individually granted exemptive orders from the SEC. [50] Historically, only "index" ETFs, which are designed to mirror the performance of certain public market indices, were available in the United States; however, in 2008, the SEC began to issue exemptive orders involving actively managed ETFs. [51] Recognizing the increasing popularity of ETFs, the SEC also proposed new rules that would codify much of the exemptive relief granted in the ETF

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area, including in respect of actively managed ETFs, [52] although to date it has only adopted rules addressing ETF disclosure and prospectus requirements. [53]

A registered investment company is subject to very significant ongoing disclosure [54] and regulatory requirements. Although disclosure to investors and potential investors is an important part of the Investment Company Act's scheme, its primary focus is on substantive regulation, including:

- the composition of the board of directors;
- transactions between an investment company and its promoters, underwriters, advisers and other affiliated persons;

- issuance of debt or other "senior" securities and other borrowings to create leverage;
- investment in other investment companies;
- securities custody arrangements; and
- prices at which redeemable securities may be offered or redeemed.

This detailed substantive regulation derives from Congressional intent to curb specific types of abuses. For example, because fund managers of the 1930s "refused to recognize their fiduciary obligations to the shareholders" and engaged in transactions that victimized investors while benefiting themselves, [55] the Investment Company Act includes very restrictive provisions regarding related party transactions. Similarly, the provisions restricting ownership by one investment company of securities of another derive directly from "fund of funds" abuses, involving fees and self-dealing to the benefit of advisers and promoters but to the detriment of investors. [56] Although these and other detailed regulatory provisions have laudable origins, many exceed, and in some cases are inconsistent with, requirements applicable to foreign investment companies in their local jurisdictions. In the case of foreign companies that are inadvertent investment

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companies, it is fair to say that such regulation is unheard of outside the United States.

Footnotes

45 § 4(a)(2) of the Investment Company Act.

46 According to one industry participant, as of 1990, there were only two active face-amount certificate companies in the United States. *See* Letter of IDS Financial Services Inc. (Oct. 2, 1990).

47 § 5(a)(1) of the Investment Company Act.

48 § 5(a)(2) of the Investment Company Act.

49 In addition, investment companies making public offerings in the United States are required to register such offerings under the Securities Act. *See* Chapter 3 and § 15.08. Public investment companies are also subject to many of the disclosure obligations applicable to public companies generally, as well as to many of the "buy side" pressures on disclosure and operational matters faced by public companies, including for example in the area of corporate governance. *See, e.g.*, ICI, *Enhancing a Culture of Independence and Effectiveness*, Report of the Advisory Group on Best Practices for Fund Directors (June 24, 1999).

50 *See, e.g.*, *Foreign Fund Inc.*, SEC Release Nos. IC-21737 (Feb. 6, 1996) (notice) and IC-21803 (Mar. 5, 1996) (Order).

51 *See, e.g.*, *Wisdom Tree Trust*, SEC Release Nos. IC-28147 (Feb. 6, 2008) (notice of application) and IC-28174 (Feb. 27, 2008) (Order); *Barclays Global Fund Advisors*, SEC Release Nos. IC-28146 (Feb. 6, 2008) (notice of application) and IC-28173 (Feb. 27, 2008) (Order); *Bear Stearns Asset Management, Inc.*, SEC Release Nos. IC-28143 (Feb. 5, 2008) (notice of application) and IC-28172 (Feb. 27, 2008) (Order); and *Power-Shares Capital Management LLC*, SEC Release Nos. IC-28140 (Feb. 1, 2008) (notice of application) and IC-28171 (Feb. 27, 2008) (Order).

52 SEC Release No. IC-28193 (Mar. 11, 2008) (proposing new Rules 6c-11 and 12d1-4 and amendments to Rule 12d1-2 and Form N-1A under the Investment Company Act).

53 SEC Release No. IC-28584 (Jan. 26, 2009) (amending Form N-1A); *see also* SEC Release No. IC-32315 (Oct. 13, 2016).

54 *See, e.g.*, SEC Release No. IC-32314 (Oct. 13, 2016).

55 86 Cong. Rec. 2844 (1940).

56 The "anti-pyramiding" provisions, which addressed abuses identified by Congress in 1970, *see* Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 7, 84 Stat. 1413, 1418–1421 (1970), have since been relaxed by the NSMIA to permit "fund of fund" structures in which a fund acquires shares in other

funds to provide certain asset allocation options to investors. The SEC has also adopted rules that to a certain extent further expand the circumstances in which a fund may invest in shares of another investment company. SEC Release No. IC-27399 (June 20, 2006).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.04, JURISDICTION OVER FOREIGN INVESTMENT COMPANIES

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 § 15.04 (11th and 12th Editions 2014-2017)
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The Investment Company Act regulates foreign investment companies by restricting their offerings of securities in the United States. A foreign investment company is prohibited under the Investment Company Act from making a public offering in the United States unless it has received an order from the SEC permitting it to register as an investment company, and those orders generally impose conditions that parallel the provisions of the Investment Company Act. [57] The requirements that must be met to obtain such an order are such that, as discussed in § 15.08, with the exception of a few Canadian investment companies, U.S. public offerings by foreign investment companies are effectively prohibited. Although the Investment Company Act does not explicitly address private offerings by foreign investment companies, the SEC also has placed substantial limitations on such offerings based on the rules applicable to U.S. private investment companies, as discussed in § 15.06.

Footnotes

57 § 7(d) of the Investment Company Act and Rule 7d-1 thereunder.

U.S. Regulation of the International Securities and Derivatives Markets, § 15.05, EXCLUSIONS AND EXEMPTIVE RELIEF

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 § 15.05 (11th and 12th Editions 2014-2017)
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As discussed above, the definition of "investment company" has posed special problems for foreign entities that may fall within the definition—as interpreted by the SEC—but that would not ordinarily be considered investment companies within the common sense meaning of the term. A company falling within the definition of investment company may seek special exemptive relief from the SEC from all or certain provisions pursuant to § 6(c) of the Investment Company Act. The exemptive process, discussed in § 15.05[7], is uncertain and generally protracted and expensive. In recent years, the SEC staff has been reluctant to grant exemptive orders containing any novel elements, and even when granted, it has taken inordinate amounts of time to obtain such orders. Seeking such orders is therefore often unattractive for foreign companies seeking exemption from the Investment Company Act. Where the SEC has developed a consistent view in the context of successive § 6(c) applications presenting similar issues, the SEC has, through its rule-making power, excluded foreign finance subsidiaries, as well as foreign banks and insurance companies and their holding companies, and certain other companies from the definition of investment company, despite their asset composition.

[1] Finance Subsidiaries—Rule 3a-5

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The SEC has excluded certain finance subsidiaries from the Act's definition of investment company in Rule 3a-5 under the Investment Company Act. [58] The rule is applicable to finance subsidiaries organized within or outside the United States, and to those of both U.S. and foreign issuers. Rule 3a-5 provides that such a subsidiary will not be considered an investment company and that the securities of the subsidiary held by its parent [59] or a company controlled by the parent [60] will not be "investment securities" if the conditions of the rule are satisfied. The rule requires that the parent company own all of the securities (except

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for debt securities and nonvoting preferred shares) of the finance company, although the staff has granted no-action relief for a structure in which the parent company effectively controlled, but did not actually own, the securities of the finance subsidiary. [61] Among its other requirements, Rule 3a-5 specifies that payment of any publicly offered or publicly held nonvoting preferred stock and debt securities [62] of the finance subsidiary must be unconditionally guaranteed by its parent. [63] For these purposes, a "keepwell" or support agreement between the parent and the subsidiary, providing, for example, that the parent will assure that the

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issuing subsidiary has sufficient resources to satisfy its obligations, is not sufficient. [64] Where the parent company is a foreign bank, [65] however, 1991 amendments to Rule 3a-5 [66] permit the parent to issue an irrevocable letter of credit in favor of security holders in lieu of a guaranty, provided that payment on the letter of credit is conditioned only upon presentation of "customary documentation" and beneficiaries may proceed to enforce the letter of credit directly against the parent. [67] Any convertible or exchangeable securities issued by the finance subsidiary must be convertible solely into or exchangeable solely for the parent's securities or other debt or nonvoting preferred stock of the subsidiary that meets the guarantee and other requirements of Rule 3a-5 under the Investment Company Act. [68]

Rule 3a-5 also places limitations on the use of proceeds received as a result of the finance subsidiary's offering. At least 85% of such proceeds in the form of cash or cash equivalents must be invested in or loaned to its parent or a company controlled by the parent within six months of receipt. [69] In addition, the finance

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subsidiary may not trade or own any securities other than U.S. government securities, commercial paper meeting the requirements of § 3(a)(3) of the Securities Act [70] and securities of its parent or companies controlled by its parent. [71] The restrictions on the types of securities in which the finance subsidiary may invest are apparently intended to assure that the finance subsidiary does not present risks that would make its regulation as an investment company appropriate. The restriction nevertheless can raise significant issues, particularly in the case of non-U.S. entities whose investments properly include other obligations, such as government securities issued by their "host" government. The impediment to rational financing strategies that Rule 3a-5 presents in this context often prevents issuers from taking advantage of the rule's exemption, and its various limitations should be reconsidered by the SEC.

Finally, the parent company providing the guarantee and any affiliated company to which the proceeds are loaned may not be an investment company or must be exempted under § 3(a) or (b) of the Investment Company Act or one of the SEC's rules under those sections, [72] although the SEC has provided exemptive relief to parent companies that are excluded from the definition of "investment company" under § 3(c)(3), [73] § 3(c)(5)(A), § 3(c)(5)(B) [74] or

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§ 3(c)(6) [75] but that otherwise satisfy the requirements of Rule 3a-5. [76] Because Rule 3a-6 under the Investment Company Act excludes foreign insurance companies and banks (including government-owned institutions that qualify as "foreign banks" under the rule) [77] from the definition of "investment company," finance subsidiaries of these entities may now rely on Rule 3a-5 if they satisfy the rule's other conditions.

Because the parent guarantee requirement of Rule 3a-5 is applicable only in the case of finance subsidiaries that have outstanding debt securities and nonconvertible preferred stock that were "issued to or held by the public," the rule is available—without the need for a parent guarantee—to finance subsidiaries whose debt and preferred stock are issued in private placements, [78] including private placements contemplating the possibility of resales under Rule 144A under the Securities Act. [79]

The SEC staff has also taken the position that the phrase "issued to or held by the public," as used in Rule 3a-5, does not encompass an offering undertaken pursuant to Regulation S under the Securities Act. [80] Securities of a finance company so offered need not be guaranteed by the company's parent to comply with Rule 3a-5 under the Investment Company Act.

[2] Foreign Banks and Insurance Companies—Rule 3a-6

Rule 3a-6 under the Investment Company Act excludes banking institutions and insurance companies organized outside the United States from the definition of "investment company," exempting them entirely from the operation of the Investment Company Act, if they are regulated by home country authorities

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as a banking institution or insurance company, as applicable, and either engaged substantially in commercial banking activity [81] or engaged primarily and predominantly in writing insurance contracts [82] or the reinsurance of such insurance contracts underwritten by insurance companies, as applicable. [83] Rule 3a-6 replaced and broadened Rule 6c-9, [84] which provided a more limited exemption available only to foreign banks and their finance subsidiaries in the case of certain offerings of debt securities and nonvoting preferred stock. [85] Issuers seeking to rely on Rule 3a-6 in connection with a U.S. public offering registered under the Securities Act must file with the SEC a brief form (Form F-N) that identifies the issuer and its agent for purposes of receiving service of process in the United States. [86]

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Because Rule 3a-6 excludes foreign banks and insurance companies from the definition of "investment company" rather than merely exempting them from the requirements of the Investment Company Act, such entities (and their holding companies and finance subsidiaries) can take advantage of other exemptive provisions that depend on their status as noninvestment companies. [87] For example, the restriction on the holding of the securities of investment companies by registered investment companies does not apply to their holdings of securities of foreign banks and insurance companies because they are excluded from the definition of "investment company" (and not merely exempted from the operation of the Investment Company Act). [88]

Common or collective trusts, separate accounts or other pools of assets in which interests are offered (as opposed to direct interests in the issuer) will not qualify as foreign banks or insurance companies under the rule. [89] Additionally, Rule 3a-6 does not address the situation of a number of foreign bank-like entities that have sought to make offerings in the United States but, because of the nature of their assets, have sought assurances that they are not subject to regulation under the Investment Company Act. [90] Certain special credit institutions have received exemptive relief, including a non-governmental issuer of covered bonds backed by public sector debt and mortgage obligations that was not permitted to take deposits and was therefore not a "bank" for purposes of Rule 3a-6. [91] Nevertheless, relief was granted on the basis of the regulatory and supervisory home-country regime and the restricted nature of the issuer's activities.

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Government-owned and controlled non-bank credit institutions also generally fall outside the scope of Rule 3a-6. These foreign institutions are most often involved in using their funds, which they obtain from the governments that control them and from borrowings from banks and in the capital markets, to make loans to finance economic development, export or import transactions or other activities that are part of government policy. Their assets, however, are predominantly loan receivables that may be viewed as securities under the Investment Company Act.

If these entities are not regulated as banks or "substantially engaged in commercial banking activity," they are not able to rely on Rule 3a-6 (nor would their finance subsidiaries be able to rely on Rule 3a-5 under the Investment Company Act), notwithstanding that they are generally referred to as "banks." It would appear sound, both as a matter of policy and interpretation of the Investment Company Act in light of the provisions of the Securities Act, that an issuer filing a registration statement under Schedule B of the latter as a "foreign government or political subdivision thereof" should not be viewed as an investment company. However, the SEC appears to have taken the position that, while it may be inclined to be more flexible in avoiding application of the Investment Company Act in such cases, Schedule B status is not in itself grounds for doing so. Export-import banks have generally obtained no-action relief confirming that they may rely on the exemption for companies principally engaged in purchasing and financing receivables, discussed at § 15.05[3], on the grounds that their activities generally involve lending money for, or purchasing or otherwise refinancing, purchases of goods or services in connection with import or export transactions. [92] The SEC has granted exemptions from all provisions of the Investment Company Act under § 6(c) to development banks and other government-related financing institutions where the exemptions for specific kinds of financing activity cannot be relied on. [93] The SEC has relied on the

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strong elements of foreign government policy and foreign government control behind the activities of these entities in granting these exemptions. In other cases, where application for no-action or exemptive relief under the Investment Company Act has not been made, the SEC has apparently not raised the question of whether Investment Company Act registration is required and has declared effective under the Securities Act registration statements for governmental entities such as development banks that have filed under Schedule B.

[3] Asset-Backed Arrangements

[a] Companies "Primarily Engaged" in Purchasing Mortgages and Receivables—§ 3(c)(5)

As a result of negotiations at the time the Investment Company Act was adopted, exclusions from the operation of the Act were provided for finance and similar companies that were not banks but that purchased and financed mortgages and receivables for goods and services. [94] This exclusion, in addition to being relied on by such companies, was, at least until the adoption in 1992 of Rule 3a-7 under the Investment Company Act, the principal provision relied on to keep many asset-backed arrangements from having to register under the Investment Company Act (for purposes of this chapter, asset-backed arrangements are referred to as "ABAs"). In particular, the issuers of mortgage-backed securities and of many receivables-backed securities, whether organized within or outside the United States, have been able to fit within these exclusions. [95] These provisions have also been the basis for conclusions that certain foreign issuers, particularly government-related entities, whose business is the financing of the purchase of specified merchandise and services (such as special purpose entities designed to refinance military equipment sales) are not investment

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companies. [96] In cases of close questions regarding these provisions, the SEC appears disposed to grant exemptive orders under § 6(c) of the Investment Company Act rather than interpret the exemptive provisions themselves to permit the proposed activities in order to maintain the ability to impose additional conditions on a particular exemption's availability.

These provisions raise a number of interpretive questions, and, on some, SEC guidance has been received. The question of what is required to be "primarily engaged" has been considered extensively in the case of mortgage-backed ABAs. In some cases, only a portion of the assets of an issuer consists of "whole loans" secured by mortgages, which are considered by the SEC to be "mortgages and other liens on and interests in real estate," [97] while the remainder consists substantially of participations or other partial interests in such loans, which, in the view of the SEC, are not "mortgages and other liens on and other interests in real estate." The SEC has granted no-action relief where pools of assets contain at least 55% by value of whole loans, finding that such pools satisfy the "primarily engaged" test. [98] The SEC has undertaken a review of market practice and its guidance under § 3(c)(5)(C), requesting comment on whether such arrangements should be prohibited from relying on § 3(c)(5) and limited—by statute or rule—to reliance on Rule 3a-7 only (discussed below). [99]

There have also been a number of interpretations regarding the types of activities that constitute the purchase of receivables and the sorts of assets that constitute permissible receivables within § 3(c)(5) of the Investment Company Act. [100] For example, relief has been granted where the purchased receivables consisted of intellectual property royalty payments where such payments were directly based on the sales price of the products using the intellectual property in

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question. [101] In another instance, no-action relief was granted to a non-governmental issuer of covered bonds that made loans to public sector entities for construction and renovation projects, based in part on the analysis that the loans were to prospective purchasers of specified merchandise and services within the meaning of § 3(c)(5)(B). [102] In some credit card receivables securitization transactions involving ABAs and relying on § 3(c)(5), transaction participants have agreed to place restrictions on the use of such receivables resulting from cash advances, as opposed to receivables resulting from the purchase of goods and services, on the theory that only the latter receivables fall within the categories enumerated in § 3(c)(5). [103]

[b] Other Asset-Backed Arrangements—Rule 3a-7

Largely in response to comments that it received in response to the Concept Release, [104] the staff adopted Rule 3a-7 under the Investment Company Act to exclude from the definition of "investment company" issuers that do not issue redeemable securities [105] and that pool receivables, the cash flow on which is the principal source of funds for payment of the securities of those issuers. [106] Rule

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3a-7 is available for pools of "eligible assets," which are defined as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure servicing or timely distribution of proceeds to security holders." [107] The definition is intended to include credit and liquidity facilities "designed to assure the servicing or timely distribution of proceeds to security holders." [108]

To qualify for the Rule 3a-7 exemption, an issuer may only issue "fixed income securities" [109] or other securities that entitle their holders to receive payments that depend "primarily" on the cash flow from eligible assets. [110] The payment of residual interests out of proceeds from the sale or other disposition of underlying assets will therefore not prevent reliance on the exemption. Only fixed-income securities that are rated at the time of initial sale in one of the four highest rating categories applicable to long-term debt (or an equivalent short-term category depending on the maturity of the securities)—that is, are rated "investment grade"—by at least one nationally recognized statistical rating organization, may be sold publicly by the issuer or its underwriters without any

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restriction. [111] While the SEC has proposed removing reliance on credit ratings from certain rules, [112] the SEC has requested comment on whether this and other references to credit ratings in Rule 3a-7 should be retained, or whether references to credit ratings should be replaced with conditions that are tailored to address Investment Company Act and related concerns. [113] In contrast, noninvestment grade fixed income securities may be sold only to institutional "accredited investors" within the meaning of Rule 501(a)(1), (2), (3) or (7) under the Securities Act, and to other institutions all of the equity of which is owned exclusively by such investors. All other securities, including residual interests, may be sold only to "qualified institutional buyers" within the meaning of Rule 144A under the Securities Act [114] and to persons who are involved in the organization or operation of the issuer and their affiliates. [115] Issuers and underwriters must exercise reasonable care, including through the use of legends and contractual restrictions, [116] to ensure that nonconforming securities (*i.e.*, securities that do not qualify as "fixed-income securities" or meet the rating condition) are sold or resold solely to the applicable types of institutional investors. [117] The SEC staff has orally confirmed, and transactions have proceeded on the understanding, that

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investors in offerings by non-U.S. issuers under Rule 3a-7 that are not U.S. persons (generally following the definition set forth in Regulation S under the Securities Act) and that purchase these unrated or lower-rated securities (either in a primary offering or in the secondary market) need not meet the requirement that they be qualified institutional buyers or institutional accredited investors. But the SEC staff has provided no formal guidance as to whether U.S. persons acquiring such securities from non-U.S. persons in the secondary market must meet this requirement. [118]

Dispositions and acquisitions of eligible assets during the term of the securities are permitted as long as these actions (i) are authorized in the documents governing the financing, (ii) do not result in a downgrade of outstanding fixed-income securities of the issuer and (iii) are not undertaken for purposes of recognizing gains or preventing losses resulting from volatility in the market value of eligible assets. [119]

Finally, Rule 3a-7 requires, other than in the case of asset-backed commercial paper programs, that the issuer appoint a trustee for the pool and that the trustee be unaffiliated with the issuer or any person involved in the organization or operation of the issuer. [120] The SEC has, however, permitted as trustee a disclosed affiliate of an underwriter of the issuer's securities. [121] The rule, nevertheless, permits a trustee to act as servicer if the primary servicer becomes unable to act as such, but prohibits a trustee from providing any credit enhancement for the securities. [122] A trustee must agree that it will not resign until the financing is liquidated or a successor trustee is appointed. [123] The issuer must take reasonable steps to ensure that the trustee has "a perfected security interest or ownership interest valid against third parties" in the assets of the issuers that "principally" [124] provide the cash flow to make payments of the securities. Under the standard imposed by the rule, a trustee need not therefore have a *first* priority perfected security interest. [125]

The adoption of Rule 3a-7 has facilitated offerings in the U.S. public markets of a variety of ABAs that prior thereto were restricted or effectively prohibited. Among these instruments are nonredeemable securities representing an interest in a pool of debt securities created in a repackaging strategy or securities backed by receivables, loans or other debt instruments that do not qualify for exemption under § 3(c)(5) of the Investment Company Act. Rule 3a-7 has also facilitated U.S. public offerings of structured products consisting of interests in a combination of one or more of such instruments combined with, for example, a currency or interest-rate swap. [126] In recent years, the SEC staff has indicated a growing antipathy to the uses of Rule 3a-7 and has been construing the provisions of the rule increasingly strictly, with the result that novel ABA structures may have difficulty qualifying under the rule.

[4] Rules 3a-1 and 3a-3

Rule 3a-1 under the Investment Company Act somewhat limits the impact of § 3(a)(1)(C) of the Investment Company Act in the case of certain inadvertent investment companies having more than 40% of their assets invested in investment securities.

Under Rule 3a-1, an issuer will not be considered an investment company if (i) no more than 45% of the value of such issuer's total assets (exclusive of U.S. government securities, cash items, securities of majority owned subsidiaries and securities of companies "controlled primarily" by the issuer and through which it engages in non-investment company businesses) [127] consists of, and (ii) no more than 45% of such issuer's net income after taxes for the last four

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fiscal quarters is derived from, investment securities. Rule 3a-1 requires that "wholly-owned subsidiaries," subsidiaries in which the issuer owns 95% or more of the voting securities, be consolidated for purposes of its asset and income tests.

Regarding the exclusion of securities issued by companies "controlled primarily" by the issuer, as described above, while the Investment Company Act provides a definition of "control," [128] which is presumed to exist when a person owns more than 25% of the voting securities of an issuer, neither the Act nor the rules thereunder define the term "controlled primarily." In proposing Rule 3a-1, the SEC stated that the "controlled primarily" standard was designed to limit the effect of subsection (a)(4)(i) of the rule to those companies that are controlled to the same extent as a majority-owned subsidiary is controlled. [129] Where an entity owns 25% to 50% of a company's shares, but there is another potential control block, the facts and circumstances of the relationship of the parties must be considered. [130]

The excluded securities must also be issued by a company "through which" the issuer engages in a business other than that of an investment company. [131] This requires that the issuer exercise active control over the company in question. [132] In the absence of facts evidencing close involvement with the company, an issuer may have difficulty demonstrating that it is acting "through" the company.

The final element of Rule 3a-1 requires that the issuer not be a "special situation investment company." [133] A special situation investment company is a company that secures control of other companies primarily for the purpose of making a profit in the sale of their securities, as opposed to a holding company that secures control of other companies primarily for the purpose of engaging in those companies' lines of business. [134]

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Rule 3a-3 under the Investment Company Act builds on Rule 3a-1 by exempting from the registration requirements of the Act any issuer all of whose securities (other than short-term paper and certain other limited classes of securities) are owned, directly or indirectly, by a company that meets the asset and income tests of

Rule 3a-1 and that either is not an investment company as defined in § 3(a) [135] or is excluded from the definition by specified provisions. A principal benefit of Rule 3a-3 for foreign companies has been to provide an exemption for finance companies that are wholly owned by their parent, have no long-term debt to third parties and issue only short-term instruments (*e.g.*, commercial paper) without requiring such issuers to meet all of the additional conditions of Rule 3a-5 under the Investment Company Act. [136]

[5] Transient Investment Companies—Rule 3a-2

Companies that would otherwise come within the definition of investment company under § 3(a)(1) of the Investment Company Act may be able to avoid being subject to the Act for up to one year under Rule 3a-2. [137] Rule 3a-2, which codifies a line of no-action letters issued by the staff, requires such a company to have a *bona fide* intent to be engaged primarily in a business other than investing, reinvesting, owning, holding or trading of securities as soon as reasonably possible, and at most within a year. [138] A company seeking to rely on Rule 3a-2 must evidence such intent by both its business activities and an appropriate resolution of the company's board of directors. [139] This rule can be particularly useful in certain situations, such as for a start-up company with substantial assets temporarily in investment securities pending the purchase of operating assets or the consummation of planned acquisitions, [140] or alternatively, for a company that

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holds a valuable minority interest in another enterprise acquired, for example, as part of a planned, but ultimately abandoned, acquisition.

Rule 3a-2 may not be used by a company that holds itself out as being in the business of investing or trading securities. [141] Also, a company may not rely on Rule 3a-2 more than once in any three-year period. [142]

[6] Research and Development Companies—Rule 3a-8

Certain research and development companies that would otherwise come within the definition of investment company under § 3(a) are, as a result of the adoption by the SEC of Rule 3a-8, exempt from the Act. [143] Research and development companies tend to come within the definition of investment company for two reasons: first, they seldom have substantial tangible assets and often raise large amounts of capital, invest the proceeds and use the return on those investments to fund their operations; and second, as part of a strategic alliance to conduct research and develop products, they may purchase a noncontrolling equity stake in another company. [144]

To qualify for the safe harbor provided by Rule 3a-8, a research and development company must satisfy four principal [145] criteria: first, a company's

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research and development expenses, for its last four fiscal quarters combined, must constitute a "substantial percentage" of its total expenses over the same period; second, a company's net income derived from investments in securities, for its last four quarters combined, may not exceed twice the amount of its research and development expenses for the same period; third, a company may devote no more than five percent of its total expenses for its last four fiscal quarters combined to investment advisory, management and related activities; and fourth, with two exceptions, a company's investments in securities must constitute "capital preservation investments." [146]

[7] SEC Exemptive Power

[a] Section 6(c)

The detailed regulatory provisions of the Investment Company Act are coupled in many cases with a grant of exemptive power to the SEC. [147] In addition, § 6(c) of the Investment Company Act [148] grants the SEC, subject to satisfaction of the statutory standard, broad exemptive authority with respect to any or all of the provisions of the Investment Company Act. In order for relief to be

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granted under § 6(c), an applicant bears the burden of showing that the relief requested is "necessary or appropriate in the public interest" *and* "consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the Investment Company Act. [149] The SEC's authority under § 6(c) is permissive rather than mandatory: the SEC "may" grant an exemption upon a finding satisfying the statutory standard. Nevertheless, if the required finding is made, the SEC's power under § 6(c) appears to be very broad. [150] The inclusion of § 6(c) was the result of the recognition by the drafters of the Investment Company Act that its provisions could prove too specific to accommodate innovation in the investment fund industry. [151] The SEC thus has the express authority to exempt persons, transactions and securities from the operation of any provision of the Investment Company Act or any rule or regulation thereunder, as well as to grant relief on an unconditional basis or subject to whatever conditions it

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deems appropriate to ensure compliance with the terms of the relief, to protect investors or otherwise to implement the intent of the Investment Company Act in the circumstances of the relief granted.

Foreign companies have used the § 6(c) exemptive process both to gain relief with respect to specific provisions of the Investment Company Act and to obtain exemption from the entire Investment Company Act. [152] As an example of the former, in the few cases in which foreign funds have been permitted to register under § 7(d) of the Investment Company Act for purposes of making a public offering in the United States, an SEC order under § 6(c) has sometimes been necessary to address differences between the Investment Company Act and foreign regulations. As an example of the latter, a very large number of foreign banks obtained exemptions from the Investment Company Act under § 6(c) to issue debt securities in the United States prior to the adoption of the predecessor to Rule 3a-6 discussed in § 15.05[2].

Both U.S. and foreign companies have also received § 6(c) exemptive orders in situations where foreign laws or other considerations prevent the companies from acquiring majority interests or control over foreign ventures, thereby increasing the risk that these interests would qualify as "investment securities" under the Investment Company Act and that the companies would be classified as investment companies. [153] In order to obtain the exemptive relief, however, a company must take an active role in the development of the foreign ventures, and not merely be a passive investor. [154]

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The application for exemptive relief must describe the relief sought, as well as an "adequate basis" for requesting the relief. [155] The SEC also encourages applicants to provide detail with respect to SEC precedents that may be relevant to a determination of an exemptive request. After receiving an application, [156] the SEC will publish in the *Federal Register* for public comment a notice of the application containing the names of the parties involved and a brief description of the proposed transaction or circumstances prompting the application, the basis for relief and the key representations and undertakings contained in the application. In response to the notice, interested parties may submit comments to the SEC concerning the application or may request a public hearing to present their views.

According to internal guidelines of the SEC's Division of Investment Management, the division responsible for administration of the Investment Company Act, the SEC aims to provide initial comments on an exemptive application within 45 days of receipt (although the guidelines clarify that complex or novel issues may require a longer period of review), and notices of routine requests are to be published for comment within 60 days of receipt of the application. In recent years, however, the staff has often had difficulty in adhering to these guidelines and has evidenced a general reluctance to exercise its exemptive authority, with the result that requests for exemptive orders have remained pending for extended periods. In the case of requests raising new issues, one or more rounds of staff comments requiring the preparation and filing of a revised formal application are common and add significantly to the time required to obtain relief. Publication of the notice occurs generally only after the SEC is satisfied with the application, and the notice period generally extends for 25 to 28 days. [157] The guidelines also require that SEC orders granting exemptive requests be published within two business days after the expiration of the notice period, if no hearing request is filed. In general, because all issues have been settled with the staff between the first filing of the request for exemption and publication of notice, this last very short deadline is not only difficult for the SEC to meet, but

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also is not particularly relevant in a consideration of the overall length of the process.

The § 6(c) process has significant shortcomings. First, because the relief is exemptive, each applicant seeking an exemption, even if it is identical to one already granted, must proceed separately. As a result, although the SEC often processes applications for repeat relief expeditiously, a minimum of four to six weeks is likely to be necessary. Second, for other exemptive requests in which something more is sought than relief identical to that previously granted to another applicant, the time and expense involved can increase significantly. Conducted as described above, with publication of the application and opportunity for interested parties to object to the requested relief through a hearing process, obtaining an exemption can, under the best of circumstances, take a number of months and applications containing novel elements have sometimes remained pending for several years. The exemptive process under § 6(c) may also create a disincentive to pioneer new investment products because, although the first application for relief may require significant time and expense, subsequent applications by others requesting identical relief are processed more quickly and involve considerably less expense for the applicants. Commenters responding to the Concept Release urged that the SEC take action to reduce the time and expense associated with exemptive relief under § 6(c). At least one commenter suggested that the SEC make broader use of its ability to exempt classes of securities or transactions under § 6(c) under the Investment Company Act. [158]

The SEC acknowledged the inefficiency of the current exemptive process in the 1992 Report and proposed amendments to Rule 0-5 under the Investment Company Act to permit the staff to address on an expedited basis exemptive applications for which there is precedent and amendments to Rule 30-5 of the SEC's Rules of Practice that would increase the number of provisions of the Investment Company Act as to which the Division of Investment Management would be authorized by the SEC to take action pursuant to delegated authority. [159] The SEC adopted the changes to Rule 30-5 of its Rules of Practice in 1995, [160] but it has not taken action on the proposed changes to Rule 0-5 under the Investment Company Act. [161]

[b] Section 3(b)(2)

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During the height of the "Internet boom" in 1999 and 2000, a number of "Internet incubator" and other "new economy" companies availed themselves of the staff's exemptive power under § 3(b)(2) of the Investment Company Act, [162] which excepts from the definition of "investment company" those companies that the SEC declares to be "primarily engaged" in a business other than investing, reinvesting, owning or holding securities. Some of these companies had significant, but not "controlling," interests [163] in other Internet-related companies, and when the market value of these holdings increased very rapidly, the companies were unable to avoid tripping the 40% test in the definition of investment company under § 3(a)(1)(C) of the Act. For example, both Yahoo! Inc. and Bill Gross's idealab! had "strategic holdings" that were considered "investment securities" under § 3(a)(1)(C) of the Investment Company Act. Both of these companies were, however, successful in obtaining exemptive relief under § 3(b)(2) of the Investment Company Act. [164] More recently, a company that was a member of a joint venture outside the technology sector was able to obtain exemptive relief where, despite owning 50% of the outstanding voting securities, it was only entitled to elect a minority of the board of directors but retained significant veto rights over board and shareholder actions by virtue of supermajority voting requirements and active participation in the management and affairs of the joint venture company. [165]

In considering applications for exemptive relief under § 3(b)(2), the SEC has stated that it considers:

- the company's historical development;
- the company's public representations of policy;
- the activities of the company's officers and directors;
- the nature of the company's present assets; and
- the source of the company's present income.

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The determination of whether a company has qualified for exemption is based on all of the relevant facts and circumstances. [166] Like other exemptive relief under the Investment Company Act, obtaining relief under § 3(b)(2) can be expensive and time consuming. But for companies like Yahoo! or Bill Gross's idealab!, which are dependent on access to U.S. capital markets, there may be no alternative.

Certain foreign companies have used similar Internet-related business models and have faced similar issues under the Investment Company Act. But the very substantial time and cost required to obtain such exemptive relief have usually dissuaded potential foreign issuers from doing so.

Footnotes

58 Rule 3a-5(b) under the Investment Company Act defines "finance subsidiary" as any corporation:

> (i) All of whose securities other than debt securities or non-voting preferred stock meeting the applicable requirements of paragraphs (a)(1) through (a)(3) [relating to the parent company's guarantee of such securities] or directors' qualifying shares are owned by its parent company or a company controlled by its parent company; and
>
> (ii) The primary purpose of which is to finance the business operations of its parent company or companies controlled by its parent company.

Although the rule defines "finance subsidiary" as a "corporation" that satisfies the conditions in clauses (i) and (ii), the SEC staff has taken the position that finance subsidiaries organized as partnerships issuing nonvoting preferred partner interests, *Andrews & Kurth* (avail. Apr. 5, 1994), as limited liability companies issuing nonvoting preferred member interests, *Lehman Brothers Inc.* (avail. Mar. 8, 1994); *Merrill Lynch & Co.* (avail. Mar. 2, 1994), or as business trusts issuing preferred securities, *Lehman Brothers Inc.* (avail. May 26, 1995), debt securities or other securities representing nonvoting preferred beneficial interests, *Merrill Lynch & Co.* (avail. May 25, 1995), or nonvoting preferred trust certificates, *Goldman, Sachs & Co.* (avail. Apr. 27, 1995), may rely on the exemption for finance subsidiaries so long as the subsidiaries and the related transactions comply fully with the remaining requirements of the rule.

59 "[P]arent company" is defined in Rule 3a-5(b)(2) under the Investment Company Act as any corporation, partnership or joint venture:

> (i) That is not considered an investment company under section 3(a) or that is excepted or exempted by order from the definition of investment company by section 3(b) or by

> the rules or regulations under section 3(a);
>
> (ii) That is organized or formed under the laws of the United States or of a state or that is a foreign private issuer, or that is a foreign bank or foreign insurance company as those terms are used in [R]ule 3a-6 [under the Investment Company Act]; and
>
> (iii) In the case of a partnership or joint venture, each partner or participant in the joint venture meets the requirements of paragraphs (b)(2)(i) and (ii).

60 "[C]ompany controlled by the parent company" is defined in Rule 3a-5(b)(3) under the Investment Company Act as any corporation, partnership or joint venture:

> (i) That is not considered an investment company under section 3(a) or that is excepted or exempted by order from the definition of investment company by section 3(b) or by the rules or regulations under section 3(a);
>
> (ii) That is either organized or formed under the laws of the United States or of a state or that is a foreign private issuer, or that is a foreign bank or foreign insurance company as those terms are used in [R]ule 3a-6 [under the Investment Company Act]; and
>
> (iii) In the case of a corporation, more than 25 percent of whose outstanding voting securities are beneficially owned directly or indirectly by the parent company; or
>
> (iv) In the case of a partnership or joint venture, each partner or participant in the joint venture meets the requirements of paragraphs (b)(3)(i) and (ii), and the parent company has the power to exercise a controlling influence over the management or policies of the partnership or joint venture.

"[F]oreign private issuer" is in turn defined as "any issuer which is incorporated or organized under the laws of a foreign country, but not a foreign government or political subdivision of a foreign government." Rule 3a-5(b)(4) under the Investment Company Act. The definitions of "foreign bank" and "foreign insurance company" are discussed *infra* at Notes 81–82 and accompanying text.

61 *See Brown & Wood* (avail. Feb. 24, 2000).

62 In no-action correspondence relating to Rule 6c-9 under the Investment Company Act, now rescinded but which provided a similar exemption for foreign banks, the SEC staff concluded that cash-settled stock index warrants constitute debt for purposes of the rule where the warrants in question (warrants on certain broad-based indices, such as the S&P 500 Index and the Nikkei Index) represented direct obligations of the issuer to pay the cash value of warrants on their exercise date and would rank *pari passu* with all present and future unsecured senior debt of the issuer. The staff also noted that the warrants were expected to receive investment grade debt ratings from one or more nationally recognized national statistical rating organizations and that the warrants would not entitle their holders to any of the rights normally incident to equity securities, such as voting rights. *Barclays Bank PLC* (avail. Mar. 16, 1991). In that context, the SEC has also taken the position that preferred stock having limited voting rights in extraordinary circumstances, such as in connection with the liquidation of the issuer or a modification of the terms of the preferred stock, would constitute "nonvoting preferred stock." *Barclays Bank PLC* (avail. June 26, 1989).

63 Rule 3a-5 permits the parent guarantee to be subordinated in right of payment to other debt of the parent (Rules 3a-5(a)(1) and 3a-5(a)(2)), although security holders must have the right, pursuant to the terms of the

guarantee, to institute suit directly against the parent without first proceeding against the subsidiary (Rule 3a-5(a)(3)). Although there is no published no-action letter addressing the point, a parent guarantee that ranks *pari passu* with preferred stock of the parent would apparently also constitute a guarantee in compliance with the rule. A "guarantee" of preferred stock need only cover dividends after they are declared. *Cleary, Gottlieb, Steen & Hamilton* (avail. Dec. 23, 1985); *see also Chieftain International Funding Corporation* (avail. Nov. 3, 1992); *In the Matter of Echo Bay Finance Corp.*, SEC Release Nos. IC-18802 (June 22, 1992) (notice of application) and IC-18848 (July 15, 1992) (Order) (exemption from requirement to guarantee liquidation preference with respect to preferred stock).

64 SEC Release No. IC-16093 (Oct. 29, 1987). Certain precedents suggest, however, that the SEC might grant an exemption under § 6(c) of the Investment Company Act in the case of a finance subsidiary that otherwise meets the requirements of Rule 3a-5 but issues securities publicly with the benefit of a parent keepwell rather than a guarantee. 52 Fed. Reg. 42,280, 42,282 (Nov. 4, 1987). The exclusion of keepwell arrangements from Rule 3a-5 has raised particular difficulties for finance subsidiaries of Japanese companies, which for Japanese regulatory reasons much prefer "strong" keepwell arrangements, providing enforceable undertakings that the parent assure that the subsidiary has sufficient resources to meet its obligations and even that the parent's undertakings are directly enforceable by the holders of the subsidiary's securities benefiting from the keepwell, rather than guarantees. These difficulties have been significantly ameliorated by clarification that the guarantee requirement does not apply to either offerings outside the United States under Regulation S under the Securities Act, or to offerings sold in private placements as discussed below.

65 *See infra* Note 81 and accompanying text.

66 SEC Release No. IC-18381 (Oct. 29, 1991).

67 Rule 3a-5(a)(7) under the Investment Company Act. In so amending Rule 3a-5, the SEC was responding to concerns that many banks may not provide guarantees under applicable law. SEC Release No. IC-18381 (Oct. 29, 1991).

68 Rule 3a-5(a)(4) under the Investment Company Act.

69 Rule 3a-5(a)(5) under the Investment Company Act. The SEC has granted an exemptive order under § 6(c) to the effect that a company eligible to receive loans under Rule 3a-5(a)(5) could include a company otherwise meeting the definition of a "company controlled by a parent company" that engages in certain activities, including: (i) providing financing to the parent's subsidiaries through loans and through the purchase of accounts receivable, (ii) investing in temporary investments, (iii) receiving short-term funds on an ongoing basis from the parent's subsidiaries and others, and (iv) participating in a continuous program of short-term lending so long as the company only holds securities that are either permitted under Rule 3a-5(a)(6), have a remaining maturity of no greater than 12 months or consist of accounts receivable from the parent's subsidiaries. The primary purpose of the finance subsidiary must also continue to be the lending of money to the parent company or a company controlled by the parent company in accordance with their business needs. Rule 3a-5(b)(1)(ii) under the Investment Company Act; *In the Matter of IBM International Finance, N.V.*, SEC Release Nos. IC-19548 (June 29, 1993) (notice of application) and IC-19602 (July 28, 1993) (Order). In the exemptive order, the SEC took the position that a back-to-back loan from a finance subsidiary to a parent company or a company controlled by a parent company, where the subsidiary deposits funds with a bank that are in turn loaned to a specified subsidiary of the parent company, although appearing as a bank deposit on the books of the subsidiary, may be included within the 85% minimum investment required by Rule 3a-5(a)(5) and within the investments permitted by Rule 3a-5(a)(6) under the Investment Company Act. *In the Matter of IBM International Finance*, SEC Release No. IC-19602 (July 28, 1993) (Order).

70 The SEC staff has taken the position that an investment in money market mutual fund shares, repurchase agreements with respect to U.S. government securities and demand and time deposits of foreign banks, even if such deposits may not satisfy § 3(a)(3) of the Securities Act, are permitted investments under Rule 3a-5(a)(6) under the Investment Company Act. No percentage limitations apply to such an investment.

Hewlett-Packard Finance Company (avail. July 17, 1996); *see also Hewlett-Packard Finance Company* (avail. Oct. 7, 1992); *In the Matter of IBM International Finance, N.V.*, SEC Release Nos. IC-19548 (June 29, 1993) (notice of application) and IC-19602 (July 28, 1993) (Order).

71 Rule 3a-5(a)(6) under the Investment Company Act.

72 Rules 3a-5(b)(2) and 3a-5(b)(3) under the Investment Company Act.

73 Section 3(c)(3) of the Investment Company Act exempts from the definition of "investment company" U.S. banks, insurance companies and related entities. Rule 3a-6(a), in turn exempts foreign banks and insurance companies. *See* text accompanying *infra* Notes 81–85.

74 In granting an exemptive order under § 6(c), the SEC took the position that the parent company or the controlled company to which the proceeds are loaned may also be a company that qualifies for an exemption from the Investment Company Act pursuant to § 3(c)(5)(A) or § 3(c)(5)(B) solely by reason of its holding accounts receivable of its customers or of other subsidiaries of the parent company or the controlled company, or by reason of loans made by it to those customers or subsidiaries. *In the Matter of IBM International Finance, N.V.*, SEC Release Nos. IC-19548 (June 29, 1993) (notice of application) and IC-19602 (July 28, 1993) (Order).

75 Section 3(c)(6) of the Investment Company Act exempts from the definition of "investment company" companies predominantly engaged in banking activities described in § 3(c)(3), lending activities described in § 3(c)(4) or receivables financing activities described in § 3(c)(5).

76 *In the Matter of MetLife, Inc.*, SEC Release Nos. IC-29101 (Dec. 30, 2009) (notice of application) and IC-29124 (Jan. 26, 2010) (Order).

77 *See* text accompanying *infra* Notes 81–88.

78 *Sony Capital Corp.* (avail. Apr. 27, 1992) (private placement permitting resales under Rule 144A); *PSEG Capital Corp.* (avail. July 13, 1988); *see also General Electric Overseas Capital Corp.* (avail. July 7, 1983). The private placements involved in these letters provided for resales to be conducted solely under Rule 144A or otherwise to certain sophisticated investors—apparently for the life of the securities—leaving open the question whether Rule 3a-5 would continue to be available if the securities were "held by" the U.S. public as a result of resales in accordance with Rule 144 under the Securities Act. The better view, based on the staff's positions in the case of securities offered under Regulation S under the Securities Act (which may trade freely into the U.S. public market after expiration of any applicable distribution compliance period), would seem to be that the exemption would continue to be available. *See also KDSM, Inc., Sinclair Capital* (avail. Mar. 17, 1997).

79 *See* § 7.02[3].

80 *Société Générale* (avail. Feb. 14, 1992); *MEC Finance USA, Inc.* (avail. Oct. 25, 1991).

81 Being "[e]ngaged substantially in commercial banking activity" continues to be defined, as previously provided in Rule 6c-9 under the Investment Company Act, as being

> engaged regularly in, and deriving a substantial portion of its business from, extending commercial and other types of credit, and accepting demand and other types of deposits, that are customary for commercial banks in the country in which the head office of the banking institution is located.

Rule 3a-6(b)(2) under the Investment Company Act. The SEC staff has taken the position that time deposits and interbank deposits can qualify as "deposits and extensions of credit" within the meaning of Rule 3a-6, where U.S. local banking regulations would treat them as such and as customary banking activities. *Safra Republic Holdings, S.A.* (avail. Apr. 21, 1998).

What constitutes a "substantial portion of its business" is open to interpretation, although it clearly means something less than "principal" or "primary." *See Safra Republic Holdings, S.A.* (avail. Apr. 21, 1998). The SEC staff has rejected a proposed "ten percent test" based on a foreign bank's revenues and assets (with respect to credit extensions) and liabilities (with respect to deposits), but has indicated that, to constitute a "substantial portion," the banking activities of a foreign bank must be more than nominal, and that the bank should generally: (i) be authorized to accept demand and other types of deposits and extend commercial and other types of credit, (ii) hold itself out as engaging in, and engage in, each of those activities on a continuous basis, including actively soliciting depositors and borrowers, (iii) engage in both deposit taking and credit extension at a level sufficient to require separate identification of each in publicly disseminated reports and regulatory filings describing the bank's activities, and (iv) engage in either deposit taking or credit extension as one of the bank's principal activities. *See Seward & Kissel* (avail. Oct. 12, 2005).

82 As defined in § 3(a)(8) of the Securities Act, except for the substitution of supervision by foreign government insurance regulators for the regulators referred to in that section.

83 Entities operated for the purpose of avoiding the Investment Company Act cannot rely on Rule 3a-6.

84 SEC Release No. IC-18381 (Oct. 29, 1991).

85 The treatment of banks under the Investment Company Act amply illustrates the Investment Company Act's breadth. Absent the express exemption contained in § 3(c)(3) of the Investment Company Act, banks and insurance companies would be covered by the Act. That exemption is, however, limited by its terms to U.S. banks and insurance companies, with the result that exemption of foreign banks and insurance companies, other than their U.S. branches and agencies subject to U.S. federal or state supervision, *see* SEC Release No. IC-17681 (Aug. 17, 1990), required special SEC action.

86 Rule 489 under the Securities Act. Rule 489 excepts from this requirement Canadian issuers that are filing Form F-X in connection with an offering made under the U.S./Canadian multijurisdictional disclosure system (*see* Chapter 13) and issuers filing a registration statement with respect to debt securities or nonvoting preferred stock and that have a currently accurate Form N-6C9 (the predecessor to Form F-N) on file with the SEC. Rule 489 under the Securities Act. Filings are not required in connection with offerings not required to be registered under the Securities Act (*e.g.*, private placements).

87 *See* § 15.05[1] and [4].

88 *See* § 15.09[1].

89 Rules 3a-6(b)(1)(iii) and 3a-6(b)(3)(iii) under the Investment Company Act. Rule 3a-6 also expressly includes Canadian trust and loan companies and U.K. building societies as foreign banks. Rule 3a-6(b)(1)(ii) under the Investment Company Act. Although other similar institutions would not be covered by Rule 3a-6, they may seek individual exemptive relief under § 6(c) of the Investment Company Act. *See* SEC Release No. IC-18381 (Oct. 29, 1991); § 15.05[7].

90 Many of these offerings have been made under Schedule B under the Securities Act, which applies to obligations of foreign governments. *See* § 3.05[1].

91 *Compagnie de Financement Foncier*, SEC Release Nos. IC-28835 (July 22, 2009) (notice of application) and IC-28848 (Aug. 13, 2009) (Order). *See also Erste Abwicklungsanstalt* (avail. Oct. 10, 2012) (granting no-action relief to a German government backed winding-up agency established for the purpose of taking over and disposing of the assets, liabilities and exposures of a distressed state-owned bank); *Dexia Municipal Agency* (avail. Dec. 26, 2007) (granting no-action relief to a similar nongovernmental credit institution based on an analysis under § 3(c)(5) of the Investment Company Act, discussed at *infra* Note 102 and the accompanying text).

92 *See, e.g.*, *Banque Francaise du Commerce Extérieur* (avail. June 26, 1975).

93 *See, e.g.*, *Korea Finance Corp.*, SEC Release Nos. IC-29332 (June 25, 2010) (notice of application) and IC-29343 (July 20, 2010) (Order); *Banco de Comercio Exterior de Colombia S.A.*, SEC Release Nos. IC-20992 (Apr. 11, 1995) (notice of application) and IC-21044 (May 5, 1995) (Order); *Western Australian Treasury Corp.*, SEC Release Nos. IC-17617 (July 26, 1990) (notice of application) and IC-17673 (Aug. 14, 1990)

(Order); *Nacional Financiera S.A.*, SEC Release Nos. IC-11584 (Jan. 26, 1981) (notice of application) and IC-11642 (Feb. 23, 1981) (Order). The SEC has given some indication that it may be applying a more flexible policy of granting no-action letters to foreign financial institutions carrying out government development and similar policies. *See Municipality Finance Ltd.* (avail. Apr. 28, 1994) (granting no-action relief for a Finnish credit institution that was essentially a government instrumentality making loans to municipalities for the purchase of merchandise and services). The SEC earlier had appeared to be moving towards favoring more cumbersome exemptive relief under § 6(c) of the Investment Company Act. *Compare Development Finance Corporation of New Zealand* (avail. Jan. 27, 1979) *with Australian Industry Development Corp.* (avail. Aug. 11, 1980). The staff in any event will grant no-action relief where it considers it can rely on a specific exemption under the Act or rules. *See* § 15.05[3]; *see also* the discussion of § 3(c)(5) of the Investment Company Act below in § 15.05[3][a].

94 § 3(c)(5) of the Investment Company Act excludes from the definition of "investment company":

> Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

95 *See* § 15.05[3][b] for a discussion of Rule 3a-7 under the Investment Company Act.

96 *See, e.g.*, *Hellenic Republic* (avail. Jan. 10, 1991); *Islamic Republic of Pakistan* (avail. Jan. 18, 1989); *Hashemite Kingdom of Jordan* (avail. Nov. 21, 1988); *Republic of Turkey* (avail. Nov. 3, 1988); *State of Israel* (avail. Aug. 17, 1988); *see also supra* Notes 90–93 and accompanying text for a discussion of exemptions for other foreign government financing vehicles, such as export-import banks and development banks.

97 The SEC has granted no-action relief where the assets purchased under a mortgage-backed ABA consisted of subordinated interests in whole loans, basing its relief in part on the holder's ability to control the process of foreclosing on the underlying loan, which the SEC viewed as making the investment one in the nature of mortgage interests rather than an interest in a person that invests in mortgage interests (*i.e.*, the participation seller). *Capital Trust, Inc*. (avail. Feb. 3, 2009).

98 *E.g., Bear Stearns & Co.* (avail. Oct. 3, 1986); *Salomon Brothers Inc.* (avail. June 17, 1985); *Shearson Lehman American Express Inc.* (avail. Mar. 20, 1985). Other mortgage-backed ABAs organized in the United States have received § 6(c) exemptions when it was not certain that they would be able to meet the 55% whole loan test. In addition to imposing a 55% requirement, the staff has in other no-action letters placed restrictions on the assets comprising the remaining 45% of the relevant asset pool. *See, e.g.*, *Citytrust* (avail. Dec. 19, 1990); SEC Release No. IC-29779 (Aug. 31, 2011).

99 SEC Release No. IC-29779 (Aug. 31, 2011).

100 *See Econo Lodges of America* (avail. Dec. 22, 1989); *Ambassador Capital Corp.* (avail. Oct. 6, 1986).

101 *Royalty Pharma* (avail. Aug. 13, 2010).

102 *Dexia Municipal Agency* (avail. Dec. 26, 2007) (citing *Municipality Finance Ltd.* (avail. Apr. 28, 1994), discussed in *supra* Note 91, and relying in part on the private nature of the U.S. offering and the special nature of covered bonds).

103 With the adoption of Rule 3a-7 under the Investment Company Act, discussed in § 15.05[3][b], the SEC stated that it had determined not to pursue any amendments to § 3(c)(5) of the Investment Company Act. SEC Release No. IC-19105 (Nov. 19, 1992).

104 *See* text at *supra* Note 2.

105 The SEC staff has taken the position that an ABA involving two or more securities that alone are not redeemable, but when combined give holders direct withdrawal rights, may involve the issuance of redeemable securities, depending upon the restrictions on the investor's ability to withdraw portfolio assets. Facts that the SEC staff has indicated are relevant include: (i) whether a holder's withdrawal right is conditional or absolute, (ii) whether the ABA offers the component securities for sale to holders at the same time or at different times, (iii) whether and how often the ABA sponsors activities (such as auctions and mandatory tender offers) designed to facilitate a holder's ability to acquire the component security or securities and present them for withdrawal, (iv) whether the amount of portfolio securities that a holder may withdraw from the ABA at any time is limited or unlimited, (v) how often a holder may withdraw portfolio securities from the program, (vi) whether or not there is a required "holding period" prior to withdrawal, (vii) the denomination of the securities and the minimum amount needed to withdraw portfolio securities, and (viii) how the withdrawal right is presented to investors. *Brown & Wood* (avail. Feb. 24, 1994).

106 SEC Release No. IC-19105 (Nov. 19, 1992) (the "*Adopting Release*"). Rule 3a-7(a) also allows an issuer to engage in "activities related or incidental" to the pooling of receivables. The SEC has stated that holding assets (which are not "eligible assets," see text accompanying *infra* Note 107), such as money market shares, in a pre-funded account could be viewed as a related activity or incidental activity if this activity supports and is secondary to the issuer's business of pooling receivables. The relevant factors to be considered in reaching a determination on this point include the length of the pre-funding period, the maturity date of the asset-backed securities issued by the issuer and the cash amount deposited in the pre-funded account compared with the total offering proceeds. *See Federated Investors, Inc.* (avail. July 8, 1997).

107 Rule 3a-7(b)(1) under the Investment Company Act. Presumably, assets in default at the time of pledge would also qualify since their probable cash flows can be statistically analyzed, fixed-income securities can be rated based on those cash flows and, by their terms, the assets would convert into cash as required by the rule. The SEC staff has, however, taken the position that cumulative preferred stock that has no predetermined liquidation date is not an eligible asset within the meaning of the rule; the characteristics of a security, and not its label, will be determinative. *Brown & Wood* (avail. Feb. 24, 1994). Unsecuritized commitment fees would also not constitute "eligible assets." *Citicorp Securities, Inc.* (avail. Aug. 4, 1995).

108 *Brown & Wood* (avail. Feb. 24, 1994).

109 "Fixed income securities" are defined in Rule 3a-7(b)(2) under the Investment Company Act as any securities that entitle the holder to receive:

> (i) A stated principal amount; or
>
> (ii) Interest on a principal amount (which may be a notional principal amount) calculated by reference to a fixed rate or to a standard or formula which does not reference any change in the market value or fair value of eligible assets; or
>
> (iii) Interest on a principal amount (which may be a notional principal amount) calculated by reference to auctions among holders and prospective holders, or through remarketing of the security; or
>
> (iv) An amount equal to specified fixed or variable portions of the interest received on the assets held by the issuer; or
>
> (v) Any combination of amounts described [above];

provided, that substantially all of the payments to which the holders of such securities are entitled consist of the foregoing amounts.

110 Rule 3a-7(a)(1) under the Investment Company Act.

111 Allotment securities, when first sold by the underwriter to the public, would also have to meet the rating condition. Issuers that are concerned about the availability of the exemption upon a downgrade in these circumstances could require the underwriters to sell any securities that do not meet the rating condition only in private placements to sophisticated investors. Adopting Release, 57 Fed. Reg. 56,248, 56,252 n.48 (Nov. 27, 1992).

112 SEC Release No. IC-29592 (Mar. 3, 2011), 76 Fed. Reg. 12,896, 12,897 n.11 (Mar. 9, 2011).

113 SEC Release No. IC-29779 (Aug. 31, 2011). The release notes that the purpose of these requirements was not principally to assess creditworthiness but rather the issuer's investor protection measures under the assumption that rating agencies, when providing a rating assessing the credit risk of an asset-backed issuer, evaluated whether the issuer was structured in a manner that also addressed investor protection under the Investment Company Act.

114 *See* § 7.02[3][a]. Rule 3a-7 permits an issuer to issue only noninvestment grade securities, provided that the securities are issued solely to institutional accredited investors and to qualified institutional buyers. *See Citicorp Securities, Inc.* (avail. Aug. 4, 1995).

115 In late 2006, a registration statement was filed for a public offering of securities by an issuer a significant portion of the assets of which consisted (directly or through a subsidiary holding company) of equity interests in so-called "CDOs" that were themselves relying on Rule 3a-7. *See* Highland Financial Trust, Registration Statement No. 333-138334 (Oct. 31, 2006). The question was raised in the course of the SEC staff review of this registration statement whether the sale of the issuer's equity interests to persons who are not "qualified institutional buyers" would violate § 48(a) of the Investment Company Act, which provides that it is unlawful for any person, directly or indirectly, to cause anything to be done through another person that would be unlawful for the first person to do under the Investment Company Act or any rules thereunder, such as Rule 3a-7. The registration statement was subsequently withdrawn by the issuer, which indicated in the withdrawal letter that it might undertake a subsequent private offering in reliance on Rule 155(c) under the Securities Act.

116 Adopting Release, 57 Fed. Reg. 56,248, 56,253 n.54 (Nov. 27, 1992).

117 Rule 3a-7(a)(2) under the Investment Company Act.

118 *Compare* the position under § 3(c)(1) of the Investment Company Act as set forth in *Investment Funds Institute of Canada* (avail. Mar. 4, 1996) *with* the position under § 3(c)(7) under the Investment Company Act as set forth in *Goodwin, Proctor & Hoar* (avail. Feb. 28, 1997), as discussed in § 15.06.

119 Rule 3a-7(a)(3) under the Investment Company Act.

120 Rule 3a-7(a)(4) under the Investment Company Act. The SEC staff has taken the position that the term "trustee" does not include a custodian bank. *Brown & Wood* (avail. Feb. 24, 1994). *But see Global Exempt Certificates of Ownership in NHA MBS Securities Inc.* (avail. Dec. 30, 1994) (confirming that a trustee whose responsibilities are limited to holding legal title to the securities, receiving payments thereon and protecting and enforcing its legal title and the rights of certificate holders against adverse claims or actions meets the requirements of Rule 3a-7).

121 *In the Matter of Citibank N.A.*, SEC Release Nos. IC-28717 (Apr. 29, 2009) (notice of application) and IC-28746 (May 26, 2009) (Order) (granting relief under § 6(c) of the Investment Company Act where, among other things, the underwriter affiliate will not be involved in the operation of the issuer (though it may participate in the selection of assets to be pooled) or provide credit support).

122 Adopting Release, 57 Fed. Reg. 56,248, 56,254 (Nov. 27, 1992).

123 Rule 3a-7(a)(4) under the Investment Company Act.

124 Adopting Release, 57 Fed. Reg. 56,248, 56,255 (Nov. 27, 1992).

125 Adopting Release, 57 Fed. Reg. 56,248, 56,255 (Nov. 27, 1992).

126 In adopting new and amended rules to address the registration, disclosure and reporting requirements for asset-backed securities under the Securities Act and the Exchange Act, the SEC has requested further comment on the treatment of synthetic securitizations under Rule 3a-7. SEC Release No. 33-8518 (Dec. 22, 2004). Synthetic securitizations are designed to create exposure to an asset that is not transferred to or otherwise part of the asset pool from which payments on the asset-backed securities are meant to be made. This exposure is often created through the use of derivatives such as credit default or total return swaps. One question that can arise under these securitizations is whether the right to receive payments on the securities depends "primarily" on the cash flow from eligible assets included in the pool. *See* text accompanying *supra* Note 109.

127 The term "cash items," which are excluded from the valuation of an issuer's total assets under subsection (a) of the rule, is not defined by the Investment Company Act but is generally narrowly construed. However, the SEC has stated that shares of registered money market funds subject to Rule 2a-7 are the equivalent of cash items for purposes of Rule 3a-1. *Willkie Farr & Gallagher* (avail. Oct. 23, 2000).

128 "Control" as defined in § 2(a)(9) of the Investment Company Act means "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Section 2(a)(9) further states that "[a]ny person who owns beneficially, either directly or through one or more controlled companies, more than 25 per centum of the voting securities of a company shall be presumed to control such company." Although this presumption may be rebutted, it remains effective "until a determination to the contrary [is] made by the [SEC]."

129 *See* SEC Release No. IC-10937 (Nov. 13, 1979).

130 Where, for example, management of the company must be jointly exercised by both owners of control blocks, the company would not be "controlled primarily" by either such owner. *See* SEC Release No. IC-10937 (Nov. 13, 1979).

131 Rule 3a-1(a)(4)(ii) under the Investment Company Act.

132 *See* SEC Release No. IC-10937 (Nov. 13, 1979).

133 Rule 3a-1(b) under the Investment Company Act.

134 SEC Release No. IC-10937 (Nov. 13, 1979).

135 *See* § 15.02.

136 *See* § 15.05[1].

137 Rule 3a-2 under the Investment Company Act.

138 Rule 3a-2 under the Investment Company Act. Note, however, that the SEC has granted an exemptive order under § 6(c) to a company that was unable to reduce its holdings of investment securities within a year of becoming a "transient investment company" to effectively extend the one-year period for two additional years. *In the Matter of Cohesion Technologies, Inc.*, SEC Release Nos. IC-24425 (Apr. 27, 2000) (notice of application) and IC-24462 (May 23, 2000) (Order); *see also Price Communications Corp.*, SEC Release Nos. IC-25533 (Apr. 23, 2002) (note of application) and IC-25579 (May 22, 2002) (Order under § 6(c) exempting a cellular telephone company that, as part of the contemplated liquidation of its business, had contributed its business to a limited partnership in return for a 45% interest in the partnership along with certain significant management and other rights with respect to the partnership, from all provisions of the Investment Company Act for up to four years).

139 Rules 3a-2(a)(1) and 3a-2(a)(2) under the Investment Company Act.

140 In recent years, there has been a proliferation of securities offerings by "blank check companies" or "SPACs" that have no operations and no specific business plan other than to engage in a merger with or acquisition of a company or companies yet to be identified. Rule 419 under the Securities Act requires that

the proceeds from such offerings, if they involve the issuance of "penny stock" (as defined in Rule 3a51-1 under the Exchange Act), be deposited in an escrow account, invested in bank deposits, money market funds or U.S. government securities, and returned to the investors if they have not been released from escrow and used for an acquisition within 18 months after the offering. The adopting release noted that, although the escrow account established pursuant to Rule 419 may be an investment company under the Investment Company Act, in light of the purposes served by the regulatory requirement to establish such an account, the limited duration of the account and the limited nature of the investments, such an account will neither be required to register as an investment company nor regulated as an investment company as long as it meets the requirements of Rule 419. SEC Release No. IC-18651 (Apr. 13, 1992), 57 Fed. Reg. 18,037, 18,040 (Apr. 28, 1992).

Rule 419 does not apply to many of the so-called "SPAC" offerings that have been done because they do not involve the issuance of penny stock. The trust account arrangements that are customarily employed in these SPAC offerings, however, have a similarly limited purpose and duration (though they frequently last up to 30, rather than 18, months) and provide for the similarly limited investments permitted by Rule 419, and are therefore not considered to create investment companies.

141 SEC Release No. IC-10943 (Nov. 16, 1979). In a subsequent release, the SEC clarified that an issuer's intent to satisfy the requirements of Rule 3a-1(a) would not necessarily satisfy Rule 3a-2's required intent to be involved primarily in a business other than being an investment company. SEC Release No. IC-11552 (Jan. 14, 1981).

142 Rule 3a-2(c) under the Investment Company Act.

143 Rule 3a-8 under the Investment Company Act.

144 *See* SEC Release No. IC-26077 (June 16, 2003) (adopting Rule 3a-8 under the Investment Company Act).

145 In addition to the four principal criteria, a company may not hold itself out as being engaged, or be primarily engaged, in the business of investing, reinvesting or trading in securities.

146 "Capital preservation investment" is defined by Rule 3a-8 to mean "an investment that is made to conserve capital and liquidity until the funds are used in the issuer's primary business or businesses." Rule 3a-8(b)(4) under the Investment Company Act. The rule requires that a company's board of directors adopt a written investment policy with respect to its capital preservation investments. Rule 3a-8(a)(7) under the Investment Company Act. In a recent no-action letter, the SEC staff clarified that what constitutes a capital preservation investment, including the appropriate tenor of the investment, will depend on the particular facts and circumstances of the relevant research and development company's business and the terms of the investment. *Ark Therapeutics Group plc* (avail. Apr. 15, 2005). In appropriate circumstances, capital preservation investments can include securities that are not denominated in U.S. dollars or that are non-U.S. securities. *Ark Therapeutics Group plc* (avail. Apr. 15, 2005).

Rule 3a-8 permits a company relying on the rule to acquire investments that are not capital preservation investments if (i) no more than ten percent of the company's total assets consists of such investments or (ii) no more than 25% of the company's total assets consists of such investments so long as at least 75% of those investments were made pursuant to collaborative research and development arrangements. *See* Rule 3a-8(a)(4) under the Investment Company Act.

147 *See* §§ 2(a)(9), 3(b)(2), 6(b), 6(d), 8(f), 10(e), 10(f), 16(a), 17(b), 17(f), 18(i), 22(e)(3), 23(b) and 23(c)(3) of the Investment Company Act.

148 Section 6(c) of the Investment Company Act provides that

> [t]he [SEC], by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of [the Investment Company Act] or of any rule or regulation thereunder, if and to the extent that

> such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Investment Company Act].

149 Some variation exists among the statutory standards for granting exemptive relief under the many provisions of the Investment Company Act that authorize such relief. Exemptive relief under § 6(b) of the Investment Company Act is, for example, conditioned solely on a finding by the SEC that relief is consistent with the protection of investors.

Exemptive orders under § 6(c) suggest some degree of uniformity in the SEC's treatment of asserted bases for satisfying the statutory standard. For example, the SEC has considered the sophistication of investors in a proposed fund, the existence and adequacy of alternative regulation and the terms of the securities themselves (*e.g.*, whether the securities provide for restrictions on transfer) to be relevant to a determination as to whether the exemption is appropriate in light of the § 6(c) standard. *See, e.g.*, *Condren Housing Partners*, SEC Release Nos. IC-6807 (Nov. 3, 1971) (notice of application) and IC-6851 (Nov. 29, 1971) (Order); *National Corp. for Housing Partnership*, SEC Release Nos. IC-5945 (Dec. 29, 1969) (notice of application) and IC-5955 (Jan. 13, 1970) (Order); *BP No. Am. Fin. Corp.*, SEC Release Nos. IC-4332 (Aug. 20, 1965) (notice of application) and IC-4350 (Sept. 9, 1965) (Order). To demonstrate consistency with the policies "fairly intended" by the Investment Company Act, an applicant must show that the abuses addressed by the Act would not arise if the exemption were granted and that the purposes of the provision from which relief is sought will be preserved. That a particular scheme existed at the time of the adoption of the Investment Company Act will often be fatal to an application under § 6(c), although the proposed creation of a novel pooled investment vehicle or unforeseen circumstances is generally in and of itself not a sufficient basis on which to grant relief. *See* Tamar Frankel, Arthur B. Laby & Ann T. Schwing, THE REGULATION OF MONEY MANAGERS MUTUAL FUNDS AND ADVISERS (3d ed. 2015).

150 There was some concern expressed at the time of the Concept Release that the SEC may have concluded, contrary to both the language of the statute and its legislative history, that there may be limits on its exemptive authority under § 6(c) of the Investment Company Act. In particular, there was concern that the SEC had reached this conclusion with respect to provisions of the Investment Company Act that contain specific numerical or other limitations or that are introduced by a clear prohibition, such as "it shall be unlawful.…" *See* Letter from Merrill Lynch & Co., Inc. to Jonathan G. Katz, Secretary, SEC (Oct. 18, 1990).

151 In hearings before the U.S. House of Representatives, the then-Chief Counsel for the Commission Trust Study stated that § 6(c) was included to alleviate "the difficulty of making provision for regulating any industry which has so many variants and so many different types of activities." Hearings on S. 3580 Before a Subcommittee of the Committee on Banking and Currency, 76th Cong., 3d Sess. 197 (1940).

152 *See, e.g., Worldwide Fund Ltd.*, SEC Release Nos. IC-3318 (Aug. 25, 1961) (notice of application) and IC-3327 (Sept. 18, 1961) (Order).

153 These companies are often in danger of qualifying as investment companies under § 3(a)(1)(C) of the Investment Company Act because 40% or more of their total assets might be deemed to be "investment securities" due to the minority interests that they hold in foreign operating companies, either because of local laws that restrict foreign ownership in the local enterprises or because of stakes held by other strategic partners in the operating companies. *See* text accompanying *supra* Notes 33–37. Legislative history related to the passage of the NSMIA indicates that Congress intended the SEC to exempt U.S. companies from regulation as investment companies where those companies engaged in foreign infrastructure projects in jurisdictions that limited their ability to acquire a majority interest in the projects. *See* H.R. Rep. No. 104-622, at 19 (1996) (stating expectation that the SEC would "take administrative action expeditiously … to exempt from regulations as investment companies U.S. companies that own substantial interests in foreign infrastructure companies and that are … actively involved in foreign infrastructure projects").

154 Many of these orders have been requested by companies seeking to make investments in foreign telecommunications ventures. *See, e.g.*, *Propel, Inc.*, SEC Release Nos. IC-24633 (Sept. 6, 2000) (notice of application) and IC-24673 (Oct. 3, 2000) (Order). In the *Propel* order, for example, the company sought, and obtained, an exemption under § 6(c) that permitted it, among other things, to make investments in foreign telecommunications companies, provided that the company (directly or indirectly) acquired at least a 10% economic or voting interest in each foreign telecommunications company and provided active developmental assistance to each such company. *Propel, Inc.*, SEC Release No. IC-24633 (Sept. 6, 2000) (notice of application); *see also Telesystem International Wireless Inc.*, SEC Release Nos. IC-23618 (Dec. 22, 1998) (notice of application) and IC-23658 (Jan. 20, 1999) (Order); *Formus Communications, Inc.*, SEC Release Nos. IC-23486 (Oct. 14, 1998) (notice of application) and IC-23530 (Nov. 10, 1998) (Order); *Tele-Communications International*, SEC Release Nos. IC-22797 (Aug. 22, 1997) (notice of application) and IC-22825 (Sept. 17, 1997) (Order); *Enron Corp.*, SEC Release Nos. IC-22515 (Feb. 14, 1997) (notice of application) and IC-22560 (Mar. 13, 1997) (Order).

155 SEC Release No. IC-14492 (Apr. 30, 1985).

156 Since 2008, the SEC has required that applications for orders under the Investment Company Act, including exemptive orders, be submitted *via* EDGAR. *See* SEC Release No. 33-8981 (Oct. 29, 2008).

157 1992 Report at 509 n.28.

158 *See, e.g.*, Letter from Davis, Polk & Wardwell (Oct. 10, 1990).

159 SEC Release No. IC-19362 (Mar. 26, 1993).

160 SEC Release No. 34-35483 (Mar. 14, 1995); *see also* SEC Release No. 34-35483A (Mar. 21, 1995) (correcting final rule).

161 The SEC removed consideration of the reforms to Rule 0-5 from its regulatory agenda in 1996, but stated that it may consider the reforms at some future point. SEC Release No. IC-21795 (Mar. 4, 1996).

162 *See, e.g.*, *Yahoo! Inc.*, SEC Release Nos. IC-24459 (May 18, 2000) (notice of application) and IC-24494 (June 13, 2000) (Order); *Bill Gross' idealab!*, SEC Release Nos. IC-24642 (Sept. 15, 2000) (notice of application) and IC-24682 (Oct. 10, 2000) (Order).

163 *See* § 2(a)(9) of the Investment Company Act.

164 *Yahoo! Inc.*, SEC Release No. IC-24494 (June 13, 2000); *Bill Gross' idealab!*, SEC Release No. IC-24682 (Oct. 10, 2000). Note, however, that an application by Yahoo! several years earlier had not been successful. In addition, the SEC staff has indicated informally that it would no longer be receptive to applications for exemptions by such companies.

165 *See SeaCo Ltd.*, SEC Release Nos. IC-29176 (Mar. 17, 2010) (notice of application) and IC-29206 (Apr. 9, 2010) (Order).

166 *See Tonopah Mining Company of Nevada*, 256 SEC 426, 427 (1947). In a potentially significant ruling, the court in *SEC v. National Presto Industries*, 486 F.3d 305 (7th Cir. 2007), applied the *Tonopah* facts to conclude that, even though it had not sought an exemptive order under § 3(b)(2) as suggested by the SEC, an issuer that was actively engaged in an operating business could rely on the exemption under § 3(b)(1) of the Investment Company Act for companies that are "primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities," notwithstanding the fact that more than 40% of its assets comprised investment securities so that it would otherwise be considered an inadvertent investment company under § 3(a)(1)(C) of the Investment Company Act. *See* § 15.02. Law firms have generally been hesitant about providing opinions relying on § 3(b)(1) because of its heavily factual and arguably subjective nature, and because of the SEC's strong emphasis on the asset test as being essentially dispositive absent another specifically applicable exemption. However, in at least one instance, the SEC was willing, based on an analysis using the *Tonopah* criteria under § 3(b)(1), to grant no-action relief rather than requiring an exemptive order under § 3(b)(2). *See Accor Services* (avail. June 7, 2010). More recently, the SEC applied the *Tonopah* criteria and *National Presto* analysis to find that a public medical device manufacturer that had

failed to commercialize and generate a net operating profit based on its medical device was an investment company because 90% of its assets and 90% of its income were derived from investment securities and, among other things, the company did not seek to protect its financial assets and instead invested in equities and paid dividends to shareholders. *In the Matter of Daxor Corporation*, SEC Admin. Proc. File No. 3-14055 (Aug. 31, 2011). Notably, rather than giving the five *Tonopah* criteria equal weight, the SEC emphasized these quantitative criteria as being of primary importance.

U.S. Regulation of the International Securities and Derivatives Markets, § 15.06, PRIVATE OFFERINGS BY FOREIGN FUNDS: *TOUCHE REMNANT* AND §§ 3(c)(1) AND 3(c)(7)

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 § 15.06 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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[1] Private Offerings to Qualified Purchasers Under § 3(c)(7)

Section 3(c)(7), added to the Investment Company Act in 1996 by the NSMIA, facilitates U.S. private offerings by U.S. and non-U.S. investment companies. Section 3(c)(7) excepts from the definition of "investment company" any issuer (i) whose outstanding securities [167] are, with the exception of securities

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held by "knowledgeable employees" of the issuer, [168] owned only by persons who, at the time of acquisition [169] (whether in a primary offering or in the secondary market), the fund or a person acting on its behalf reasonably believes are "qualified purchasers," [170] and (ii) that is not making and does not at such time propose to make a public offering of its securities in the United States. [171] This exception is intended to provide increased flexibility for funds owned exclusively by highly sophisticated investors— "qualified purchasers"—who are thought to possess sufficient investment acumen so as not to require the substantive protections of the Investment Company Act. [172] Unlike § 3(c)(1) of the Investment Company Act, with its 100-owner limit and resulting issues, as discussed below, there is no limit under § 3(c)(7) to the number of qualified purchasers such an issuer may have as investors.

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Section 2(a)(51) of the Investment Company Act, also added by the NSMIA, defines the term "qualified purchaser" as: (i) any natural person who owns not less than $5 million in qualifying investments (including investments held jointly with such person's spouse), [173] (ii) certain family-owned companies, including trusts, owning not less than $5 million in investments that are "owned directly or indirectly by … direct lineal descendents," [174] (iii) certain other trusts [175] or (iv) any person, acting for its own account or the accounts of other qualified purchasers (*i.e.*, institutional investors), who in the aggregate owns and invests on a discretionary basis not less than $25 million in investments. [176] Rule 2a51-1(g) under the Investment Company Act also provides that, with certain

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very limited exceptions, "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) shall be deemed to be qualified purchasers. [177]

Analogizing to its positions under § 3(c)(1) of the Investment Company Act discussed below, the SEC staff has stated that a foreign issuer would be able to avail itself of the exemption provided by § 3(c)(7) of the Investment Company Act if it engaged in no public offerings in the United States and all U.S. residents (pursuant to the definition of "U.S. person" in Regulation S under the Securities Act) that purchased its securities in a primary offering (or a secondary offering involving the foreign issuer or its agents, affiliates or intermediaries) or as part of an unbroken chain of U.S. persons that began with the primary offering (or such a secondary offering) were qualified purchasers. [178] A foreign issuer may qualify for § 3(c)(7) even if U.S. residents who have purchased in the secondary market securities that were initially placed or subsequently resold outside the United States to non-U.S. persons are not qualified purchasers. [179] A foreign fund making a private offering of its securities in the United States must therefore comply with § 3(c)(7) with respect to its securities sold directly to U.S. residents or subsequently transferred by such U.S. residents to other U.S. residents. Securities that flow into the United States in secondary market trading (including securities that are initially placed with U.S. resident investors but that are subsequently sold to non-U.S. persons and flow back to U.S. resident investors in secondary market transactions) need not be counted. [180]

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Where U.S. secondary market transactions must be monitored to ensure that any U.S. resident purchaser is a qualified purchaser, concerns regarding security, convenience, speed of settlement and liquidity have nevertheless led investors and other market participants to favor issuance of securities in global "book-entry" form rather than in physical, registered form. [181] Issuance in global "book-entry" form, however, raises a number of questions. In the ABA Interpretive Letter, the SEC explicitly rejected the suggestion that the requirement that a § 3(c)(7) fund (or a person acting on its behalf) reasonably believe that a purchaser of its securities is a qualified purchaser may be satisfied if the seller of the securities (rather than the fund) forms the reasonable belief. The fund's belief that such purchasers are both qualified institutional buyers and qualified purchasers may also not be formed exclusively on the basis of so-called "deemed" representations now commonly included in the disclosure for Rule 144A transactions—representations as to a purchaser's status that are deemed to be made by prospective investors that receive the offering document. [182] The SEC left open the possibility that a fund could develop procedures in the Rule 144A market that, if followed, would be sufficient to form the requisite reasonable belief. The SEC stated, however, that it will not respond to requests as to whether any particular set of procedures is adequate for this purpose. [183]

Members of a number of major law firms, including ours, have developed, in consultation with The Depository Trust Company ("DTC"), Euroclear and Clearstream Banking, and published a set of procedures that can be implemented to permit § 3(c)(7) monitoring for book-entry securities issued by certain non-U.S. issuers. [184] The procedures appropriate for any particular transaction are

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dependent upon, among other things, the nature of the issuer, whether the securities being offered are debt or equity and the expected level of U.S. interest and trading in the security. Among the more significant procedures applicable to most offerings relying on the 3(c)(7) procedures are:

- disclosure and "deemed" representations concerning transfer restrictions and the status of the purchaser as a qualified purchaser;
- legends on global securities and minimum denominations or purchase amounts;
- a representation by the issuer, based on factors that the issuer and its counsel consider necessary or appropriate, as to the issuer's reasonable belief about the qualified purchaser status of initial and subsequent purchasers;
- representations and covenants by the distributor of the securities, which must be a sophisticated investment bank with the ability to screen purchasers, concerning its own qualified purchaser status and that of investors to which it may make resales;
- the issuer's right under its charter, by-laws or other document, which must also be disclosed to investors, to force a noncomplying holder to resell its securities to an appropriate holder or to redeem the securities;
- periodic reminders from the issuer to securityholders and DTC (and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) participants of the § 3(c)(7) restrictions and the issuer's rights as described above;
- notations on any Bloomberg, Telekurs and/or Reuters screen that includes quotations about the

securities as to their § 3(c)(7) status;

- instruction by the issuer to DTC (and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) to take certain pre-determined steps to identify the securities as restricted under § 3(c)(7), including the distribution of notices to DTC (and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) participants and the provision of information about DTC

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(and, in the case of a non-U.S. issuer, Euroclear and Clearstream Banking) participants to the issuer; and

- the inclusion on trade confirmations of a CUSIP number bearing a "3c7" indicator.

Additional procedures that are appropriate in some circumstances, including offerings of equity securities, include limits on the amount of the offering sold into and the number of purchasers in the United States, requiring representation letters as to "qualified purchaser" status from U.S. investors and using a "gatekeeper" to monitor compliance with restrictions on resales applicable to securities initially sold to U.S. persons.

U.S. issuers must observe these procedures for all holders, whether U.S. or non-U.S. persons. Non-U.S. issuers need not implement these procedures for their non-U.S. holders, who may trade their securities through Euroclear and Clearstream freely. [185]

[2] Private Offerings Under § 3(c)(1) and *Touche Remnant*

For non-U.S. issuers that are or might be investment companies and that wish to sell their securities in a private offering to U.S. investors that are not all qualified purchasers, the SEC's no-action positions under §§ 3(c)(1) and 7(d) of the Investment Company Act effectively preclude them from selling to more than 100-beneficial owners that are U.S. residents. While, as discussed below, practitioners widely believe that the SEC's position is not supported by the statutory provisions of the Investment Company Act, there is little appetite to design offerings that operate directly in conflict with the SEC's position. In addition, the exemption provided by § 3(c)(7) of the Investment Company Act, discussed above, for offerings to an unlimited number of qualified purchasers, has reduced the practical significance of the limitations mandated by the SEC's position.

The ability of foreign investment companies to access the U.S. market in a public offering is governed by § 7(d) of the Investment Company Act, which prohibits a foreign domiciled investment company from making a public offering of its securities in the United States, [186] unless the SEC, upon application by

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the investment company, permits its registration on the basis that it is both "legally and practically" feasible to enforce the provisions of the Investment Company Act against the applicant and that the granting of relief is consistent with the public interest and the protection of investors. [187] The prohibition of § 7(d) of the Investment Company Act is against the use of U.S. jurisdictional means in connection with a public offering. [188] A "public" offering in this context was historically thought to have the same meaning as it did for purposes of determining the need for registration of an offering under the Securities Act. [189] The prohibition was thus for many years thought not to extend to other activities that might result in U.S. beneficial ownership of a fund, such as U.S. private investment or acquisitions in the secondary market by U.S. investors. Foreign

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funds could thus take advantage of the exemptions from Securities Act registration provided in § 4(a)(2) of the Securities Act and Regulation D thereunder. Under Rule 506 of Regulation D, for example, a foreign private investment company could make an offering to an unlimited number of U.S. "accredited investors" and up to 35 other investors and still qualify for safe harbor treatment under the rule.

The staff rejected this interpretation of § 7(d) of the Investment Company Act in *Touche Remnant & Co.*, where it concluded that, even if a foreign fund complied with the requirements of Rule 506 of Regulation D under the Securities Act, [190] the fund would still be subject to registration under the Investment Company Act if "upon completion of the offering there would be more than 100 persons resident in the United States who were beneficial owners of its securities." [191] The staff was careful to emphasize that its conclusion was not based on the fact that the foreign fund was offering its securities publicly outside the United States, but on the legitimate U.S. interest in activities actually conducted in the United States or the effects of the fund's offshore activities on the United States. In that regard, the staff's analysis was two-pronged. First, the staff found that § 3(c)(1) of the Investment Company Act—the so-called "private" investment company exemption [192] that limits beneficial ownership of funds within its purview to 100 persons—evidenced a U.S. regulatory interest in funds having more than 100 investors. Second, the staff asserted that § 7(d) "demonstrates Congress' intent to require foreign investment companies whose conduct has a significant effect on U.S. investors to be subject to the same type of regulation that applies to American investment companies." [193] Absent the 100-U.S. resident limitation, foreign and U.S. funds would be treated unequally, a result that would be, in the staff's view, contrary to the policy expressed in § 7(d). The *Touche Remnant* position has been interpreted to apply not only to closed-end, but also to open-end, funds. [194]

Industry groups, as well as the private securities bar, strongly criticized *Touche Remnant* and, in response to the Concept Release, urged the withdrawal of the staff's position as a matter of both law and policy. [195] The first criticism leveled at the staff's position is that it is inconsistent with the language of § 7(d) and the very structure of the Investment Company Act. Section 7(d) regulates foreign investment companies; the baseline inquiry must thus be whether an entity is an "investment company" within the meaning of the Investment Company Act. If not—because it is, for example, an operating company or falls within a statutory exclusion from the definition, such as § 3(c)(1)—there is no further inquiry under the Investment Company Act. On the other hand, if the entity is an investment company, it is subject to the general prohibitions of § 7 of the Investment Company Act. A comparison of the restrictions set forth in subsections (a) and (b) of § 7 with subsection (d) evidences a clear legislative intent to differentiate between the regulation of domestic and foreign investment companies. In the case of U.S.-domiciled investment companies, §§ 7(a) and 7(b) require registration under the Investment Company Act. In the case of foreign-domiciled investment companies, the language of § 7(d) is clear: the use of the jurisdictional means is forbidden only where used in connection with a public offering in the United States of the securities of the foreign fund. Section 3(c)(1) is thus definitional only.

Moreover, there is no other authoritative legal basis for attributing a different meaning to "public offering" for purposes of the Investment Company Act than that which has developed under the Securities Act. [196] Regulation D and Rule 144A under the Securities Act do not restrict the number of large U.S. offerees or purchasers, whether primary or secondary, in order to avoid a public offering subject to registration under the Securities Act. More important, § 3(c)(1) itself provides convincing evidence that the 100-owner standard cannot be read into § 7(d) of the Investment Company Act. Section 3(c)(1) contains a two-pronged standard requiring that there be no public offering and that there be no more than 100-beneficial owners of the issuer's securities (excluding short-term paper). If exceeding the 100-owner standard by itself resulted in a "public offering" within the meaning of the Investment Company Act, the second prong of § 3(c)(1) imposing the 100-owner limit would be superfluous since it would be

subsumed in the concept of a "public offering." Moreover, there is no indication in the legislative history of the Investment Company Act of any intent to read § 3(c)(1) into the regulation of foreign investment companies and require registration when, as a result of or following a U.S. private placement, a foreign investment company has more than 100 U.S. beneficial owners. [197]

Although there was some disagreement among the private bar, the *Touche Remnant* position has been interpreted by many practitioners to require only that there be no more than 100-beneficial owners of a foreign fund's securities who are U.S. residents immediately following the private placement in the United States (relying, for these purposes, on the definition of "U.S. person" provided by Regulation S under the Securities Act in counting U.S. owners). Under this interpretation, *Touche Remnant* is considered not to apply to secondary market trading in securities placed with non-U.S. persons in a primary offering, so long as the issuer, its agents and affiliates are not involved in that trading. This "snapshot" approach still necessitates an inquiry as to the residence of any owners of the investment company's securities at the time of the placement. Although a difficult task in view of the substantial overseas use of bearer securities and the increasingly widespread practice of holding securities in "street name," this approach does not entail any procedures, such as transfer restrictions, to police secondary flowback into the United States of securities placed initially with non-U.S. persons.

This interpretation has been confirmed by the SEC in *Investment Funds Institute of Canada*, in which the staff noted that *Touche Remnant* and § 7(d) do not "as a general matter" require an issuer to monitor resales of its securities independently made by such holders in secondary market transactions. [198] Therefore, securities of a foreign fund that are initially placed outside the United States

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under Regulation S to non-U.S. persons need not be counted toward the 100-beneficial-owner limit even if they are subsequently transferred to U.S. investors in the secondary market, so long as neither the foreign fund nor any of its agents, affiliates or intermediaries is involved in promoting such transfers. For the purposes of applying the 100-owner test to securities initially sold by the issuer to U.S. persons, it is the view of the authors that one should count (i) securities sold in the United States in previous private offerings that remain in the United States and (ii) securities originally sold to U.S. persons that are either held by the original purchaser or have been resold to other U.S. resident investors and remain owned by U.S. resident investors. Securities that flow into the United States in secondary market trading after the placement, however (including securities that are initially privately offered to U.S. resident investors but that subsequently are sold to non-U.S. persons and then flow back again to U.S. resident investors in secondary market transactions), need not be counted. [199]

Prior to the adoption of § 3(c)(7) of the Investment Company Act, the result of *Touche Remnant* was often that foreign funds and inadvertent investment companies had no practical recourse but to forgo U.S. private offerings that they and their underwriters would otherwise consider. This result in turn forced U.S. institutional investors interested in purchasing these securities into foreign markets to do so. The detailed sales restrictions that would have to be adopted in connection with a U.S. private offering, described below, are not attractive, especially for secondary market transactions of companies listed and publicly traded outside the United States. The alternative of a § 6(c) exemption, which is sometimes pursued in the context of a U.S. public offering by such an issuer, is too time-consuming, expensive and uncertain to be considered as a practical alternative in the context of a private offering—the foreign offering to which the U.S. private offering is probably an adjunct will not wait for the exemptive process to be completed, the U.S. private offering is probably not a crucial element of the overall offering for the issuer (although it might be beneficial to U.S. investors and dealers), and in many cases success in pursuing the exemptive process cannot be guaranteed. The absence of applications for § 6(c) exemptive relief in connection with U.S. private offerings by foreign inadvertent investment companies is empirical evidence that it is not a practical solution to the problems caused by *Touche Remnant*. [200]

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Like domestic funds, a foreign fund may not simultaneously rely on both §§ 3(c)(1) and 3(c)(7) of the Investment Company Act by offering securities in a private placement in the United States both to qualified purchasers and to less than 100 U.S. resident nonqualified purchasers. [201] A foreign fund may, however, make an offshore public offering of its securities in accordance with Regulation S under the Securities Act while at the same time making a private placement under § 3(c)(1) or § 3(c)(7) without causing the offerings to be integrated. In this case, any U.S. persons to whom securities were initially sold by the foreign fund in the offshore public offering would be required, for the purposes of the U.S. private placement as discussed above, to count towards the § 3(c)(1) 100-owner limit or to be qualified purchasers under § 3(c)(7), as applicable. [202]

[3] *Touche Remnant* and Beneficial Ownership Issues Under § 3(c)(1)

[a] General

For foreign funds that choose to rely on § 3(c)(1) rather than § 3(c)(7) of the Investment Company Act, the SEC's *Touche Remnant* doctrine not only requires that a foreign "private" investment company have 100 or fewer beneficial owners who are U.S. residents in order to avoid violation of § 7(d) of the Investment Company Act, [203] but also notwithstanding that § 7(d) is silent on the point, requires consideration of the rules regarding ownership and attribution of ownership under § 3(c)(1) of the Investment Company Act. [204] The latter requirement—even though it has no relation to the number of actual offerees—demonstrates how far the SEC's position has strayed from the § 7(d) "public offering" requirement. In general, any person or entity that has any ownership interest in an investment company's securities, whether debt or equity, is an owner for purposes of determining the 100-U.S.-beneficial owner limitation. Subject to the Investment Company Act's attribution rules discussed below, entities such as corporations and partnerships will generally be treated as a single beneficial owner, [205] although where the owners of such an entity may be deemed to be making a separate investment decision to invest in a private investment fund, the SEC may look through the entity and find each of such owners to be a beneficial owner. [206]

Procedures must be adopted in all cases to determine beneficial ownership, although the types of steps taken by issuers have varied. Where the securities are in registered form, determination of beneficial ownership is a relatively easy inquiry, at least insofar as registration places the issuer on notice of facts that may result in attribution of beneficial ownership. Where a question is raised as to the identity of an issuer's beneficial owners, certifications containing appropriate representations and warranties may be obtained from purchasers. In many cases, additional procedures have been implemented that provide ongoing ability to police U.S. beneficial ownership. Some issuers have, for example, imposed payment and transfer restrictions that prohibit the transfer of, or the payment of

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any distribution on, their securities in the absence of certification that the securities are not beneficially owned by U.S. persons.

As noted above, investors and other market participants now broadly favor "book-entry" securities. However, even under the principles of the *Investment Funds Institute of Canada* letter, secondary market sales by a U.S. beneficial owner purchasing in the original offering to another investor (and subsequent transfers in this chain of U.S. resident purchasers) must be monitored to ensure compliance with the 100-U.S.-beneficial owner limitation. This requirement has made practitioners reluctant to permit securities of non-U.S. private investment companies offered in the United States under the strictures of § 3(c)(1) of the Investment Company Act and *Touche Remnant* to be held in global form, for example at DTC, where secondary market transactions cannot generally be monitored. [207] Nonetheless, issuance of such securities in global form has been countenanced in particular transactions where the existence of special circumstances, generally confirmed by the sole manager (or lead manager), permits the conclusion that U.S. secondary trading can be effectively monitored.

In the case of bearer securities, on the other hand, even upon original issuance an issuer cannot know with certainty how many U.S. residents are beneficial owners of its securities. Issuers have derived comfort in these circumstances from a variety of factors, including the absence of any offering of the issuer's securities in the United States or of any active trading market in the United States for the issuer's securities—particularly if the issuer is managed and controlled wholly outside the United States. The selling restrictions for certain offerings with a private placement component have also included specific restrictions on the underwriters not to make a sale in the United States if the underwriter would have reason to believe that, immediately following the sale, there would be more than 100 U.S. residents who beneficially own the issuer's securities.

In addition, issuers sometimes reserve the right to deny transfer in any instance in which the issuer believes that the transfer will result in breach of the 100-U.S.-resident limitation. Issuers also typically include other protections in their articles of incorporation or other constituent documents. Those provisions often require an automatic redemption or repurchase of the issuer's securities (or alternatively permit the issuer to cause such a redemption or repurchase) in any case in which the beneficial ownership restrictions of the Investment Company Act or the related terms of the securities may have been violated. It would appear, however, that even the most rigid of restrictions may not pass SEC muster if there is any possibility that the *Touche Remnant* standard could be violated. [208]

[b] Attribution Rules

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Following the adoption of the NSMIA, the attribution rules of the Investment Company Act are only called into play when an investment company (or an entity that would be an investment company but for the exceptions provided by § 3(c)(1) or § 3(c)(7) of the Investment Company Act) owns "10 per centum or more of the outstanding voting securities of the issuer." In that event, § 3(c)(1)(A) of the Investment Company Act provides that beneficial ownership will be "attributed" to the owners of such investment company's outstanding securities (other than short-term paper), all of which will then be counted against the 100-U.S.-beneficial owner limit. Although the Investment Company Act defines "voting security" as any security entitling the holder "to vote for the election of directors of a company," [209] the SEC has found other types of securities to qualify, such as limited partnership interests that entitle their holders to remove or select a general partner in any but the most restricted of circumstances [210] and securities that represent a sufficiently large economic interest in the investment company to permit the holder to exercise power and control over the investment company. [211]

[c] Integration

Even where procedures are adopted to ensure that a foreign investment company has no more than 100 U.S. residents who are beneficial owners of its securities, the *Touche Remnant* limitations on U.S. beneficial ownership may still be breached if the sponsor of the investment company has sponsored one or more other similar investment companies. [212] In certain circumstances, the SEC has taken the position that two or more funds may be "integrated" for purposes of determining compliance with the private investment company exception contained in § 3(c)(1) of the Investment Company Act. The NSMIA added new § 3(c)(7)(E) of the Investment Company Act providing that a § 3(c)(7) fund will generally not be integrated with a § 3(c)(1) fund. However, a single issuer may not rely on both §§ 3(c)(1) and 3(c)(7) of the Investment Company Act. [213]

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The purpose of the integration doctrine is to prevent circumvention of the Investment Company Act's registration and other requirements through the use of artificially distinct investment vehicles. Where the doctrine is applicable, if the aggregate number of beneficial owners of the integrated funds exceeds the 100-U.S.-beneficial owner limitation, none of the funds will be entitled to be exempted from registration under the Investment Company Act.

Although the application of the integration doctrine requires a highly fact-intensive analysis, the SEC has in no-action letters emphasized several factors relevant to determining whether two or more funds ought to be considered together for purposes of § 3(c)(1) of the Investment Company Act. As stated by the staff of the SEC, a key inquiry is whether an interest in one fund, as compared to a second fund, "would be considered materially different by a reasonable investor qualified to purchase both." [214] In *PBT Covered Option Fund*, the staff refused to take a no-action position where two funds had the same investment objectives, the same types of portfolio securities and similar portfolio risk/return characteristics. The staff concluded that it could not determine that a reasonable investor would find one fund to be materially different from the other. [215] Moreover, artificial differences between funds, such as a condition to investment based on residency in one state as opposed to another, do not provide a sufficient basis on which to conclude that two funds should not be integrated. [216]

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The SEC staff's concern for these "cookie cutter" funds has resulted in its issuance of letters refusing no-action positions that contain overly broad language that can inhibit development of legitimate institutional products. Consequently, where the characteristics of two or more funds raise the potential for integration such that the funds together may have more than 100 beneficial owners that are U.S. residents, it may be desirable that the documentation for each fund reflect limitations on the ability of U.S. persons to purchase the funds' securities in the aggregate.

Footnotes

167 Unlike § 3(c)(1) of the Investment Company Act, even holders of short-term paper must meet the qualified purchaser standard. *See American Bar Association Section of Business Law* (avail. Apr. 22, 1999) (the "ABA Interpretive Letter").

168 Rule 3c-5 under the Investment Company Act. The rule encompasses only those employees who actively participate in the management of a fund's investments and does not include those persons who merely obtain information regarding the fund's activities. The SEC has indicated that, as a general matter, marketing and investor relations professionals who act for a fund, attorneys who provide advice to a fund, brokers and traders of a broker-dealer related to a fund and financial, compliance, operational and accounting officers of a fund, would *not* qualify. *See* the ABA Interpretive Letter. However, in a recent no-action letter, the SEC staff emphasized that knowledgeable employee status depends on the relevant facts and circumstances of a particular investment manager's business operations, and indicated that, under certain circumstances, the following individuals could qualify as knowledgeable employees: (i) individuals in charge of information technology or investor relations departments; (ii) members of a policy making group or committee of an investment manager; (iii) research analysts; (iv) members of an analytical risk team; (v) traders; (vi) tax professionals; (vii) attorneys; (viii) employees involved in the investment activities of certain separate accounts; and (ix) the employees of related advisers. *See Managed Fund Accounts* (avail. Feb. 6, 2014). Similarly, securities owned by knowledgeable employees are excluded for the purposes of determining, pursuant to Rule 2a51-3(b) under the Investment Company Act, whether each beneficial owner of a company's securities is a qualified purchaser. *Paragon Advisers, Inc.* (avail. Oct. 1, 1998). Securities held by knowledgeable employees are not excluded, however, for purposes of Rule 2a51-3(a), when a company is formed for the purpose of acquiring securities offered by a § 3(c)(7) fund, in order to avoid permitting nonqualified purchasers to do indirectly what they could not do directly. *Paragon Advisers, Inc.* (avail. Oct. 1, 1998). Persons who participate in the investment activities of "foreign or offshore investment companies" are also eligible for knowledgeable employee status. In addition, the spouse (but not a dependent) of a knowledgeable employee who invests jointly with the employee does not have to be a qualified purchaser or a knowledgeable employee, and the spouse is not counted towards the 100-owner limit under § 3(c)(1) of the Investment Company Act (although a dependent is). A family company trust or similar estate planning vehicle for which the knowledgeable employee is both responsible for investment decisions and the source of funds invested is eligible for knowledgeable employee status. *See* the ABA Interpretive Letter.

169 The status of a qualified purchaser need not be reaffirmed in connection with the crediting of a fund's earnings to an investor's account, although a reinvestment of dividends may, in certain circumstances, be considered an offering of securities. *See* the ABA Interpretive Letter.

170 Rule 2a51-1(h) under the Investment Company Act.

171 § 3(c)(7) of the Investment Company Act.

172 *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997).

173 § 2(a)(51)(A)(i) of the Investment Company Act. Rule 2a51-1 under the Investment Company Act clarifies how the amount of investments owned by a prospective qualified purchaser should be determined. Privately offered funds and employees' securities companies may count their unfunded capital

commitments as "investments" for these purposes. *The BSC Employee Fund, L.P.* (avail. Oct. 14, 1997). Equity interests held by individuals in securities-related businesses structured as partnerships or limited liability companies (rather than corporations) are also "investments," even if not technically "securities." *Sullivan & Cromwell* (avail. Dec. 29, 1997).

174 § 2(a)(51)(A)(ii) of the Investment Company Act. A trust is "owned directly or indirectly by … direct lineal descendants" if the beneficiaries of the trust were lineal descendants of a settlor and related as aunts or uncles and nieces and nephews. A trustee is not an owner for purposes of this provision, which is aimed at identifying the holder of the economic interest (whether present or future, vested or contingent) in the trust. *Meadowbrook Real Estate Fund* (avail. Aug. 26, 1998); the ABA Interpretive Letter. *But see Cabot Wellington, LLC* (avail. June 17, 2008) (recommending no enforcement action be taken with respect to the treatment as a "qualified purchaser" of a § 3(c)(1) fund in which the non-familial executive director and principal investment director (a "qualified purchaser" in his own right) also invests).

175 § 2(a)(51)(A)(iii) of the Investment Company Act. The requirement that "each settlor or other person who has contributed assets to the trust" be a qualified purchaser applies even if the settlor has died. The settlor must have been a qualified purchaser at least once when assets were contributed to the trust. The ABA Interpretive Letter; *see also SCP Private Equity Partners II, L.P.* (avail. June 6, 2006).

176 § 2(a)(51)(A)(iv) of the Investment Company Act. The $25 million threshold may be satisfied by aggregating investments that a person owns with investments that the person invests on a discretionary basis. *Service Corporation International* (avail. Oct. 6, 1998). This approach is consistent with the SEC's interpretation of the definition of a "qualified institutional buyer" in Rule 144A(a)(1)(i) under the Securities Act, which permits aggregation of proprietary and managed holdings. In addition, a company may aggregate its investments with investments of its majority-owned subsidiaries, its parent company (so long as it is a majority-owned subsidiary) and any other majority-owned subsidiaries of its parent. *Service Corporation International* (avail. Oct. 6, 1998). A company is not a qualified purchaser if it was formed for the specific purpose of acquiring a § 3(c)(7) fund's securities, unless each beneficial owner of the company's securities is a qualified purchaser. Rule 2a51-3 under the Investment Company Act. Whether or not a company is formed for that purpose depends on an analysis of all of the surrounding facts and circumstances. Although relevant, the percentage of a company's assets invested in the fund is not determinative of this inquiry. The ABA Interpretive Letter.

177 In the context of employee benefit funds, a fund that is a qualified institutional buyer may not qualify as a qualified purchaser in circumstances where individual participants in the fund have the discretion to decide whether and how much to invest in specific investments, including § 3(c)(7) funds. In those situations, a § 3(c)(7) fund must look through the employee benefit fund to determine whether each beneficial owner of the employee benefit fund is a qualified purchaser. The SEC has provided no-action relief with respect to this look-through requirement in certain circumstances. *See, e.g.*, *Invesco Advisers, Inc.* (avail. Apr. 8, 2014).

Similarly, for purposes of calculating the 100-person limitation applicable to investment companies exempt from registration as such under § 3(c)(1) of the Investment Company Act (*see infra* Note 192), a § 3(c)(1) fund must look through such discretionary employee benefit funds and count each beneficial owner as a separate person.

178 *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997). A foreign investor temporarily present (but not resident) in the United States may purchase an interest in a foreign issuer without having to be a qualified purchaser under § 3(c)(7) of the Investment Company Act. *Wilmer, Cutler & Pickering, Davis Polk & Wardwell* (avail. Oct. 5, 1998).

179 *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997); *see also Investment Funds Institute of Canada* (avail. Mar. 4, 1996).

180 Relying on this interpretation, in 2006, a number of private equity firms established permanent capital vehicles that qualified as "foreign private issuers" for purposes of the Securities Act and that invested the proceeds of their offerings in several U.S. private equity funds managed by such firms. Such funds conducted private placements of their shares outside the United States and listed their shares on non-U.S.

exchanges, such as Euronext Amsterdam, while concurrently offering to U.S. qualified purchasers "restricted depositary units" that allowed them to restrict transfer to U.S. qualified purchasers or to secondary trading on the non-U.S. exchanges.

181 The difficulties of monitoring ownership in the case of bearer securities will presumably raise issues and require special circumstances or imposition of special measures if such securities are used. *See* § 15.06[3][a].

182 *See* Chapter 7. Among other issues, not all qualified institutional buyers are qualified purchasers. Rule 2a51-1(g)(1) under the Investment Company Act excludes (i) dealers that own and invest less than $25 million in securities and (ii) participant-directed employee plans. Moreover, while transfer restrictions in most Rule 144A transactions fall away after six months in the case of Exchange Act-reporting issuers (and one year in the case of all other issuers) due to the availability of public resales under Rule 144 under the Securities Act, restrictions under § 3(c)(7) of the Investment Company Act must be monitored for the life of the fund.

183 *See* the ABA Interpretive Letter.

184 *See New Developments in Procedures for Book-Entry Deposit of Rule 144A Securities by Certain Issuers Relying on Section 3(c)(7) of the Investment Company Act*, INVESTMENT LAWYER (Part I, Mar. 2003; Part II., Apr. 2003). *See Book-Entry Deposit Procedures for Certain Offerings by Non-U.S. Issuers under Section 3(c)(7) of the Investment Company Act*, INVESTMENT LAWYER (June 2008); *see also Investment Company Act Status of Non-U.S. Issuers—Updated Commentary on Book-Entry Deposit Procedures under Section 3(c)(7) of the Investment Company Act*, INVESTMENT LAWYER (Mar. 2012).

Neither the original nor the supplemental procedures are appropriate for U.S. fund issuers seeking to issue securities in book-entry form due to the requirement that they confirm qualified purchaser status for all of their investors—both U.S. and non-U.S.—and the resulting greater potential to end up being held by investors that are not qualified purchasers. U.S. fund issuers, however, could satisfy the reasonable belief standard by, for example, using a private book-entry depositary that functions as a closed system and allows only participants that meet the necessary qualifications. In 2007, a number of new transfer systems (including, for example, systems operated by American Stock Transfer & Trust Company and The Bank of New York), which are able to restrict transfers in securities to investors that are both qualified institutional buyers and qualified purchasers, were established in part to facilitate trading by investors in hedge funds, private equity funds and other alternative asset vehicles for which the book-entry procedures described above would not be appropriate.

185 Generally, secondary sales of securities by non-U.S. persons need not be monitored so long as the issuer (and its affiliates and agents) have not participated in any "secondary market trading" within the meaning of the SEC no-action relief granted in *Goodwin, Procter & Hoar* (avail. Feb. 28, 1997) and *Investment Funds Institute of Canada* (avail. Mar. 4, 1996).

186 The prohibition of § 7(d) is not by its terms limited to U.S. public offerings, although the correctness of this conclusion is clearly supported by the legislative history of the Investment Company Act and decades of market practice and SEC acquiescence. *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. 13 (1940). The conclusion was confirmed by the SEC in adopting Rule 144A under the Securities Act. SEC Release No. 33-6862 (Apr. 23, 1990).

187 Section 7(d) of the Investment Company Act provides:

> No investment company, unless organized or otherwise created under the laws of the United States or of a State, and no depositor or trustee of or underwriter for such a company not so organized or created, shall make use of the mails or any means or instrumentality of interstate commerce, directly or indirectly, to offer for sale, sell, or deliver after sale, in connection with a public offering, any security of which such company is the issuer. Notwithstanding the

> provisions of this subsection and of Section 8(a) [of the Investment Company Act], the [SEC] is authorized, upon application by an investment company organized or otherwise created under the laws of a foreign country, to issue a conditional or unconditional order permitting such company to register under this title and to make a public offering of its securities by use of the mails and means or instrumentalities of interstate commerce, if the [SEC] finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Investment Company Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors.

As originally proposed, § 7(d) would not have authorized the SEC to grant relief from the § 7(d) prohibition against U.S. public offerings by foreign investment companies. H.R. Rep. No. 2639, 76th Cong., 3d Sess. 13 (1940). For a discussion of § 7(d), *see* § 15.08.

188 The SEC staff has clarified that § 7(d) prohibits the use of U.S. jurisdictional means by a foreign investment company only in connection with a public offering in the United States or to U.S. persons, rather than the use of U.S. jurisdictional means generally. To the extent that this clarification is inconsistent with the position previously taken by the SEC staff in *KBS International Ltd.* (avail. Mar. 18, 1985), that position has been expressly superseded. *Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

189 *Stars & Stripes GNMA Funding* (avail. Apr. 17, 1986); *see also* § 6.01. Subsequent to the elimination of the requirement, in connection with the securities trading safe harbor under the Internal Revenue Code (the "IRC"), that a foreign entity's principal office be located outside the United States, the SEC confirmed that the performance in the United States of those specific activities (typically referred to as the "ten commandments") in connection with a private U.S. offering or an offshore public offering would not implicate § 7(d) as long as those activities that amount to an offer or sale of securities are consistent with the regulatory restrictions on nonpublic offerings or offshore offerings to non-U.S. persons. *Wilmer, Cutler & Pickering, Davis Polk & Wardwell* (avail. Oct. 5, 1998); *Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

190 In this regard, the *Touche Remnant* letter reversed earlier staff advice that offerings made pursuant to Rule 506 (the only Regulation D safe harbor available to investment companies) were nonpublic offerings for purposes of the § 3(c)(1) "private" investment company exemption from registration as an investment company. *See, e.g., San Jose Capital Corporation* (avail. Feb. 14, 1983); *Ideal Mortgage and Realty Service Corp.* (avail. Jan. 4, 1978) (relating to Rule 146, the predecessor of Regulation D). For a description of Rule 506, including recent changes to the general solicitation and "bad actors" restrictions, see § 7.02[2].

191 *Touche Remnant & Co.* (avail. Aug. 27, 1984).

192 Section 3(c)(1) of the Investment Company Act provides an exception from the definition of "investment company," and, therefore, from registration and compliance with most of the requirements of the Investment Company Act, for "[a]ny issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities."

193 *Touche Remnant & Co.* (avail. Aug. 27, 1984).

194 *Touche Remnant & Co.* (avail. Aug. 27, 1984).

195 *See, e.g.*, Letter from Cleary, Gottlieb, Steen & Hamilton (Oct. 12, 1990); Letter from Ropes & Gray (Oct. 9, 1990).

196 For many years following the adoption of the Securities Act and in part based upon SEC staff advice, practitioners addressing the presence of a public offering attached significant weight to the number of offerees and purchasers. *See* § 7.02[1].

Nevertheless, the SEC subsequently rejected the importance of that factor in adopting Regulation D, and the SEC division responsible for administering the Investment Company Act has never explicitly distinguished the public offering concept for purposes of that Act from the context in which the concept has evolved under the Securities Act.

197 *See* S. Rep. No. 1775, 76th Cong., 3d Sess. 13 (1940) ("Foreign investment companies may not … *publicly* offer securities of which they are the issuer in the United States unless the [SEC] finds that these foreign investment companies can be effectively subjected to the same type of regulation as domestic investment companies." (emphasis added).

198 *Investment Funds Institute of Canada* (avail. Mar. 4, 1996). The same principle was applied in *Indosuez Asset Management Asia Ltd* (avail. Feb. 14, 1997), where the SEC stated that a fund would not have to aggregate holders of fund shares that were purchased in offshore secondary market transactions not involving the fund or its affiliates that are deposited in a depositary receipt facility with holders of shares or depositary receipts acquired either in a U.S. private placement or from the fund or its affiliates pursuant to Regulation S under the Securities Act, so long as the fund does not promote the public use of the depositary receipts or take any other action that is intended or could be expected to condition the market in the United States for fund shares or facilitate the creation of a public secondary market for fund shares or depositary receipts. *See also Cantor Fitzgerald & Co.* (avail. June 16, 2004); *Merrill Lynch, Pierce, Fenner & Smith Inc.* (avail. Sept. 3, 1999).

The SEC staff has also confirmed that the definition of "U.S. person" under Regulation S should be used to determine whether to count an entity as a U.S. resident owner for purposes of complying with the § 3(c)(1) exemption *. Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

199 *See Investment Funds Institute of Canada*, at n.13 (avail. Mar. 4, 1996).

200 The SEC staff also proposed in the 1992 Report that § 7(d) of the Investment Company Act be amended to clarify the application of the Act's registration requirement to foreign-domiciled funds that have not made a public offering of their securities in the United States. The staff's recommended amendments would in effect codify its position taken in *Touche Remnant* that the Investment Company Act applies to foreign investment companies that do not make a public offering in the United States. Under the proposal, a foreign fund that is not otherwise excepted from the definition of "investment company" would be prohibited from using U.S. jurisdictional means: (i) to offer, sell or deliver any of its securities or (ii) to facilitate U.S. secondary market trading in its securities, including through listing on an exchange and quotation by a registered "securities information processor," if the fund has, or as a result of either of these activities "can reasonably expect" to have, more than 100 shareholders of record (as opposed to beneficial owners under *Touche Remnant*) that are U.S. residents. 1992 Report at 218–19. Because the staff's recommendation regarding § 7(d) would have effectively legislated compliance with *Touche Remnant*, it was not supported by market participants or the private bar. The staff's recommendation, which was part of a broader proposal to clarify the operation of § 7(d) that raises a number of controversial issues, see § 15.08, has not in fact received significant attention from U.S. legislators, and Congressional initiatives to revise § 7(d) are not expected in the near term.

201 *Goodwin, Procter & Hoar*, at n.10 (avail. Oct. 5, 1998); *see also The Townsend Group*, *Inc.* (avail. July 9, 2008).

202 *Goodwin, Procter & Hoar* (avail. Oct. 5, 1998).

203 Note that an investor who becomes a knowledgeable employee of a fund after purchasing securities of that fund may be treated as having been a knowledgeable employee at the time of the prior purchase and thus cease to be counted for the 100-owner limit test. *See* the ABA Interpretive Letter, *supra* Note 167.

204 *See* SEC Release No. 33-6862 (Apr. 23, 1990).

205 § 3(c)(1)(A) of the Investment Company Act.

206 *See, e.g.*, *Tyler Capital Fund, L.P./South Market Capital* (avail. Sept. 28, 1987). On the other hand, the SEC has taken the position that shares of a § 3(c)(1) fund that are jointly owned by both spouses should be considered to be owned by one beneficial owner, even where each spouse may have discretionary authority over the shares. *See* SEC Release No. IC-22597 (Apr. 3, 1997), 62 Fed. Reg. 17,512, 17,518

n.69 (Apr. 9, 1997); *see also* the ABA Interpretive Letter.

In a 2005 no-action letter, the SEC staff also concluded that the look-through requirement would not apply to a deferred compensation plan in which the amount that plan participants deferred would be paid by the employer to participants at a later time after being adjusted for the performance of a "benchmark" selected by the individual participant from among a group of possible benchmarks designated by the plan's committee. Benchmarks could be based on the performance of individual investment indices, registered investment companies and/or individual § 3(c)(1) or § 3(c)(7) funds. In reaching its conclusion, the SEC staff relied, among other factors, on the employer's representations that (i) the plan was not formed for the purpose of investing in a particular § 3(c)(1) or § 3(c)(7) fund, (ii) the plan committee would act in accordance with the "prudent man" standard set forth in § 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") (*see* § 15.07[1][a]) in connection with the selection and retention of any § 3(c)(1) or § 3(c)(7) fund as a performance benchmark under the plan, and (iii) the plan committee would not condition the selection of any § 3(c)(1) or § 3(c)(7) fund on the agreement of such fund to use the employer (The Goldman Sachs Group, Inc.) or any of its affiliates as a prime broker. Also of relevance were the fact that the employer was not obligated to invest in any of the benchmark funds to hedge its obligations to plan participants (although it retained the option to do so) and that plan participants were only general creditors of the employer, and did not have the right to any amount held in a segregated account. *The Goldman Sachs Group, Inc*. (avail. Mar. 8, 2005). It is not clear, however, whether this no-action position will be applied by the SEC staff to other reference instruments that are based on the performance of § 3(c)(1) or § 3(c)(7) funds.

207 *But see* the discussion of monitoring resales under § 3(c)(7) of the Investment Company Act at § 15.06[1].

208 *See Alpha Finance Corp.* (avail. July 27, 1990) (response stated that the staff could not assure that it would not recommend enforcement action if, notwithstanding extensive transfer restrictions, more than 100 persons in the United States beneficially own the securities at any time).

209 § 2(a)(42) of the Investment Company Act.

210 SEC Release No. IC-8456 (Aug. 9, 1974); *see also Weiss, Peck & Greer Venture Associates II, L.P.* (avail. Apr. 10, 1990). *But see Horsley Keogh Venture Fund* (avail. Apr. 27, 1988) (taking the position that an interest that gives the right to name a new general partner constitutes a voting security).

211 *See, e.g.*, *Devonshire Capital Corp.* (avail. Feb. 15, 1976); *Pierce, Lewis & Dolan* (avail. Mar. 17, 1972).

212 The staff has taken a similar position where funds have common advisers and promoters. *Monument Capital Management, Inc.* (avail. July 12, 1990).

213 § 3(c)(7)(B) of the Investment Company Act; *see also Goodwin, Procter & Hoar* (avail. Feb. 28, 1997). *But see Washington Capital Joint Master Trust* (avail. Sept. 25, 2006) in which the staff, while noting the distinction in facts from *Coutts Global Fund* (avail. Apr. 11, 1994) in which sub-funds of an offshore "umbrella" trust were deemed to be separate issuers for purposes of § 3(c)(1), nonetheless granted no-action relief in the case of sub-funds of a domestic trust subject to ERISA that relied on various exceptions from the definition of "investment company," such as those set forth in §§ 3(c)(1), 3(c)(5) and 3(c)(7) of the Investment Company Act. In both cases, the assets and liabilities of each sub-fund in the trust were separate from those of any other sub-funds, and the ownership interests in the trust were composed of units representing interests in the property of a discrete sub-fund the assets of which could only be applied to discharge claims against that sub-fund and could not be applied to discharge claims against any other sub-fund.

214 *PBT Covered Option Fund* (avail. Feb. 17, 1979).

215 *PBT Covered Option Fund* (avail. Feb. 17, 1979); *see also Monument Capital Management, Inc.* (avail. July 12, 1990); *Rogers, Casey & Associates, Inc.* (avail. June 16, 1989). *But see Resolution Trust Corp.* (avail. July 18, 1991) (granting no-action relief where there would be materially different cash flows allocated to securities of various funds, notwithstanding that all funds had a single adviser); *Oppenheimer Arbitrage Partners, L.P.* (avail. Dec. 26, 1985) (granting no-action relief where funds had dissimilar portfolio risk/return characteristics, different investment objectives and different portfolio composition and were

designed for different classes of investors such that no reasonable investor would be qualified to invest in both funds); *Pasadena Investment Trust* (avail. Jan. 22, 1993) (granting no-action relief where a non-U.S. fund and a U.S. registered fund, as a result of the non-U.S. fund's offering and selling its securities outside the United States and investing substantially all of its assets in the U.S. registered fund, shared the same investment objectives and risk/return characteristics but created materially different investment opportunities for foreign and U.S. investors because of differing tax laws and other regulatory disparities).

216 *See, e.g.*, *Madison Park Investment Management* (avail. Mar. 4, 1986) (denying no-action relief where two funds that would use different broker-dealers had the same investment objectives and risk/return characteristics and portfolio composition, notwithstanding differences in investment strategy that could result from the transaction costs associated with each broker and the timing of the formation of each fund).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.07, OTHER REGULATORY ISSUES FOR FOREIGN FUNDS

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 § 15.07 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Foreign funds seeking to make offers in the United States, and even to U.S. investors seeking to acquire interests in such funds in the secondary markets abroad, must also address other regulatory issues in addition to those arising under U.S. federal securities laws. For example, funds that trade futures and commodity options may be "commodity pools" within the meaning of the CEA, thus necessitating registration of the fund's managers as "commodity pool operators." [217]

Aside from issues pertaining directly to the fund's operation, a foreign fund must also take into account issues relevant to its targeted investors. Pension funds regulated under ERISA are subject to a variety of restrictions, certain of which, if not adequately addressed, may result in the foreign fund manager's being deemed to be a "fiduciary" and in the foreign fund assets becoming "plan assets" within the meaning of ERISA, thereby subjecting the foreign fund manager to the fiduciary standards imposed by ERISA and subjecting the assets of the foreign fund to the custody and prohibited transaction requirements of ERISA and the U.S. tax laws. The effects of U.S. federal income taxation on portfolio investment—principally the "passive foreign investment company," or "PFIC," rules—must also be considered in planning an offering targeted to U.S. investors.

[1] U.S. Pension Investment in Foreign Funds

ERISA does not prohibit investment by U.S. pension funds in the securities of foreign investment companies, including those denominated in currencies

other than U.S. dollars. [218] Rather, each investment must be judged in light of ERISA's "prudent man" rule. [219]

The most significant ERISA provision that may affect foreign funds is that if investments by pension funds subject to ERISA and certain other types of investors in the aggregate equal or exceed 25% by value of any class of equity securities of the foreign fund, the assets of the foreign fund itself are likely to be treated as plan assets. In such a case, as discussed in more detail below, the application of ERISA to the assets of the foreign fund would have very significant consequences. [220]

ERISA has no specific requirements relating to investment in foreign securities except concerning their custody. Only foreign securities or, in certain limited circumstances, foreign currency may be held outside the United States, and then only if certain conditions are satisfied.

[a] The “Prudent Man” Rule

The legislative history of ERISA recognized that "investment in securities of foreign companies and governments have [sic] been and may well continue to be in the best interests of plan participants in appropriate circumstances and with proper safeguards." [221] The standard for judging a fiduciary's decision to invest in foreign securities is the same as that applied to any investment decision made by a fiduciary: a fiduciary must make the decision to invest in foreign securities "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." [222]

Although U.S. Department of Labor regulations interpreting the prudent man rule provide little objective guidance, they do provide that the prudent man rule will be satisfied with respect to an investment made by a fiduciary if the fiduciary has given "appropriate consideration" to all the facts and circumstances, given the scope of the fiduciary's investment duties, that the fiduciary knows or should know are relevant to the particular investment. [223] Among the considerations that might be appropriate in the context of a decision whether to

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invest in foreign securities are opportunities for increased return and diversification by investing in foreign securities, volatility of certain foreign equity markets, currency risks and hedging costs, tax implications, political risk, relative lack of disclosure regarding investments and lower levels of liquidity in certain foreign markets.

There is no limitation in ERISA regarding the maximum percentage of pension fund assets that may be invested in foreign securities. There is, however, a general rule that requires a pension fund manager to invest the fund's assets in a diversified manner so as to prevent the risk of large losses—the so-called diversification rule. [224] As with the prudent man rule, the diversification rule provides little objective guidance in determining the appropriate mix of foreign securities in a pension fund's portfolio.

[b] Plan Asset Regulations

Under regulations issued by the U.S. Department of Labor, as modified by § 3(42) of ERISA (the "Plan Asset Regulations"), the assets of a foreign fund or other entity in which an employee benefit plan subject to ERISA invests can, under certain circumstances, be deemed assets of the pension plan itself ("plan assets"). [225] The Plan Asset Regulations generally provide that when a “plan acquires an equity interest [226] in a foreign fund or other entity, the plan's assets include both the equity interest and an undivided interest in the underlying assets of the entity, unless it is established that: (i)(a) the equity interest acquired is a "publicly offered security" [227] or (b) although unlikely for reasons discussed in § 15.08 below, the equity interest acquired is a security issued by an investment company registered under the Investment Company Act, (ii) the entity is an "operating company," or (iii) equity participation in the entity by "benefit plan investors" does not equal or exceed 25% of the value of any class of equity securities of the entity (the "25% test"). [228] As a result, generally, unless a foreign fund

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is registered under the Investment Company Act, or qualifies as a "venture capital operating company" or a "real estate operating company," participation in the fund by benefit plan investors should be limited in order to avoid having assets of the fund considered "plan assets." [229] If the assets of the fund constitute plan assets, the whole panoply of ERISA's substantive fiduciary provisions would apply to the foreign fund. It is often difficult, if not impracticable, to comply with such provisions.

For purposes of the 25% test exception, a "benefit plan investor" is any of the following:

- any employee welfare benefit plan or employee pension benefit plan subject to the provisions of Title I of ERISA;
- any plan described in I.R.C. § 4975(e)(l) to which I.R.C. § 4975 applies, such as individual retirement plans ("IRAs") or Keogh plans; [230] and
- any entity whose underlying assets include plan assets by reason of a plan's investment in the entity (a "plan asset entity"). [231]

Benefit plan investors therefore include not only U.S. plans subject to ERISA, IRAs and Keogh plans, but also entities such as collective trusts, insurance company separate accounts and, in certain cases, general accounts and limited partnerships holding assets deemed to be plan assets.

Because of the Plan Asset Regulations, some foreign funds completely prohibit sales to benefit plan investors. Other funds strictly limit sales to benefit plan investors and include restrictions on subsequent transfers in order to ensure that the 25% test is not violated as a result of secondary market sales.

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Some foreign funds seek to qualify as venture capital operating companies ("VCOCs"). An entity is a VCOC if at least 50% of its assets (valued at cost) are invested in "venture capital investments" and the entity, in the ordinary course of its business, actually exercises "management rights" with respect to one or more of the operating companies in which it invests. [232] A "venture capital investment" is an investment in an operating company (other than another VCOC) as to which the investor obtains "management rights." An "operating company" generally is defined as an entity that is primarily engaged, directly or indirectly through majority-owned subsidiaries, in the production or sale of a good or service other than the investment of capital. [233] "Management rights" are contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company. In order to qualify as a VCOC, an entity must meet these requirements on the date it makes its first long-term investment and annually during an "annual valuation period." An entity cannot qualify as a VCOC before it makes its first investment in an operating company. Therefore, a manager of an investment fund seeking to qualify as a VCOC generally will not accept funds from plans until the closing of the fund's first investment in an operating company. [234]

The consequences of deeming the assets of a foreign investment company to be plan assets could potentially be severe. In addition to imposing general fiduciary standards, ERISA generally prohibits a broad range of transactions involving the assets of a plan subject to ERISA and persons having a specified relationship to the plan, such as advisers, brokers and others with whom a foreign fund would normally do business. [235] Many transactions undertaken in the ordinary course by a foreign fund would probably be prohibited. Under U.S. law, excise tax liability for "parties in interest" or "disqualified persons" to plans and civil liability for such plans' fund advisers and other "fiduciaries" could result from prohibited transactions. [236] The fact that private litigants can bring suit for fiduciary breaches, that indemnities for, and disclaimers of, breaches of fiduciary

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duty may be unenforceable and that such excise taxes could be imposed cause many foreign funds to take steps to avoid the applicability of ERISA. [237]

[c] Holding Plan Assets Outside the United States

ERISA prohibits a pension fund subject to ERISA from holding the indicia of ownership [238] of any securities outside the jurisdiction of the U.S. district courts unless held in a manner permitted by U.S. Department of Labor regulations. [239]

Under the regulations, only "foreign securities" (and, in limited cases, foreign currency) may be held outside the jurisdiction of the U.S. district courts. [240] There are three principal alternatives under which foreign securities or currency may be held outside the jurisdiction of the U.S. district courts: the asset manager alternative, the direct custody alternative or the indirect custody alternative.

Under the asset manager alternative, the pension fund's assets must be managed and controlled by a U.S. entity with a principal place of business within the United States that is a bank, insurance company or SEC-registered investment adviser that meets certain capital and regulatory requirements. [241] Under this alternative, the pension fund manager may prudently select any capable person, domestic or foreign, to act as a custodian of pension fund assets, regardless of whether that person is a qualifying bank, insurance company, broker or dealer.

Under the direct custody alternative, foreign securities may be held outside the jurisdiction of the U.S. district courts in the physical possession of a U.S.

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entity that is a bank or SEC-registered broker or dealer with a principal place of business in the United States and that meets certain capital requirements. [242]

Under the indirect custody alternative, foreign securities may be held outside the jurisdiction of the U.S. district courts by an SEC-registered broker or dealer in the custody of an entity designated by the SEC as a satisfactory control location [243] holding as agent for the broker or dealer, or by a U.S. bank in the custody of an entity that is a foreign securities depositary, a foreign clearing agency that acts as a securities depository, or a foreign bank, provided in each case that certain additional requirements are met. [244]

[2] U.S. Federal Income Tax Considerations

A foreign investment company that invests in U.S. securities will need to take steps to ensure that it will not become subject to U.S. federal income tax on a net income basis as a result of its activities in the United States. The foreign investment company will also need to consider whether U.S. withholding tax will be imposed on income it receives in respect of the U.S. securities and whether it will be required to withhold U.S. tax on distributions that it makes.

Additional U.S. tax considerations will arise if shares in the foreign investment company are marketed to U.S. investors. In that case, the U.S. shareholders of the foreign investment company may be subject to potentially adverse U.S. tax treatment under special rules that apply to U.S. shareholders of "passive foreign investment companies."

[a] Investing in U.S. Securities

[i] *U.S. Federal Income Tax*

To preserve investor returns, foreign investment companies are usually structured so that they will not be subject to significant foreign or U.S. net income taxes. Foreign taxes may be minimized by organizing the foreign investment company in a "tax haven" jurisdiction, such as the Cayman Islands, the Netherlands Antilles or Bermuda. Tax havens do not impose significant taxes on the net income of domestic corporations and usually do not impose withholding taxes on distributions of earnings to nonresident shareholders.

Income of a foreign investment company will not be subject to U.S. federal income tax on a net income basis if the company is not "engaged in trade or business within the United States." If the foreign investment company is so

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engaged, the net taxable income of the company that is "effectively connected" with the trade or business will be subject to U.S. federal income tax at the normal rates applicable to U.S. corporations and, upon distribution of the effectively connected earnings, the foreign investment company may be subject to a 30% U.S. tax under U.S. "branch profits tax." [245]

To encourage foreign investors to trade in the U.S. capital markets, the U.S. tax rules provide a "safe harbor" that generally exempts such investors from U.S. federal income tax. [246] Under the safe harbor rule, a foreign investment company will not be engaged in a U.S. trade or business as a result of its securities trading activities in the United States, and thus will not be subject to U.S. federal income tax as a result of such activities, if the company is not a "dealer" in securities. [247]

Additional U.S. tax considerations will be relevant if the foreign investment company invests in a partnership that is engaged in a U.S. trade or business. The U.S. tax rules attribute the U.S. trade or business of a partnership to its foreign partners, [248] and a foreign partner may be allocated a distributive share of the effectively connected income of the partnership. As a result, if a foreign investment company acquires an interest in such a partnership, the company's

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share of the income of the partnership (after taking into account allowable deductions connected to such income) generally will be subject to U.S. federal income tax. [249] In addition, partnership income allocable to the foreign investment company may be subject to a 30% U.S. tax under the U.S. "branch profits tax." [250] Even if the foreign investment company is not allocated any effectively connected income from the partnership, it will be obligated to file a U.S. federal (and possibly state and local) income tax return due to the fact that it is treated as engaged in a U.S. trade or business. The foregoing rules relating to investments in a U.S. partnership will not apply if the partnership is treated as a corporation for U.S. tax purposes because interests in the partnership are publicly traded. [251] An investment in such a partnership by a foreign investment company will be treated the same as an investment in stock of a U.S. corporation. Furthermore, the foregoing discussion generally assumes that the foreign investment company is itself treated as a corporation for U.S. tax purposes. If a foreign investment company instead is treated as a partnership for U.S. tax purposes, the applicable rules are somewhat different, although they generally raise the same issues.

Special U.S. tax considerations also apply if the foreign investment company invests in a "United States real property interest" ("USRPI"), such as stock of U.S. corporations whose assets consist primarily of U.S. real property. [252] A foreign investment company's gain from the disposition of a USRPI is treated as effectively connected income. Accordingly, such gains would be subject to U.S. federal income tax, and the company would be required to file a U.S. federal income tax return. However, stock that is regularly traded on an established securities market will not be treated as a USRPI if the foreign investment company did not hold more than 5% of such stock at any time during the five-year period ending on the date the stock is sold. [253] Stock in a "real estate investment trust" also will not be treated as a USRPI if either (i) the trust is majority owned by U.S. persons or (ii) the foreign investment company did not hold more than 10% of such stock at any time during the five-year period ending on the date the stock is sold. [254]

[ii] *U.S. Withholding Tax*

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Foreign investment companies that invest in stock or securities of U.S. issuers must also consider whether income from those investments will be subject to U.S. withholding taxes. Most U.S. source interest income from standard capital markets debt securities will qualify as "portfolio interest" that is exempt from U.S. withholding tax. [255] However, subject to certain other exemptions, the gross amount of dividends and other payments of "fixed or determinable annual or periodical" income, including interest that is not "portfolio interest," received by a foreign investment company from sources within the United States will be subject to U.S. withholding tax at the rate of 30%. [256] The tax is deducted and withheld from the payment by the U.S. payor and is not refundable. [257] The 30% rate for U.S. withholding tax may be reduced under an applicable U.S. income tax treaty (although the United States has not entered into such treaties with the tax haven jurisdictions where many foreign investment companies are organized). [258]

Because U.S. withholding taxes can significantly reduce a foreign investment company's returns from investments in the United States, potential U.S. withholding taxes must be considered in connection with each such investment. Many foreign investment companies have established investment guidelines that help them to determine efficiently whether income from proposed investments will be subject to U.S. withholding taxes.

A detailed discussion of the U.S. tax rules applicable to foreign investors in securities of U.S. issuers is beyond the scope of this book. However, the most important exemptions from U.S. withholding tax other than the "portfolio interest" exemption that may apply include interest paid on a bank deposit in the United States, [259] discount on an obligation with a maturity of 183 days or less

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from the date of original issue [260] and capital gains realized by a foreign corporation. [261]

In 2010, an additional level of U.S. withholding tax was enacted under the so-called Foreign Account Tax Compliance Act ("FATCA") rules to deter U.S. taxpayers from hiding foreign assets and income from the Internal Revenue Service ("IRS"). [262] In general, FATCA imposes a 30% withholding tax on all dividends, interest and other fixed or determinable annual or periodical payments from a U.S. source, and on the gross proceeds from the sale or disposition of any assets that can produce U.S. source dividends or interest, made to, or received by, a "foreign financial institution" ("FFI"), unless the FFI agrees to report information about its U.S. direct and indirect investors to the IRS and to withhold U.S. tax on distributions to investors who do not comply with the FATCA rules. [263] The definition of an FFI includes a foreign bank and a foreign entity that, as a substantial portion of its business, holds financial assets for the account of others, or that is engaged primarily in the business of investing or trading in securities or other financial assets. [264] Based on this broad definition, most foreign investment companies will be treated as FFIs.

In general, in order to avoid the 30% FATCA withholding tax, a foreign investment company that is an FFI will be required to enter into an agreement with the IRS pursuant to which it generally will be required to identify and report to the IRS information with respect to direct and indirect U.S. investors, withhold 30% tax on U.S. source payments to investors and other FFIs that refuse to comply with FATCA's requirements, and, in some cases, close accounts with respect to which reporting is not permitted. [265] Less onerous rules will apply if the foreign investment company satisfies the IRS that it has no U.S. investors or if it does not qualify as an FFI. [266] Regulations also impose detailed diligence requirements on FFIs; however, these are satisfied in many cases by collecting

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U.S. tax forms (*e.g.*, Form W-8BEN, Form W-8BEN-E, Form W-9) from investors. [267] As a result, investment companies should generally expect to collect U.S. tax forms from their investors, and provide such forms to their counterparties. The United States has entered into intergovernmental agreements ("IGAs") with many jurisdictions to implement FATCA. Most IGAs require FFIs in a particular jurisdiction to report account holder information to local tax authorities, who in turn provide such information to the IRS.

Withholding on payments to non-compliant investors commenced on July 1, 2014 in respect of dividends, interest and other fixed or determinable annual or periodical payments, and will commence in 2019 with respect to gross proceeds on the sale or disposition of U.S. financial assets. [268]

[b] Tax Consequences for U.S. Shareholders

U.S. shareholders of a corporation generally are not subject to U.S. tax on corporate earnings until those earnings are distributed to them as dividends. However, under complex rules that apply to U.S. holders of equity securities of a "passive foreign investment company" ("PFIC"), U.S. holders of equity securities of most foreign investment companies are denied the benefits of tax deferral on undistributed earnings. [269] A foreign investment company will be a PFIC if it is a foreign corporation and either a substantial portion of its assets consists of stock or securities or its income is mainly derived from stock or securities. [270] Under these rules, most foreign investment companies will be PFICs. Some foreign entities that are inadvertent investment companies for purposes of the Investment Company Act may not be PFICs, but a case-by-case evaluation is required.

The PFIC rules provide several alternative mechanisms for eliminating tax deferral on the undistributed earnings of a PFIC. If neither of the elections described below is made, "excess distributions" in respect of the PFIC shares and

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gain realized on the sale of the PFIC shares will be allocated over the shareholder's holding period and the U.S. shareholder's tax liability (*i.e.*, the applicable rate of tax and interest charges for deemed underpayments of tax) will be determined accordingly. [271]

Alternatively, if a "qualified electing fund" election is made, the U.S. shareholder will be required to include in gross income for each taxable year of the PFIC its share of the undistributed earnings of the PFIC. [272] The U.S. shareholder may, subject to an interest charge, elect to defer the payment of taxes on undistributed PFIC earnings included in income. [273] To enable its U.S. shareholders to make a qualified electing fund election, a foreign investment company whose potential investors include U.S. investors generally must separately calculate its income in accordance with U.S. tax principles and make this information available to its U.S. shareholders or provide its U.S. shareholders with sufficient access to its books and records to permit them to perform the required calculations. [274]

A third option is available generally for a U.S. shareholder of PFIC stock that is "marketable." [275] This option permits such a shareholder to elect to use a mark-to-market approach whereby it includes any increase or, to the extent of net prior mark-to-market inclusions, any decrease in the fair market value of its PFIC stock as of the close of the taxable year as ordinary income or loss. [276] Stock in a PFIC is marketable if it is regularly traded on a U.S. securities exchange or regulated foreign exchange satisfying certain specified requirements, or if the PFIC offers for sale or has outstanding stock that is redeemable at its net asset value in a manner similar to U.S.-registered investment companies. [277]

Because adverse tax rules apply to U.S. shareholders of a PFIC, equity securities of a foreign investment company may not be an attractive investment for taxable U.S. investors. However, U.S. pension funds and other tax-exempt investors should not be affected by the PFIC rules. Offering materials for equity securities of a foreign investment company that will be offered in the United States generally should indicate that the foreign investment company will be a PFIC and that U.S. investors will be subject to adverse U.S. tax rules applicable to U.S. shareholders of a PFIC.

[3] Anti-Money Laundering Compliance Obligations

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[a] Registered Investment Companies

Registered investment companies that operate as open-end investment companies, or "mutual funds," are required under the Bank Secrecy Act ("BSA") and the Financial Crimes Enforcement Network's ("FinCEN") implementing regulations thereunder to develop and implement an anti-money laundering program pursuant to § 352 of the PATRIOT Act. [278] In order to implement an anti-money laundering program under FinCEN's rules, a mutual fund is required to adopt written policies and procedures reasonably designed to ensure that it not be used to launder money. The mutual fund is also required to provide for periodic independent testing of the program, designate an anti-money laundering compliance officer and provide ongoing training to employees.

The BSA imposes additional requirements on mutual funds, many of which are similar to the applicable requirements for broker-dealers, discussed in § 14.07[4]. For example, mutual funds are required under § 326 of the PATRIOT Act to maintain a CIP (customer identification program) as part of their broader anti-money laundering program. [279] The CIP requirements for mutual funds are similar to the requirements summarized in § 14.07[4][d] for broker-dealers. Additionally, like broker-dealers, mutual funds are among the financial institutions required to identify and verify the identity of the beneficial owners of their legal entity customers under FinCEN's final customer due diligence rule issued in May 2016, the requirements of which are summarized in § 14.07[4][e]. [280] Mutual funds also are subject to FinCEN's information sharing rule, [281] which is summarized in § 14.07[4][f] as it relates to broker-dealers, and its private banking and correspondent account due diligence and enhanced due diligence rules, which are similarly summarized in § 14.07[4][g]. [282]

Mutual funds are also subject to reporting and record-keeping requirements, including a requirement to file suspicious activity reports with FinCEN

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based on criteria that are similar to the criteria that must be applied by broker-dealers, as described in § 14.08[3][a]. [283]

[b] Unregistered Investment Companies

In November 2008, FinCEN withdrew proposed rules that would have required certain types of unregistered investment companies, including certain hedge funds, real estate investment trusts, commodity pools and other investment funds and vehicles, to develop and implement an anti-money laundering program pursuant to § 352 of the PATRIOT Act. [284] In August 2015, FinCEN released proposed rules, which are summarized in § 16.15, that would impose AML compliance obligations on registered investment advisers pursuant to the BSA. [285] Due to the Dodd-Frank Act's expansion of the scope of investment advisers required to register with the SEC, the proposed rules would apply to many investment advisers to unregistered investment companies, such as hedge funds, private equity funds and other private funds, and would achieve similar coverage of the asset management industry as the proposed rules for unregistered investment companies withdrawn in 2008. [286]

Footnotes

217 Security futures products are defined both as securities and as futures contracts. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS TWELFTH EDITION, DERIVATIVES MARKETS, § 2.16[5].

218 *See* H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 306, *reprinted in* 1974 U.S.C.C.A.N. 5038, 5086.

219 § 404(a)(1)(B) of ERISA.

220 § 3(42) of ERISA; Labor Reg. § 2510.3-101(a)(2)(ii) and (f) under ERISA; *see* § 15.07[1][b]. Additionally, in April 2016, the Department of Labor issued a final rule defining who is a “fiduciary” of an employee benefit plan under ERISA. *See* § 14.07[1][a].

221 H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 306, *reprinted in* 1974 U.S.C.C.A.N. 5038, 5086.

222 § 404(a)(1)(B) of ERISA.

223 Labor Reg. § 2550.404a-1(b)(2)(i) under ERISA.

224 § 404(a)(1)(C) of ERISA.

225 § 3(42) of ERISA; Labor Reg. § 2510.3-101(a)(2) under ERISA.

226 "Equity interest" means any interest in an entity other than an instrument that is treated as indebtedness under applicable local law and that has no substantial equity features. Labor Reg. § 2510.3-101(b)(1) under ERISA.

227 "Publicly offered security" means a security which is: (i) part of a class of securities owned by more than 100 investors independent of the issuer and each other, (ii) freely transferable, which is determined by a facts and circumstances test, and (iii) either part of a class of securities (1) registered under § 12(b) or § 12(g) of the Exchange Act or (2) acquired by the plan in a U.S. public offering and subsequently and timely registered under § 12 of the Exchange Act. Labor Reg. § 2510.3-101(b)(2) under ERISA.

228 § 3(42) of ERISA; Labor Reg. § 2510.3-101(a)(2) and (f) under ERISA. In determining the ownership percentage of benefit plan investors, any interests held by a person who has discretionary authority or control with respect to the assets of the foreign fund or other entity or any person who provides investment advice for a fee (direct or indirect) with respect to any such assets or any affiliate of such a person is excluded. The 25% test must be met each time an acquisition of any equity interest in the foreign fund or other entity is made.

229 The exception for publicly offered securities is available only for securities publicly offered in the United States and/or registered under the Exchange Act. Other foreign entities that are inadvertent investment companies for purposes of the Investment Company Act may nonetheless be operating companies under the Plan Asset Regulations, but an evaluation must be made on a case-by-case basis.

230 An IRA is a written trust or custodial account to which eligible individuals may make cash contributions up to certain limits, with the benefit of tax-deferred buildup of income available for retirement. A Keogh plan is a qualified retirement plan established for the benefit of a self-employed individual.

231 § 3(42) of ERISA. With respect to a plan asset entity, its investment will be counted as an investment by a benefit plan investor only to the extent its own equity interests are held by benefit plan interests (*i.e.*, its

investment will be pro rated between benefit plan investor money and non-benefit plan investor money by reference to the proportion of its own equity interests held by benefit plan investors and non-benefit plan investors).

232 Labor Reg. § 2510.3-101(d) under ERISA.

233 Labor Reg. § 2510.3-101(c) under ERISA.

234 A "real estate operating company" ("REOC") is similar to a VCOC except that it is designed to invest in real property. A REOC must invest at least 50% of its assets in real estate that is managed or developed and with respect to which the entity has the right to substantially participate directly in the management or development activities. The entity must be engaged directly in real estate management or development activities in the ordinary course of its business. Labor Reg. § 2510.3-101(e) under ERISA.

235 §§ 406 and 3(14) of ERISA; *see also* I.R.C. § 4975(a), (b), (c) and (e)(2).

236 I.R.C. § 4975; §§ 409 and 502(1) of ERISA; *see also Harris Trust and Savings Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238 (2000).

237 In addition, if the assets of the foreign fund are deemed to be plan assets, the rules regarding holding plan assets outside the United States discussed in § 15.07[1][c] would apply to all of the assets of the foreign fund, which, in the case of a fund having assets other than securities or currency, would prove unworkable.

238 The term "indicia of ownership" means the documents that represent the pension fund's ownership interest, *e.g.*, a stock certificate, a bond or, according to a Department of Labor interpretation, an ADR. The latter means that if an ADR is maintained within the jurisdiction of the U.S. district courts, the underlying foreign security need not be maintained within the jurisdiction of the U.S. district courts. Preamble to Labor Reg. § 2550.404b-1 under ERISA, 42 Fed. Reg. 54,122, 54,122 (Oct. 4, 1977); Department of Labor Advisory Opinions 75-80 (Feb. 13, 1975) and 87-03A (May 5, 1987).

239 § 404(b) of ERISA.

240 Labor Reg. § 2550.404b-1(a)(1) under ERISA. "Foreign securities" include (i) securities issued by a person (other than an individual) that is not organized under the laws of the United States or any state and that does not have its principal place of business within the United States, (ii) securities issued by a foreign government or its instrumentalities and (iii) securities issued by a person (other than an individual), the principal trading market for which is outside the jurisdiction of the U.S. district courts. Foreign currency may only be held outside the jurisdiction of the U.S. district courts solely as an incident to the purchase, sale or maintenance of foreign securities.

241 Labor Reg. § 2550.404b-1(a)(2)(i) under ERISA.

242 Labor Reg. § 2550.404b-1(a)(2)(ii)(A) under ERISA.

243 *See* § 14.07[1][b], Note 309.

244 Labor Reg. § 2550.404b-1(a)(2)(ii)(B) and (C) under ERISA.

245 I.R.C. §§ 882(a)(1) and 884.

246 The safe harbor is nonexclusive and, in certain cases, a foreign investment company that does not meet all of the requirements for "safe harbor" treatment may nevertheless not be engaged in a U.S. trade or business under the relevant case law. *See, e.g.*, *Higgins v. Commissioner*, 312 U.S. 212 (1941). For example, a foreign investment company generally will not be engaged in a U.S. trade or business where it has a foreign-based investment adviser and no investment discretion is given to any agent in the United States at any time, no investment decisions are made in the United States and the investment company has no office or fixed place of business in the United States through which, or at the direction of which, transactions are effected.

247 I.R.C. § 864(b)(2)(A)(ii). The safe harbor applies to securities transactions effected by employees of the foreign investment company or through a U.S. broker, commission agent, custodian or other agent, whether or not the employee or agent has discretionary authority. The number of transactions effected in the United States is irrelevant. *See* Treas. Reg. § 1.864-2(c)(2)(i). A foreign investment company will be a dealer if it is regularly engaged in purchasing stocks or securities and selling them to customers. Treas. Reg. § 1.864-

2(c)(2)(iv). Under this rule, very few foreign investment companies will be considered to be dealers. Foreign investment funds may rely on a similar safe harbor for commodities trading activities, subject to certain additional requirements. I.R.C. § 864(b)(2)(B)(ii).

Certain investment-like activities of a foreign investment company may not qualify for the safe harbor. For example, originating loans to U.S. borrowers rather than purchasing loans as an investor may result in a foreign investment company being engaged in a U.S. trade or business. *See* I.R.S. A.M. 2009-010 (Sept. 22, 2009). Furthermore, a foreign investment company that invests in U.S. mortgages or mortgage-backed securities may be treated as engaged in a U.S. trade or business if it purchases distressed mortgages with a view to negotiating a workout with mortgagors or if it forecloses on a mortgage and as a result holds a direct interest in U.S. real estate.

248 I.R.C. § 875(1).

249 Under I.R.C. § 1446, a partnership that is engaged in a U.S. trade or business is required to withhold taxes in respect of a foreign partner's share of the partnership's effectively connected income. Special rules apply to publicly traded partnerships that are not treated as corporations for U.S. tax purposes. *See* Treas. Reg. § 1.1446-4.

250 *See* I.R.C. § 884.

251 *See* I.R.C. § 7704.

252 *See* I.R.C. § 897.

253 I.R.C. § 897(c)(3). Interests in publicly traded partnerships and trusts are subject to rules similar to those that apply to publicly traded corporations. *See* Treas. Reg. § 1.897-1(c)(2)(iv).

254 *See* I.R.C. § 897(h)(2), (k)(1). In addition, stock in a "real estate investment trust" will not be treated as a USRPI if held by certain publicly traded foreign investment corporations. *See* I.R.C. § 897(k)(2).

255 The "portfolio interest" exemption applies to interest paid on debt obligations issued after July 18, 1984. Interest will not qualify as "portfolio interest" if the foreign investment company owns, directly or indirectly, 10% or more of the voting stock of the issuer of the debt obligation. I.R.C. § 881(c)(3)(B). The portfolio interest exemption also is subject to certain other limitations.

256 I.R.C. § 881(a)(1). Whether investment income is considered to be from sources within the United States for U.S. withholding tax purposes is determined under special rules that vary depending upon the particular type of income received. In 2017, similar withholding rules will apply to payments on equity derivatives and other equity-linked instruments that are determined by reference to dividends from sources within the United States. *See* I.R.C. § 871(m).

257 I.R.C. § 1442(a).

258 A foreign investment company may be able to claim benefits on behalf of investors under a tax treaty with their home jurisdiction if such jurisdiction treats the foreign investment company as a pass-through entity such that individual investors are required to include their allocable share of income on their income tax returns and the investors would otherwise qualify for the benefits of such tax treaty if they had earned this income directly. Treas. Reg. § 1.894-1(d).

259 I.R.C. §§ 881(d) and 871(i)(2)(A). In order for the exemption to apply, interest received on the bank deposit must not be effectively connected with the conduct of a trade or business within the United States.

260 I.R.C. § 871(g)(1)(B)(i).

261 Under I.R.C. §§ 865(a)(2) and 865(g)(1)(B), capital gains of a foreign corporation generally will not be U.S. source income and thus will not be subject to U.S. withholding tax under I.R.C. § 881(a)(1). *See also* Treas. Reg. § 1.1441-2(a)(3), which states that gain from the sale of property is not fixed or determinable annual or periodical income.

As discussed above, special rules apply to gains realized on the sale of a ("USRPI"). *See* I.R.C. §§ 897 and 1445.

262 FATCA, originally titled the Foreign Account Tax Compliance Act, was enacted as part of the Hiring

Incentives to Restore Employment Act of 2010, Pub. L. No. 111-147 124 Stat. 71 (2001) (the "HIRE Act"). The FATCA rules are located in I.R.C., Chapter 4 (§§ 1471-1474) and the Treasury Regulations promulgated thereunder.

263 I.R.C. §§ 1471 and 1473(1)(A).

264 I.R.C. §§ 1471(d)(4) and 1471(d)(5).

265 *See* Treas. Reg. §§ 1.1471-2, 1.1472-1.

266 I.R.C. § 1471(b)(2) (FFI with no U.S. investors); I.R.C. § 1472(b) (foreign investment company that is not an FFI).

267 Treas. Reg. § 1.1471-3(c).

268 IRS Notice 2015-66, 2105-41 I.R.B. 541 (Sept. 18, 2015). However, payments on debt obligations issued prior to January 1, 2014 are generally not subject to FATCA withholding. Treas. Reg. § 1.1471-2(b). Debt obligations issued prior to the date six months after final regulations implementing gross proceeds withholding are similarly exempted from FATCA withholding on gross proceeds from their sale or disposition. Treas. Reg. § 1.1471-2(b)(i)(3).

269 *See* I.R.C. §§ 1291–98. Undistributed earnings of a foreign investment company may also be taxed to its U.S. shareholders under the rules of the I.R.C. relating to controlled foreign corporations (I.R.C. §§ 951–65). In most cases, however, a foreign investment company will not be a controlled foreign corporation. A foreign investment company will not be a controlled foreign corporation unless, on any day during its taxable year, more than 50% of the voting power or value of its stock is owned by U.S. persons that own (directly or indirectly) 10% or more of the voting power of the corporation.

270 I.R.C. § 1297(a).

271 I.R.C. § 1291.

272 I.R.C. § 1293.

273 I.R.C. § 1294.

274 The rules for making a qualified electing fund election are specified in I.R.C. § 1295 and Treas. Reg. § 1.1295-1.

275 I.R.C. § 1296.

276 I.R.C. § 1296(a). Losses are allowable only to the extent of net mark-to-market gains previously included by the shareholder with respect to such stock. I.R.C. § 1296(a)(2). Additionally, corresponding adjustments are made to a shareholder's tax basis in its PFIC stock to the extent of any income or loss included by the shareholder. I.R.C. § 1296(b).

277 I.R.C. § 1296(e); Treas. Reg. § 1.1296-2(d).

278 *See* 31 U.S.C. § 5318(h)(1); 31 C.F.R. § 1024.210.

279 *See* 31 C.F.R. § 1024.220 (Treasury); 17 C.F.R. § 270.0-11 (SEC); *see also* SEC, Division of Investment Management, Questions and Answers Regarding the Mutual Fund [CIP] Rule (31 C.F.R. § 103.131) (Aug. 11, 2003).

280 *See* Final CDD Rule, 81 Fed. Reg. 29,397, 29,409 (May 11, 2016); 31 C.F.R. § 1010.230.

281 *See* 31 C.F.R. §§ 1024.500–1024.540.

282 *See* 31 C.F.R. §§ 1024.600–1024.630; *see also* Letter from Investment Company Institute to FinCEN (Feb. 3, 2006) (requesting concurrence that § 312 does not apply to accounts opened by U.S. financial institutions with mutual funds for the purpose of effecting fund share transactions cleared and settled through the National Securities Clearing Corporation Fund/SERV system, even if the NSCC member firm's customer is a non-U.S. financial institution).

283 *See* 31 C.F.R. §§ 1024.300–1024.410; *see also* FinCEN, Frequently Asked Questions: SAR Requirements for Mutual Funds (Oct. 4, 2006).

284 *See* 67 Fed. Reg. 60,617 (Sept. 26, 2002), *withdrawn* 73 Fed. Reg. 65,568 (Nov. 4, 2008).

285 *See* Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680 (Sept. 1, 2015).

286 *See* Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680, 52,682 (Sept. 1, 2015).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.08, PROSPECTS FOR U.S. PUBLIC OFFERINGS BY FOREIGN FUNDS

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 § 15.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Section 7(d) of the Investment Company Act prohibits a public offering in the United States by a foreign investment company without an SEC order permitting its registration. [287] Such an order must be based on a finding that it is legally and practically feasible to enforce the Investment Company Act against the foreign investment company and that allowing the foreign investment company to register is consistent with the public interest and protection of investors. [288]

As a practical matter, the standard mandated by § 7(d) has proven exceptionally difficult to meet, [289] and few entities have succeeded in obtaining

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relief. [290] Indeed, SEC practice under § 7(d) has proven to be little more than a series of unsuccessful attempts to reconcile the statutory standard of § 7(d) to the demands of an international market.

Although, with the exception of Rule 7d-1 under the Investment Company Act, the SEC has proceeded on a case-by-case basis under § 7(d), it has provided some guidance as to factors relevant to its disposition of applications for relief. For many years, these guidelines were in fact based on Rule 7d-1. [291] Rule 7d-1 provides class relief under § 7(d) for Canadian management investment companies, on order of the SEC upon application, if the conditions of the rule are satisfied. While the SEC stated that the adoption of the rule was a recognition of the "high degree of comity that has prevailed between …[the United States] and Canada, the existing treaties, the proximity of the two countries, their joint heritage of the common law, and the essential similarity of statutes and law relating generally to corporations and the rights of stockholders," [292] the conditions of the rule in fact do little to recognize or accommodate differences between Canadian and U.S. securities laws. [293] Those conditions include, for example, requirements that a majority of the board of directors of the company be U.S. citizens of whom a majority are resident in the United States, that the company's charter or other constituent documents contain all of the substantive provisions of the Investment Company Act, which must be enforceable by the company's shareholders, and that all of the assets of the company be maintained in the United States. The rule requires, in effect, that the company be a U.S. investment company in all respects other than the location of its domicile. [294]

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Even subsequent to the adoption of Rule 7d-1 and the promulgation of the SEC's guidelines, few Canadian companies—and even fewer non-Canadian companies—sought or were granted the right to register under the Investment Company Act. [295] Not only have the requirements of the rule and the guidelines themselves been burdensome, but they also often conflict irremediably with local law applicable to a foreign investment company. In one well-known example—the attempt by the German company, Union-Investment-Gesellschaft mbH ("UI"), to register one of its funds, Unifonds, under § 7(d)—the Investment Company Act's terminology alone presented insurmountable obstacles. Whereas the Investment Company Act's definitions of "bank," "broker" and "underwriter" are derived from U.S. regulatory schemes that clearly separate these functions, under German law Unifonds was able to engage in banking, brokerage and underwriting activities. The consequences of the distinctions under the Investment Company Act are understood to have made compliance by UI and Unifonds with, for example, the requirements for independent members of the board of directors of UI and the restrictions imposed by the Investment Company Act on affiliated transactions uncertain at best. Nevertheless, after two years of negotiations, Unifonds reached agreement with the SEC as to the manner of its compliance with the provisions of the Investment Company Act, and the SEC finally published the Unifonds application for public comment. The publication drew objections from the Investment Company Institute—the most important of the investment company industry groups—which sought a public hearing as to the standards of § 7(d) and Unifonds's proposed compliance with the Investment Company Act. The prospects of such a hearing, which would likely have been lengthy and highly adversarial, prompted Unifonds to withdraw its application from consideration altogether.

The significance of these conflicts and the impediment posed by § 7(d) of the Investment Company Act to the internationalization of the securities markets have been repeatedly acknowledged by the SEC. Long before the issuance of the Concept Release, the SEC specifically requested public comment concerning appropriate standards for permitting increased access by foreign investment companies to the U.S. public market without sacrificing important concerns for investor protection. [296] In the wake of commentary that not only did not suggest

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any uniform solution to the difficult standard posed by § 7(d), but further highlighted the variety and number of obstacles encountered by foreign investment companies attempting to meet that standard, [297] the SEC determined to continue its historical practice of addressing registration of foreign investment companies on a case-by-case basis. The SEC nevertheless outlined certain conditions it would consider prerequisites to permitting registration of a foreign investment company, including that the company have a minimum three-year operating history, with at least $50 million in net assets at registration and $25 million at the time of any offering in the United States, and that the company undertake to limit U.S. investment to 50% of its total outstanding shares at the time of sale. [298] The SEC also imposed limitations on the portfolio investments of foreign companies seeking registration: a company must maintain at least 60% of the value of its portfolio in securities of issuers organized in its home country or 75% in securities of non-U.S. issuers. [299]

These additional guidelines stimulated so little activity under § 7(d) that in 1983 the SEC abandoned its efforts to formulate workable standards under § 7(d) and formally recommended that foreign investment companies consider forming a separate U.S.-domiciled company for purposes of raising capital in the U.S. public market. [300] The "mirror fund" approach—that is, the establishment of a separate U.S. registered investment company to be offered in the United States to invest in foreign securities that "mirrors" a non-U.S. fund offered outside the United States—effectively enables a foreign adviser to offer in the United States

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approximately the same product it offers outside the United States. However, the operations of the U.S. fund must be conducted within the framework of the Investment Company Act. In a 1996 no-action letter, the staff permitted the "bunching" of trades by a non-U.S. fund and its U.S.-registered mirror fund. [301] This bunching of trades and the subsequent allocation of proceeds was designed to lessen the trading inefficiencies of operating two separate funds.

The SEC staff's comprehensive review of the Investment Company Act in 1990 generated renewed interest in clarifying and ameliorating the operation of § 7(d). Among the staff's recommendations included in the 1992 Report was a call for legislative action to replace the standard imposed by § 7(d) with guidelines that would permit the SEC greater discretion in approving exemptive applications by foreign funds. The staff's proposed amendments would have authorized the SEC upon application to permit "operating foreign investment companies" [302] to make a U.S. public offering of their securities or otherwise to use U.S. jurisdictional means to offer or sell their securities, *if* (i) the SEC determines that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce" the Investment Company Act against the applicant and (ii) the SEC and the analogous authority in the domicile of the investment company have executed a "memorandum of understanding" providing for "regulatory cooperation and mutual recognition of investment company regulation by that country and the United States." [303]

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The staff's recommendations are unlikely to yield significant benefits for foreign funds. First, the staff proposed to retain the statutory standard required to be satisfied to receive an exemption that is currently provided in § 7(d). This standard has to date been the principal impediment to U.S. registration of foreign funds since it requires either that the foreign fund include all of the provisions of the Investment Company Act as part of its charter or that the fund make a detailed showing as to the comparability of local regulation to the Investment Company Act's requirements in the context of the fund's proposed activities. Moreover, this showing must be made separately by each applicant under § 7(d). The deficiencies of this approach have been amply demonstrated by the inability of all but a handful of foreign funds to make a U.S. public offering of their securities.

In addition, the staff added a requirement that had not previously been suggested for a memorandum of understanding with the jurisdictions in which acceptable funds are organized. This could provide a further obstacle to the introduction of foreign funds into the United States. On the other hand, if the staff were to make an otherwise workable proposal for the introduction of foreign funds into the United States, it is possible that the requirement for a memorandum of understanding could be satisfied in many jurisdictions.

Any foreign fund seeking authorization to register under the Investment Company Act would generally also require relief from certain of the Investment Company Act's provisions that may be inconsistent with the fund's home-country regulation. The staff's proposed amendments to § 7(d) would also authorize the SEC by rule or order to exempt any operating foreign investment company from any provision of the Investment Company Act, upon findings that (i) the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Investment Company Act, (ii) the "laws under which such company operates provide protections for investors that serve the same purposes as the protections provided by the provisions of [the Investment Company Act] from which exemption is requested or that specific conditions agreed to by the company provide such investor protections," and (iii) the company is not operated for purposes of evading Investment Company Act regulation. This approach would apparently replace, in the case of foreign funds, the existing exemptive procedure under § 6(c) of the Investment Company Act that requires that the SEC make only the findings described in clause (i) above. [304] The additional showing called for by the SEC's proposed amendments would likely entail—as in the case of registration orders—a detailed analysis of the comparability of local and U.S. investment company regulation. Although in the 1992 Report the SEC acknowledged that "the foreign regulatory system need not be identical to the provisions from which exemption is requested," [305] the staff stated that the SEC would need to find that

> the foreign law adequately addresses the same regulatory concerns and serves essentially the same purposes.…In making that finding, the [SEC] could consider the different regulatory requirements, customs, investment company business practices, and overall investment company regulatory framework in the jurisdiction in which the fund is organized. [306]

It is difficult to imagine how the revised standard, which appears only to increase the demonstrative burden of applicants while limiting the existing authority of the SEC under § 6(c) of the Investment Company Act, would expand the number of foreign funds able to access the U.S. public market. Indeed, given the SEC's authority under § 6(c), it is difficult to imagine why a second standard is at all necessary or desirable in the case of foreign funds, much less what role § 6(c) might play for those funds if the staff's recommendations were implemented. In this respect, the staff's proposal was in sharp contrast to an earlier SEC proposal to amend § 7(d) of the Investment Company Act. Among the conditions to the SEC's exemptive authority under that proposal was a finding that "compliance with the provision [for which exemption was requested] would be unduly burdensome because the company was organized or otherwise created under foreign law and invested primarily in foreign securities." [307] The ability of the SEC to consider the "burdens" of compliance with the Investment Company Act was criticized by many as providing an unfair advantage to foreign funds [308] and was expressly rejected by the staff in the 1992 Report. [309] If the universe of foreign funds operating in the United States is to expand, it is nevertheless this authority to weigh the relative benefits and burdens of compliance with the Investment Company Act that must be accorded to the SEC—a one-sided approach focusing exclusively on the benefits of U.S. regulation will, virtually by definition, fail to accommodate the often irreconcilable differences between U.S. and foreign regulators. Recent comments by the staff on opening the U.S. market to non-U.S. funds have focused on the ability of non-U.S. advisers to manage funds incorporated in the United States and not on increasing

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opportunities for non-U.S. funds. [310] Until the SEC takes any definitive action in this field, the guidelines provided in Rule 7d-1 under the Investment Company Act appear to be the best guidance available for the few companies that may seek relief under § 7(d). [311]

Footnotes

287 *See* § 15.06.

288 *See* § 7(d) of the Investment Company Act.

289 *See* SEC Release No. IC-8596 (Dec. 2, 1974); *see also* SEC Release No. IC-13691 (Dec. 23, 1983).

290 *See, e.g.*, *ASA Ltd.*, SEC Release Nos. IC-2739 (July 3, 1958) (notice of application) and IC-2756 (Aug. 13, 1958) (Order); *St. John D'el Rey Mining Company, Ltd.*, SEC Release Nos. IC-7861 (June 12, 1973) (notice of application) and IC-7885 (June 29, 1973) (Order); *Pan Australian Fund Ltd.*, SEC Release Nos. IC-7795 (Apr. 30, 1973) (notice of application) and IC-8028 (Oct. 10, 1973) (Order); *First American-Australian Investors Ltd.*, SEC Release Nos. IC-6460 (Apr. 15, 1971) (notice of application) and IC-6517 (May 12, 1971) (Order): *Worldwide Fund Ltd.*, SEC Release Nos. IC-3318 (Aug. 25, 1961) (notice of application) and IC-3327 (Sept. 18, 1961) (Order).

291 SEC Release No. IC-8959 (Sept. 26, 1975).

292 SEC Release No. IC-1945 (Jan. 28, 1954).

293 The difficult standard of § 7(d) has also resulted in the exclusion of foreign investment companies from other advantageous securities law developments. For example, the multijurisdictional disclosure system between the United States and Canada, discussed in Chapter 13, is not available for any entity subject to registration under the Investment Company Act.

294 Rule 7d-1 under the Investment Company Act also requires that each officer, director, investment adviser and principal underwriter for the company agree in writing to comply with the company's charter or other constituent documents and that failure to comply with that agreement will constitute a violation of the order issued by the SEC pursuant to Rule 7d-1. The company and each of its nonresident officers, directors and investment advisers must also agree to appoint the company's U.S. custodian as agent for service of process. Finally, the principal underwriter for the company must be a corporation organized under the laws of one of the states of the United States (or a person that is resident in and a citizen of the United States) with its principal place of business in, the United States, any accountant to the company must be qualified to act as an "independent public accountant" to the company within the meaning of the Securities Act and must have a permanent place of business in the United States and the company must maintain at least a copy of its books and records in the United States.

295 The SEC staff indicated that, as of March 19, 1999, only one Canadian fund was registered with the SEC. SEC Release No. IC-23745 (Mar. 19, 1999), 64 Fed. Reg. 14,648, 14,649 n.10 (Mar. 26, 1999).

296 SEC Release No. IC-8596 (Dec. 2, 1974).

297 Commenters representing foreign interests objected to a range of SEC regulation, including the *per se* rules prohibiting transactions with affiliates or interested persons, Letter from Crystal & Driscoll, P.C. (Jan. 30, 1975) ("Clearly, no other country has such stiff rules."); *see also* Letter from The Investment Trusts Association (Japan) (Mar. 11, 1975), structural differences between U.S. and foreign funds, Letter from Save & Prosper Group Ltd. (Jan. 27, 1975) ("[T]he majority of European funds are of a contractual, rather than corporate structure."), voting requirements, Letter from Leva, Hawes, Symington, Martin & Oppenheimer (Aug. 8, 1974) ("The German Investment Company Act does not permit, and most certainly does not contemplate, giving voting rights to investors.…"), and corporate governance matters, Letter from the Ministry of Finance of Japan (Mar. 1, 1975) (the requirement for a majority of independent members of a fund's Board of Directors is inconsistent with the Japanese-approved contractual form of investment trust).

298 SEC Release No. IC-8959 (Sept. 26, 1975).

299 SEC Release No. IC-8959 (Sept. 26, 1975). Under the SEC's guidelines, an applicant would also have to provide certain information, such as a comparison of applicable foreign law and a section-by-section description of each provision of the Investment Company Act with which the applicant was unable or unwilling to comply, together with an explanation for the proposed noncompliance.

300 SEC Release No. IC-13691 (Dec. 23, 1983). Legislative attempts to relax the standard imposed by § 7(d) have also been unsuccessful. *See, e.g.*, H.R. 8256, 93d Cong., 1st Sess. (1973) (bill to amend § 7(d) to permit the SEC, in considering applications under § 7(d), to "take into account the differing laws, regulations, customs, and business conditions of particular countries in which such companies are organized and the adequacy of existing regulation in such countries"). In 1984, the SEC again attempted to encourage Congress to increase the SEC's flexibility in granting orders under § 7(d) by proposing amendments to the statutory standard. In particular, the amendments would have permitted the SEC, under its rulemaking and exemptive authority, to grant exemption from any provision of the Investment Company Act to a foreign operating investment company upon findings that:

> (1) compliance with such provision would be unduly burdensome because the company is organized or otherwise created under foreign law and invests primarily in foreign securities, (2) the laws under which such company operates provide protections for investors which serve the same purposes as the protections provided by the provisions of [the Investment Company Act] from which exemption is requested or that specific conditions agreed to by the company provide such investor protections, (3) the exemption is consistent with the protection of investors and the purposes fairly intended by the policy of [the Investment Company Act], and (4) such company is not operated for the purpose of evading the provisions [of the Investment Company Act].…

See Letter from John S.R. Shad, Chairman, SEC, to Thomas P. O'Neill, Jr., Speaker of the U.S. House of Representatives (Jan. 31, 1984), introduced for consideration by the House.

301 *Banque Indosuez Luxembourg* (avail. Dec. 10, 1996).

302 The staff's proposal defined an "operating foreign investment company" as a company that is not organized or otherwise created under the laws of the United States or of a State, is primarily engaged in investing in securities of non-United States issuers, and at all times during the three-year period immediately preceding the filing of an application for registration under this title has met criteria prescribed by [SEC] rule or order to demonstrate that it is a *bona fide* operating foreign investment company. 1992 Report at 102.

303 1992 Report at 102.

304 *See* § 15.05[7].

305 1992 Report at 206.

306 1992 Report at 206.

307 Letter from John S.R. Shad, Chairman, SEC, to Thomas P. O'Neill, Jr., Speaker of the U.S. House of Representatives (Jan. 31, 1984). The SEC's proposed legislation was never introduced in Congress. 1992 Report at 199.

308 1992 Report at 199.

309 1992 Report at 206.

310 Paul F. Roye, Director, SEC Division of Investment Management, Remarks before the *Fédération Européene des Fonds et Sociétés d'Investissement, Regulation of Mutual Funds in the United States—A Successful Regulatory Regime* (Sept. 22, 2000). Roye stated that approximately 13% of the U.S.-registered open-end funds are managed by non-U.S. advisers, as are 12% of closed-end funds.

311 *See ASA Ltd.*, SEC Release Nos. IC-26582 (Aug. 27, 2004) (notice of application) and IC-26602 (Sept. 20, 2004) (Order); *cf. Man-Glenwood Lexington TEI, LLC* (avail. Apr. 30, 2004) ("The [SEC] has required non-Canadian, non-U.S. investment companies seeking registration orders under section 7(d) of the [Investment Company] Act to comply with the conditions of rule 7d-1."); *see also Alternative Investment Partners Absolute Return Fund STS* (avail. July 10, 2006).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.09, SPECIAL ISSUES FOR U.S. FUNDS HOLDING FOREIGN 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 § 15.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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As a natural consequence of the SEC's "mirror fund" approach to enabling foreign portfolio investment by U.S. investors and the desire of many U.S. investors to have increased investments in non-U.S. securities, many fund sponsors have established U.S.-domiciled investment companies that invest in part or primarily in foreign securities. [312] These funds are generally closed-end management investment companies (though some are open-end) established in the United States and registered under the Investment Company Act. Investment objectives have included investing principally in the securities of a number of countries other than the United States (so-called "international funds"), in the securities of a number of countries including the United States (so-called "global funds") or in the securities of a single country (so-called "country funds"). [313]

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In addition to local law requirements and the requirements of the Investment Company Act, a fund designed to invest in foreign securities can raise issues beyond those faced by investment companies generally, certain of which are summarized below.

[1] Fund Structure and Investments

A fund investing in foreign securities must of course comply with the laws of the foreign country or countries in which it invests, and an early examination of applicable foreign investment, exchange control, securities and tax laws must therefore be made to ensure that the fund's investment objectives can be accomplished. Particular attention should be directed to restrictions on investments in specific sectors or industries, exchange controls that could affect conversion of local currency into dollars, the availability of repatriation guarantees and related governmental approvals and taxation (including applicability of withholding taxes) of payments to nonresidents, such as the fund, of dividend and interest income and of capital gains. Where a local investment vehicle is used to avoid some of these issues, the vehicle must be structured so that it is not a separate investment company subject to the Investment Company Act. Section 12(d) of the Investment Company Act imposes strict limitations on the ability of a registered investment company to invest in securities of other investment companies. [314]

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Where the local vehicle may have too much substance to be disregarded as a separate entity, the fund may attempt to take advantage of § 12(d)(1)(E) of the Investment Company Act, which provides an exemption from the limitation on holdings of another fund imposed by § 12(d) where the U.S.-registered fund holds only securities of the second-tier fund and U.S. government securities and meets certain other requirements. [315] Recent amendments to § 12(d)(1) by the NSMIA have made these issues easier to address in certain circumstances. [316]

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Management investment companies must be classified under the Investment Company Act as either "diversified" or "nondiversified." To be classified as "diversified," at least 75% of the value of the fund's total assets must be represented by cash, U.S. government securities and other securities limited in respect of any one issuer to an amount not greater in value than 5% of the total assets of the fund and not more than 10% of the outstanding voting securities of such issuer. [317] A fund that elects to be classified as "nondiversified" is not required to meet these tests, but will still be subject to the diversification requirements of U.S. federal tax laws described below.

For purposes of both the Investment Company Act and U.S. tax laws, securities issued by foreign governments are treated in the same manner as securities issued by private companies; they do not benefit from the same treatment accorded to U.S. government securities. To date, neither the SEC nor the IRS has taken formal action permitting a country fund to substitute securities of its "host" government for those of the United States in satisfying the diversification tests. This may affect the short-term management of a country fund during the initial start-up period and during any period in which the portfolio manager believes a defensive posture is appropriate. Difficulties can be particularly acute where local exchange control rules restrict or prohibit free exchange from local currency into U.S. dollars or transfer of currency out of the local jurisdiction after liquidation of local investments, since in such cases the ability to invest in U.S. government securities for defensive or cash management purposes may be limited.

[2] Custody

Use of foreign custodians for foreign portfolio securities must comply with applicable SEC rules. Under a previous version of Rule 17f-5 under the Investment Company Act, the principal alternatives were:

- a local branch or office (where one exists) of a U.S. bank that qualifies as a custodian under the Investment Company Act, in which case no specific additional rules must be complied with;
- a banking institution organized under the laws of a foreign country, in which case the foreign institution must meet certain requirements under Rule 17f-5 under the Investment Company Act;
- a non-U.S. securities depositary or clearing agency that operates "the system for the central handling of securities or equivalent book-entries" in the

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  foreign country of its organization and that is regulated by a "foreign financial regulatory authority"; or
- a non-U.S. securities depositary or clearing agency that operates a "transnational system for the central handling of securities or equivalent book-entries." [318]

This issue was a significant problem for registered investment companies seeking to invest in a jurisdiction where securities can only be held through a depositary in book-entry form and where there is not clearly a single depositary that is "the central system" in the jurisdiction. [319] In certain cases, the SEC staff has granted no-action relief, although the bases for relief have varied substantially as a result of the differences in the practices among the countries in question. [320]

Recognizing the substantial difficulties associated with foreign custody issues, the SEC amended Rule 17f-5 under the Investment Company Act in 1997 to expand the types of institutions that may serve as custodians. [321] The SEC delayed implementation of the new amendments twice, [322] in response to industry concerns and finally implemented the changes in 2000. [323] Revised Rule 17f-5 applies only to funds maintaining assets with a foreign bank custodian and not to

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custody arrangements with foreign securities depositaries. [324] The revised rule permits a fund to utilize "eligible foreign custodians," which are regulated non-U.S. banks or majority-owned direct or indirect subsidiaries of U.S. banks or bank holding companies. [325] In selecting such a foreign custodian, a fund's board must ensure that certain standards are observed in (i) selecting the custodian, (ii) establishing contractual relations with the custodian and (iii) monitoring the appropriateness of maintaining the arrangement. [326]

Partly in response to the industry's concerns regarding Rule 17f-5, the SEC adopted Rule 17f-7 under the Investment Company Act to govern custody arrangements with foreign securities depositaries. [327] Under Rule

17f-7, funds may maintain their foreign assets only with an "eligible securities depositary," which must: (i) operate a central system for handling securities and be regulated by a foreign financial regulatory authority, (ii) hold the fund's assets under conditions no less favorable than those that apply to other participants, (iii) maintain records identifying the assets of each participant and keep the depositary's own assets separate, (iv) provide periodic reports to participants, and (v) be subject to periodic review by regulatory authorities or independent accountants. [328] To comply with Rule 17f-7, the fund or its adviser must receive from its primary custodian (or its agent) an initial risk analysis of the depository arrangements with the depository, and the fund's contract with its primary custodian must state that the custodian will monitor risks and promptly notify the fund or its adviser of

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material changes in risks. The primary custodian and other custodians also must agree to exercise reasonable care in this regard. [329]

[3] Investment Advisers

A fund may be set up to have a single investment adviser or a number of investment advisers, each with responsibility for a different portion of the fund's portfolio or with one or more sub-advisers. Any investment adviser to a registered investment company, including a foreign adviser or sub-adviser, is required to register under the Advisers Act. The SEC staff has taken the position that the recordkeeping and reporting requirements and certain other rules of the Advisers Act apply to a registered investment adviser in respect of both U.S. and foreign customers, and that the Advisers Act in certain circumstances can apply to or result in the imposition of requirements on affiliates of registered advisers. [330]

[4] Disclosure

In addition to registering under the Investment Company Act, funds making public offerings in the United States must register the offerings under the Securities Act. Special disclosure forms have been designated by the SEC for the Securities Act registration of investment companies. These forms include disclosure requirements particular to investment companies, including regarding investment objectives, trading policies, advisory arrangements, fund expenses, accounting policies for derivatives [331] and many others. Prospectuses of funds investing in foreign securities generally contain disclosure relating to the securities markets and economic and political background of the countries in which they plan to invest, as well as the effect of local laws on the ability of the fund to invest, reinvest and hold securities and to comply with U.S. requirements. The level of disclosure depends on a number of factors, including the percentage of

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the fund's assets expected to be invested in a particular country. The disclosure can also be expected to depend on the degree to which the country's economy, political system and securities markets present special risks.

[5] U.S. Taxation

Like other U.S.-registered investment companies, a fund investing in foreign securities can effectively avoid most U.S. federal income tax at the corporate level if it meets certain requirements. [332] While a complete discussion of tax issues for registered investment companies is beyond the scope of this book, the following summarizes the principal requirements for the operation of such a company to effectively avoid taxation at the corporate level.

First, the fund must be registered under the Investment Company Act. [333] Second, the fund must meet certain diversification requirements. It generally may not invest more than 25% of its assets in the securities of any one issuer, including any foreign government. [334] At least 50% of its assets must be invested in cash, U.S. government securities and securities of issuers each of which does not represent more than 5% of the fund's assets. [335] Third, at least 90% of the fund's gross income must derive from interest, dividends, gains from the sale or other disposition of securities or foreign currency and certain other categories of income related to securities investment. [336] Fourth, the fund must distribute to shareholders at least 90% of its net investment income from interest, dividends, options and the like and short-term capital gains (net of long-term capital losses). [337] Income subject to the distribution requirements includes realized gains attributable to currency fluctuations. It is therefore important that local exchange control regulations be flexible enough to permit the fund to repatriate a sufficient portion of its earnings to cover required distributions.

Under current law, the fund will be subject to U.S. federal income tax on net long-term capital gains (reduced by any net short-term capital losses) and other investment income not distributed to shareholders and a 4% excise tax to the extent the fund does not distribute 98.2% of its capital gains and 98% of its other net income. [338] Income tax paid by the fund on undistributed long-term capital gains (but not the excise tax) may be claimed as a credit by shareholders. [339]

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These distribution requirements make accumulation of realized gains by U.S.-registered investment companies burdensome and potentially costly. As a result, many U.S. funds have dividend reinvestment plans. Reinvested dividends generally are treated as distributed dividend income for U.S. tax purposes. [340]

Payments on foreign securities held by a U.S. investment company may be subject to withholding taxes imposed by the country from which the payments are sourced. If more than 50% of the total value of the fund's assets is invested in stocks or securities of foreign corporations as of the end of the taxable year, the fund may elect to pass-through the foreign tax credit to its shareholders who, if they are U.S. taxpayers, can thus obtain the benefit of the credit. [341] As a consequence of the election, the shareholders (including shareholders that are not U.S. taxpayers) are treated as receiving, and the fund is treated as distributing, a dividend equal to the amount of foreign taxes paid and each shareholder that is a U.S. taxpayer is entitled to a foreign tax credit or deduction for his or her proportionate share of such amount. [342]

Non-U.S. shareholders generally will be subject to withholding tax at a rate of 30% in respect of dividends paid by a U.S. investment company, subject to reduction by an applicable tax treaty. [343] It therefore may not be tax-efficient for non-U.S. persons to invest in foreign securities through U.S. investment companies.

Footnotes

312 For a description of certain issues that can arise when non-U.S. investment companies seek to invest in U.S. securities, *see* § 3.05[1], Note 521 (discussing certain restrictions applicable to participation in U.S. initial public offerings).

313 The SEC staff has provided guidance as to when a registrant may use the terms "international" and "global" in the name of a fund and requires that the name of a particular region or country be used where the fund will have a concentration of investments in that region or country. *See, e.g.*, Letter from SEC, Division of Investment Management, to Registrants (Feb. 22, 1993) (citing Letter from SEC, Division of Investment Management, to Registrants (Jan. 3, 1991)). For these purposes, a fund may count securities of issuers (i) that are organized under the laws of the particular country, (ii) for which the principal securities trading market is in that country or (iii) that derive a significant proportion (at least 50%) of their revenues or profits from goods produced or sold, investments made or services performed in the country or that have at least 50% of their assets situated in that country. Letter from Registrants, SEC, Division of Investment Management, to Registrants (Feb. 22, 1993) (citing Letter from SEC, Division of Investment Management, to Registrants (Jan. 3, 1991)). Note, however, that under Rule 35d-1 under the Investment Company Act adopted January 17, 2001, in order for a registered investment company to have a name suggesting that it focuses on a particular type of investment, the company must invest at least 80% of its assets in the type of investment suggested by its name. Rule 35d-1 under the Investment Company Act; *see also* SEC, Division of Investment Management, Frequently Asked Questions about Rule 35d-1 (Investment Company Names) (Dec. 4, 2001).

314 The limitations on a so-called "fund of funds" prohibits, subject to certain exceptions, a registered investment company (and companies under its control) from investing in the securities of another investment company if, after the acquisition, the acquiring group of companies owns in the aggregate: (i) more than 3% of the voting stock of the acquired company, (ii) securities of the acquired company representing more than 5% of the value of the total assets of the acquiring group of companies or (iii) securities of the acquired company and all other investment companies representing more than 10% of the value of the total assets of the acquiring group of companies. § 12(d)(1)(A) of the Investment Company Act. The restriction on purchasing more than 3% of the voting stock of another investment company applies in the case of investments made by a registered investment company in a fund relying on § 3(c)(1) or § 3(c)(7) of the Investment Company Act and investments by such a fund in securities of any registered investment company. Sales by a registered open-end investment company of its securities to any other investment company are similarly constrained. §§ 12(d)(1)(A) and 12(d)(1)(B) of the Investment Company Act. The SEC has adopted rules that to a certain extent expand the circumstances in which an investment company may invest in shares of another investment company. SEC Release No. IC-27399 (June 20, 2006).

The SEC staff has under certain circumstances taken the position that § 12(d) will not apply to a fund's investment through the vehicle of another fund where the fund is U.S. domiciled and is the sole owner, and will control the management and investment policies, of the vehicle and the arrangement will not result in any additional sales load to the fund or significant duplicative custodian fees or other costs to fund shareholders. *See, e.g.*, *The Spain Fund, Inc.* (avail. Mar. 28, 1988). The SEC staff has also taken the position in such cases that the offering is not an indirect offering of a foreign investment company in violation of § 7(d) of the Investment Company Act. The SEC staff has extended this reasoning to a three-tier fund structure where a registered closed-end investment company invested only in the securities of an offshore fund that, in turn, invested only in the securities of another registered closed-end fund. *Man-Glenwood Lexington TEI, LLC* (avail. Apr. 30, 2004).

The SEC staff has permitted a registered closed-end investment company to acquire securities of foreign investment companies in excess of the limitations on such ownership imposed by § 12(d)(1)(A) of the Investment Company Act. *The France Growth Fund, Inc.* (avail. July 15, 2003). In granting the requested no-action relief, the SEC staff relied, among other things, on the fact that the relevant foreign investment companies would not acquire securities of other investment companies. However, in the context of a fund of funds arrangement previously permitted under an exemptive order, the staff recently permitted the acquired companies in the fund of funds structure to acquire the securities of unaffiliated investment companies for short-term cash management purposes, even in excess of § 12(d)(1)(A) limits. *John Hancock Trust, et al.* (avail. Apr. 12, 2012).

The SEC staff also stated that it would not recommend enforcement action under § 7(d) of the Investment Company Act because the registered investment company would only acquire securities issued by foreign investment companies that conducted offerings of their securities in the United States or to U.S. persons in accordance with § 3(c)(7) of the Investment Company Act and would comply with the diversification requirements of § 5(b)(1) of the Investment Company Act. *See* text accompanying *infra* Note 317. Because the registered investment company was not currently engaged in a public offering of its shares, the SEC staff expressly did not consider whether the registered investment company's proposed actions would constitute an indirect public offering or sale of the foreign investment company's securities in the United States.

315 *See The Thai Fund, Inc.* (avail. Nov. 30, 1987) (confirming the availability of the exception provided by § 12(d)(1)(E) of the Investment Company Act and also granting no-action relief with respect to § 7(d)); *see also The Thai Fund*, SEC Release Nos. IC-16066 (Oct. 21, 1987) (notice of application) and IC-16130 (Nov. 17, 1987) (Order) (providing an exemption with respect to the requirement of § 12(d)(1)(E) of the Investment Company Act that all principal underwriters of the fund be U.S.-registered broker-dealers).

316 Such amendments added a new § 12(d)(1)(G) to the Investment Company Act that provides an additional exemption for investments by registered open-end investment companies in securities of other open-end

investment companies or unit investment trusts if (i) they are both part of the same group of investment companies (defined as two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services) and (ii) securities of the acquired company, securities of other registered open-end investment companies and unit investment trusts that are part of the same group of investment companies, government securities and short-term paper are the only investments held by the acquiring company.

317 § 5(b)(1) of the Investment Company Act.

318 17 C.F.R. § 270.17f-5 (1997).

319 If a jurisdiction has no system that may qualify under Rule 17f-5 and applicable law prohibits the holding of local securities outside that jurisdiction or there is no practical alternative manner of satisfying the requirements of § 17(f), it appears that some investment companies have used derivatives to achieve synthetic positions in the local securities. Some have also argued that where equity securities are represented by American deposit receipts ("ADRs"), there is no need for a Rule 17f-5 custodian other than with respect to the ADRs. This argument assumes that the depositary for the shares bears the custodial risk with respect to the underlying equity securities.

320 *See, e.g.*, *ING Bank N.V.* (avail. May 24, 1999); *Templeton Russia Fund Inc.* (avail. Apr. 18, 1995); *Jardine Fleming China Region Fund, Inc.* (avail. Apr. 26, 1993); *Custody of B Shares Trading on the Shenzhen and Shanghai Securities Exchanges* (avail. Apr. 26, 1993).

In the case of China, the SEC concluded in *Custody of B Shares* that each of several nonoverlapping depositaries operating book-entry systems in a single jurisdiction with respect to the same class of shares could act as custodian for a registered investment company, based in part on the fact that each of the depositaries for shares trading on the Shenzhen Securities Exchange was (i) either a foreign branch of a U.S. bank having capital, surplus and undivided profits at least equal to $500,000 or a foreign branch of a foreign bank having shareholders' equity of at least $200 million and (ii) the sole depositary for a particular issue of a class of shares. In the case of shares traded on the Shanghai Securities Exchange, the SEC granted no-action relief, subject to satisfaction of certain conditions, based on the fact that the depositary in question was the "central" book-entry depositary and sole clearing agent, transfer agent and registrar of all shares of the class traded on that Exchange.

321 SEC Release No. IC-22658 (May 12, 1997).

322 SEC Release No. IC-23201 (May 21, 1998); SEC Release No. IC-23815 (Apr. 29, 1999).

323 SEC Release No. IC-24424 (Apr. 27, 2000); *see also* SEC Release No. IC-23815 (Apr. 29, 1999).

324 Rule 17f-5 under the Investment Company Act. Arrangements with foreign depositaries are addressed by Rule 17f-7 under the Investment Company Act, discussed below.

325 Rule 17f-5 under the Investment Company Act. *See also The Brink's Company* (avail. Feb. 11, 2014) (granting relief from the requirements of § 17(f)(1) of the Investment Company Act to registered investment companies that place their gold bullion and other precious metals in the custody of a vault services company in the United Kingdom, where such company was not an entity permitted to serve as a custodian to a registered investment company pursuant to the rules and regulations adopted under § 17(f)).

326 SEC Release No. IC-24424 (Apr. 27, 2000).

327 SEC Release No. IC-24424 (Apr. 27, 2000). The SEC has declined to apply the requirements of Rules 17f-5 and 17f-7 under the Investment Company Act to funds that hold securities with a U.S. depositary that are ultimately custodied with a foreign custodian or depositary. SEC Release No. IC-25934 (Feb. 13, 2003), 68 Fed. Reg. 8438, 8441 (Feb. 20, 2003).

328 Rule 17f-7 under the Investment Company Act. Rule 17f-7 states that "a system for the central handling of securities" has the meaning set forth in Rule 17f-4 under the Investment Company Act. This definition was removed from Rule 17f-4, however, after recent changes to that provision. The SEC staff has stated that until it corrects this discrepancy, it would interpret "a system for central handling of securities" consistently with the definition previously included in Rule 17f-4, as "a system where all securities of any particular class

or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of the securities." *Austraclear Ltd.* (avail. Apr. 28, 2004).

329 Rule 17f-7(a)(1) under the Investment Company Act; SEC Release No. IC-24424 (Apr. 27, 2000).

330 *See* § 16.02.

331 *See also* Memorandum from SEC, Division of Investment Management, Regarding Mutual Funds and Derivative Instruments 11 (Sept. 26, 1994); Letter to the Investment Company Institute Regarding Derivative-Related Disclosures by Investment Companies (July 30, 2010). The SEC's Division of Investment Management has indicated that if more than 5% of a fund's net assets are at risk from its involvement in derivative instruments and transactions, its prospectus should: (i) identify the types of derivative transactions in which it will engage, (ii) briefly describe the characteristics of such transactions or instruments, (iii) state the purpose for which the fund will use derivatives, and (iv) identify the risks of derivative instruments and transactions. Letter from SEC, Division of Investment Management, to Registrants (Feb. 25, 1994). Certain uses of exchange-traded futures contracts and options on futures by registered investment companies can implicate the provisions of the CEA applicable to commodity pool operators.

332 I.R.C. Chapter 1, Subchapter M (§§ 851-860G) provides for the U.S. federal income taxation of regulated investment companies.

333 I.R.C. § 851(a)(1).

334 I.R.C. § 851(b)(3)(B).

335 I.R.C. § 851(b)(3)(A).

336 I.R.C. § 851(b)(2).

337 I.R.C. § 852(a)(1).

338 I.R.C. § 4982.

339 I.R.C. § 852(b)(3)(D)(ii).

340 *See* I.R.C. § 305(b)(1); Rev. Rul. 79-42, 1979-1 C.B. 130.

341 I.R.C. § 853.

342 I.R.C. § 853. Non-U.S. shareholders of a U.S. investment company that are not U.S. taxpayers generally would not benefit for tax purposes in their local jurisdiction from this special U.S. regime for tax credits.

343 I.R.C. §§ 871(a)(1)(A) and 881(a)(1); *see also* Treas. Reg. § 1.1441-6. However, certain capital gains dividends are not subject to U.S. withholding tax. I.R.C. § 852(b)(3)(B); Treas. Reg. § 1.1441-3(c)(2)(i)(D).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.10, ENFORCEMENT

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 § 15.10 (11th and 12th Editions 2014-2017)
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The SEC possesses broad powers of enforcement under the Investment Company Act that extend not only to registered investment companies but also to other persons, including funds that are exempt from the Act's registration and reporting requirements. For instance, §§ 42(a) and 42(b) empower the SEC to conduct investigations to determine whether any violation of the Investment Company Act has occurred. In addition, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("SERPSA") [344] significantly expanded the ability of the SEC to seek civil penalties. Pursuant to SERPSA, the SEC may seek up to $150,000 against a natural person and up to $725,000 against an entity

for violations of the Investment Company Act. [345] Further, SERPSA enables the SEC to order respondents to "cease and desist" from any act or practice that violates the Investment Company Act and to "take steps to effect compliance" with the Act. [346] Although notice and opportunity for hearing are generally required in connection with SEC hearings, in certain emergency situations, the SEC may issue temporary orders to persons that are subject to regulation, such as brokers, dealers, investment advisers, investment companies, etc., without a hearing. [347]

The SEC is also able to seek temporary and permanent injunctions in court to curtail any violations of the Investment Company Act and to enforce compliance with the Act. [348] Any evidence of violations may also be referred by the SEC to the Department of Justice for the institution, at the Department of Justice's discretion, of criminal proceedings.

In addition, under § 47 of the Investment Company Act, any contract that violates the Investment Company Act is void and unenforceable and, to the extent such a contract has been performed, may be rescinded, unless in either case a court finds that enforcement of the contract would produce a more equitable result. [349]

One court has held that an implied private right of action exists under § 7(d) of the Investment Company Act for claims brought against non-U.S. investment companies for publicly offering their securities through U.S. jurisdictional means without registering with the SEC. [350] These nonregistration claims are subject to a one-year limitation period. [351] Subsequent cases, however, have adopted more restrictive approaches to finding implied rights of action under other provisions of the Investment Company Act, calling into question whether other courts would find an implied private right of action under § 7(d). [352]

Footnotes

344 Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990); *see* § 14.11[2][b] for a discussion of the relevant SERPSA provisions in the Exchange Act.

345 § 42(e) of the Investment Company Act; 17 C.F.R. § 201.1004, Table IV to Subpart E of Part 201.

346 § 9(f)(1) of the Investment Company Act.

347 § 9(f)(3) of the Investment Company Act.

348 § 42(d) of the Investment Company Act.

349 The SEC possesses additional enforcement powers under the Investment Company Act that are applicable only to registered investment companies, including the authority to inspect accounts, books and other

records of a registered investment company pursuant to § 31(b) of the Investment Company Act and the power to bring court actions in situations involving a breach of fiduciary duty pursuant to § 36 of the Investment Company Act.

350 *Blatt v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 916 F. Supp. 1343, 1350–52 (D.N.J. 1996) (implying a one-year limitation period for nonregistration claims under § 7(d) of the Investment Company Act by analogy to the express limitations period provided for nonregistration claims under § 12(a)(1) of the Securities Act).

351 *Blatt v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 916 F. Supp. 1343, 1352 (D.N.J. 1996).

352 *See Olmsted v. Pruco Life Insurance Co.*, 283 F.2d 429, 434, 436 (2d Cir. 2002) (declining to find a private right of action for violations of §§ 26(f) and 27(i) of the Investment Company Act and noting that, although "an overwhelming majority of courts interpreting the [Investment Company Act] have recognized implied private rights of action to enforce many of its sections," many of those cases were decided when "courts had more latitude to weigh statutory policy and other considerations than they do now"); *see also In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation*, 272 F. Supp. 2d 243, 258 (S.D.N.Y. 2003) ("Notably, since the Second Circuit's decision in *Olmsted*, there appear to have been no decisions in which a court has found an implied private right of action under any section of the [Investment Company Act]."); *meVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners, L.P.*, 260 F. Supp. 2d 616, 621–25 (S.D.N.Y. 2003).

U.S. Regulation of the International Securities and Derivatives Markets, § 15.11, APPLICATION OF STATE SECURITIES LAWS

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 § 15.11 (11th and 12th Editions 2014-2017)
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In light of the effective prohibition of § 7(d) of the Investment Company Act on public offerings in the United States by foreign-domiciled investment companies, most such companies may only offer their securities in the United States on a private placement basis in order to be exempt from registration under both the Investment Company Act and the Securities Act. Exemptions from state securities law registration requirements are also generally available for such offerings since they are typically marketed to U.S. institutional investors (as distinguished from the general or "retail" public). In 1996, the NSMIA amended § 18 of the Securities Act to provide for federal preemption of any state laws and regulations requiring registration of securities or securities transactions that apply to a "covered security." Among other categories of "covered securities"described in the NSMIA that might apply to private offerings of foreign-domiciled investment companies as described above, securities that are offered or sold to "qualified purchasers," as such term is to be defined by the SEC by rule, are preempted. This development should facilitate marketing such offerings in all 50 states in a uniform manner. [353] Currently, however, although state laws provide exemptions for sales of securities to specified types of institutions, including banks, broker-dealers and insurance companies, the types of institutions to which exempt sales may be made can vary from state to state, as can other state securities law requirements incidental to the availability of an exemption thereunder. [354] The NSMIA provides for preemption of state securities registration and filing requirements with respect to "covered securities" in certain transactions that are exempt from federal registration requirements pursuant to regulations promulgated by the SEC under § 4(a)(2) of the Securities Act. Such offerings would include those exempted by Rule 506 of Regulation D under the Securities Act; however, technically, securities offered pursuant to § 4(a)(2) itself

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would not be considered "covered securities," as they are not exempt "pursuant to … regulations issued under" § 4(a)(2) of the Securities Act.

Where, on the other hand, a sponsor elects to follow the SEC's "mirror fund" approach and establish a U.S. registered investment company to invest in foreign securities for purposes of conducting a U.S. offering and market the fund's shares to the general public, the offering typically will also be subject to the registration requirements of state securities laws. In the past, registration under these statutes could lead to a significant additional administrative burden and expense. However, pursuant to the preemptive provisions of the NSMIA, one of the categories of preempted "covered securities" consists of any security issued by an investment company registered under the Investment Company Act or that has filed a registration statement thereunder. Accordingly, issuers of these types of securities will now register exclusively with the SEC and will no longer be required to register under states' laws. The NSMIA permits the states to take action, however, to require the filing with the relevant state securities regulator of (i) any document filed with the SEC, together with periodic reports of the value of securities sold to persons in the state solely for notice purposes, and (ii) a consent to service of process in the state. In addition, the states may require the payment of fees in connection with such filings. Without taking any further action, the states may continue to collect fees payable in connection with such offerings as required under state law in effect on October 10, 1996. Significantly, investment companies no longer need to receive approval from a state with respect to its filing prior to commencement of the offering. As soon as the state notice filing and fee payment requirements are met, the investment company's securities may be offered and sold in the state.

Footnotes

353 In the "covered security" context, the SEC is likely to define the term "qualified purchaser" differently than it is defined for purposes of § 3(c)(7) of the Investment Company Act. In its recent proposal to revise Regulation D, the SEC has included a request for comment on whether to define the proposed term "large accredited investor" as a "qualified purchaser" for purposes of § 18 of the Securities Act. The release also notes that the SEC's prior proposal to equate that term with the definition of the term "accredited investor" in Regulation D is no longer under consideration by the SEC.

354 *See* § 7.09 for a discussion of the application of state securities laws in the context of private placement transactions.

U.S. Regulation of the International Securities and Derivatives Markets, § 16.01, 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 § 16.01 (11th and 12th Editions 2014-2017)
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The internationalization of the securities markets is strongly evidenced in the investment advisory business. Many money management organizations have operations in the major international financial centers, and their advisory clients are in the United States and elsewhere around the world. How such organizations are run both within and outside the United States can be significantly affected by regulation under the Advisers Act.

The SEC staff had long taken the position that if an organization—wherever domiciled—was (or should have been) registered under the Advisers Act, the regulatory scheme of the Advisers Act applied to the adviser's worldwide advisory activities, including those undertaken with its non-U.S. clients outside the United States. [1] The SEC staff has moderated this view, however, in the case of advisory services provided to the non-U.S. clients of registered advisers located outside the United States. [2]

In the first of a series of no-action letters advancing this view, *Uniao de Bancos de Brasileiros S.A.* ("*Unibanco*"), [3] the staff agreed that a foreign adviser need not comply with all of the provisions of the Advisers Act in providing services to its non-U.S. clients. The relief was subject to certain procedural requirements, including the maintenance of books and records, to ensure the SEC had adequate access to the foreign adviser for enforcement purposes.

Unibanco and its progeny reflect in large measure preliminary conclusions set forth in the SEC staff report, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (the "1992 Report"). [4] The 1992 Report included a wide-ranging analysis of the then-existing regulatory consequences for foreign and multinational advisers and recommended certain alternatives. On the basis of *Unibanco* and subsequent no-action letters, the SEC staff has backed away from seeking to regulate the worldwide activities of advisers located outside the United States. Rather, the staff is moving towards regulating the U.S. activities of these advisers and assuring that the activities outside the United States of non-U.S. advisers and non-U.S. affiliates of U.S. advisers do not adversely affect U.S.

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clients, U.S. investors in clients that are investment funds, or the U.S. market. [5] The staff's position regarding the degree of regulation under the Advisers Act of activities outside the United States remains a threshold issue in structuring investment advisory operations.

Money managers that provide advice for compensation in the United States concerning securities are generally subject to regulation under the Advisers Act. [6] The Advisers Act provides for:

- registration of the adviser and disclosure concerning its business practices and personnel;
- substantive regulation of many aspects of the adviser's ongoing relationships with its clientele, particularly under general antifraud prohibitions and with respect to the ability of an adviser to charge performance-based or nonrefundable fees with certain clients and to engage in transactions with advisory clients as principal; and
- SEC oversight, inspection and disciplinary authority with respect to the adviser's activities.

Certain U.S. advisers are also subject to regulatory requirements imposed by state securities authorities that in some cases are more comprehensive than those applicable under federal law and, as discussed below, to state oversight rather than federal oversight by the SEC.

Several securities derivative products are used by investment advisers. Certain of these derivative products, such as futures, options and swaps on financial instruments and currencies, are in some instances regulated in the United States under the CEA. If an adviser's activities involve such futures, options or swaps, the adviser may also be subject to regulation as a "commodity trading advisor" (a "CTA") under the CEA. Like the Advisers Act, the CEA and the regulations promulgated by the Commodity Futures Trading Commission ("CFTC") thereunder provide for a comprehensive regulatory scheme applicable to CTAs, including registration and ongoing recordkeeping requirements, substantive restrictions on relationships with clients (including a prohibition against holding

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customer funds related to futures contracts and commodity options in its own name) and extensive disclosure obligations, as well as CFTC oversight. [7]

Following the explosive growth experienced by the money management business and numerous investor fraud scandals, U.S. Congressional and SEC attention is increasingly focused on existing regulation and the level of resources currently devoted to oversight. [8] The Investment Advisers Supervision Coordination Act of 1996 [9] effected a significant delegation of authority over investment advisers from the SEC to state securities commissions. Numerous other

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proposals have been considered by Congress and industry groups but have not been adopted, and include the creation of one or more self-regulatory organizations or the extension of the jurisdiction of the Financial Industry Regulatory Authority ("FINRA"), an existing broker-dealer self-regulatory organization ("SRO"), to include investment advisers [10] and the creation of a private right of action to permit advisory clients to sue their advisers for failure to adhere to regulatory requirements, particularly those relating to fraudulent and deceptive practices. [11] Other legislative proposals have included provisions imposing higher and ongoing registration fees on advisers, additional disclosure obligations and a requirement to obtain greater information regarding their clients' financial circumstances to ensure the suitability for those clients of the adviser's trading strategies. [12] In 1994, the SEC proposed rules that would expressly prohibit investment advisers from making unsuitable recommendations to clients. [13] Title IV of the Dodd-Frank Act, or the Private Fund Investment Advisers Registration Act of 2010 (the "Private Fund Advisers Act"), required many advisers to hedge funds and private equity funds that were formerly exempt from registration under the so-called "*de minimis*" exemption under the Advisers Act to register as investment advisers, imposed significant new reporting requirements on advisers to private funds and venture capital funds, including information about fund clients, and shifted regulation of many smaller and mid-size advisers from SEC oversight to oversight by the states. [14]

The management of accounts where the beneficiary is a regulated entity, such as an investment company [15] or a pension plan, raises additional regulatory considerations. [16] In such cases, registration as an investment adviser may be

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desirable or required as a condition to the adviser's ability to manage the assets of such entities, notwithstanding that under the Advisers Act itself an exemption from registration may be available.

Footnotes

1 *See* § 16.02.

2 The SEC staff continues to take the position that the regulatory scheme of the Advisers Act applies to activities of advisers located in the United States with all U.S. and non-U.S. clients.

3 *Uniao de Bancos de Brasileiros S.A.* (avail. July 28, 1992); *see also infra* Note 58 for related no-action letters.

4 SEC, Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992). Many of the conclusions embodied in the 1992 Report resulted from comments received in response to a "concept release" that was part of a comprehensive SEC study of the Investment Company Act and the Advisers Act. SEC Release No. 33-6868 (June 15, 1990) (the "1990 Concept Release").

5 The SEC subsequently confirmed that—in keeping with *Unibanco*—it does not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser. SEC Release No. IA-2333 (Dec. 2, 2004) (the "Hedge Fund Release"). Title IV of the Dodd-Frank Act significantly expanded the regulatory scope and obligations of advisers, but it reconfirmed the view expressed in the Hedge Fund Release relating to the application of the Advisers Act to the non-U.S. clients of non-U.S. advisers. SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 39,646, 39,681 (July 6, 2011).

6 Money managers that provide such advice concerning security futures products may also be subject to regulation as commodity trading advisors under the Commodity Exchange Act (the "CEA"). *See* § 16.16.

7 Such advisers may also be subject to regulation as "commodity pool operators" under the CEA if they manage (*i.e.*, "operate") a collective investment vehicle that trades in futures contracts, commodity options or swaps. Regulations applicable to commodity pool operators ("CPOs") are discussed U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, Chapter 7. As noted above, advisory activities with respect to transactions in security futures products may be subject to regulation under both the CEA and the Advisers Act, absent an exemption. *See* §§ 16.16 and 12.16[5]. The Dodd-Frank Act expanded the definition of CPO and CTA in the CEA to require that entities engaging in swaps activity, in addition to using or advising on futures and options, be subject to this regulatory framework. The CFTC has adopted rules in the context of rulemaking under the Dodd-Frank Act that rescind important exemptions from CPO registration and impose significant additional requirements on CTAs and CPOs. 77 Fed. Reg. 11,252 (Feb. 14, 2012).

8 The SEC conducted a Study on Investment Advisers and Broker-Dealers, required by the Dodd-Frank Act, in January 2011 with the goal of harmonizing regulation of investment advisers and broker-dealers. SEC, Study on Investment Advisers and Broker-Dealers (Jan. 2011) (the "Advisers and Broker-Dealer Study"). As of October 2015, there were 11,956 registered investment advisers. SEC Office of Inspector General, Rept. No. 533, Office of Compliance Inspections and Examinations' Management of Investment Adviser Examination Coverage Goals (Mar. 10, 2016). Although SEC staff resources dedicated to adviser examination has decreased while the number of registered advisers has increased in recent years, the Advisers and Broker-Dealer Study indicates that the SEC continues to make adviser oversight a priority. The SEC uses risk-based methods to focus resources and compliance examinations on firms that present the greatest risks to investors. In 2015, the SEC conducted "nearly 2,000 formal examinations of registrants, an increase over each of the prior five fiscal years." SEC, 2015 Annual Report at 24. On February 3, 2017, President Trump directed the Secretary of Labor to reexamine the Fiduciary Duty Rule. *See* Presidential Memorandum on Fiduciary Duty Rule (Feb. 3, 2017).

Following the Advisers and Broker-Dealer Study, the SEC's Investor Advisory Committee recommended a framework for a new fiduciary duty standard applicable to broker-dealers under the Advisers Act. *See* Recommendation of the Investor Advisory Committee Broker-Dealer Fiduciary Duty (Nov. 2013). The SEC has not yet proposed rules to implement the recommendations of the Investor Advisory Committee; however, Chair White testified before Congress in 2016 on the SEC's 2017 budget request indicating that while the issue is "complicated" and not "quick" she supports advancing "a uniform fiduciary rule for broker-dealers and investment advisers" under § 913 of the Dodd-Frank Act. *See* Hearing to Review the FY17 Budget Request for the SEC & CFTC Before the S. Comm. on Appropriations, Subcomm. on Financial Services and General Government, 114th Cong. (2016) (testimony of SEC Chair White), http://www.appropriations.senate.gov/hearings/hearing-to-review-the-fy17-budget-request-for-the-sec-and-cftc.

For a discussion of the 2016 Department of Labor rule defining a "fiduciary" of employee benefit plans under ERISA and certain retirement plans, *see* § 14.07[1][a].

9 *See infra* Note 19 and accompanying text.

10 *See* §§ 14.06[2] and 14.07[3] for a description of SRO activity and certain aspects of FINRA.

11 *See, e.g.*, Roberta S. Karmel, *The Challenge of Fiduciary Regulation: The Investment Advisors Act After Seventy-Five Years*, 10 BROOK. J. CORP. FIN. & COM. L. 405, 429–30 (2016); Richard Y. Roberts, Commissioner, Remarks at Midwest/Midsouth Securities Law Conference, Investment Adviser Reform (Feb. 14, 1992).

12 The Investment Advisers Modernization Act of 2016, if enacted, would make a number of changes to the Advisers Act and certain of its rules with respect to advisory services provided to clients other than registered investment companies. It proposes among other things to exempt certain communications from the books and records rule and amend the custody rule to only require publicly-traded securities and cash to be maintained with a qualified custodian. *See* Investment Advisers Modernization Act of 2016, H.R. 5424, 114th Cong. (2016).

13 SEC Release No. IA-1406 (Mar. 16, 1994). No further action has been taken with respect to this proposed rulemaking.

14 §§ 403, 407, 408 and 410 of the Dodd-Frank Act.

15 For a discussion of the Investment Company Act and the types of investment companies regulated thereunder, *see* Chapter 15.

16 Additionally, there are circumstances where even a registered adviser is prohibited from providing investment management services to certain types of clients. Advisers that have been convicted of felonies or have been subject to other forms of disciplinary action (so-called "bad actors") are prohibited from acting as the investment manager of hedge funds, private equity funds, registered investment companies or any other form of collective investment pool that offers its securities through private placement under Rule 506 of Regulation D. *See* SEC Release No. 33-9414 (July 10, 2013); *see also* § 7.02[2] for a description of the recently adopted "bad actor" rules for Regulation D offerings.

U.S. Regulation of the International Securities and Derivatives Markets, § 16.02, ADVISERS ACT

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 § 16.02 (11th and 12th Editions 2014-2017)
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[1] Jurisdiction

The jurisdiction of the SEC to compel registration under the Advisers Act depends in the first instance on the existence of contacts with the United States. The requisite jurisdictional nexus may be established through the provision of services from or within the United States. Thus, an adviser domiciled in the United States who provides advice to non-U.S. persons, [17] as well as a foreign adviser providing advisory services to U.S. persons, will be subject to regulation under the Advisers Act. The staff of the SEC has taken the position, however, that a foreign adviser to foreign clients may use U.S. jurisdictional means to acquire information about the securities of U.S. issuers and may effect transactions in those securities through U.S. broker-dealers without registration under the Advisers Act. [18]

[a] Allocation of Regulatory Authority Between the SEC and the States

The Investment Advisers Supervision Coordination Act of 1996 (the "Coordination Act") effected a significant reallocation of the responsibilities for regulating investment advisers between the SEC and the state securities regulatory authorities, [19] and the Private Fund Advisers Act further reallocated responsibilities. Generally, the Coordination Act required advisers with $25 million or more of assets under management to register with the SEC; advisers with less than $25 million of assets under management that were registered with a state were prohibited from registering with the SEC. This reallocation of regulatory

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responsibilities from the SEC to the states primarily grew out of Congress's concerns that the SEC's resources are inadequate to supervise the activities of the growing number of investment advisers registered with the SEC and that many large advisers operating nationally have faced significant regulatory burdens in being subject to the differing laws of many states. The Coordination Act added § 203A to the Advisers Act, which provides that an investment adviser that is regulated or required to be regulated as an investment adviser in the state in which it maintains its principal office and place of business is prohibited from registering with the SEC unless such adviser (i) has assets under management [20] of not less than $25 million (or such higher amount as the SEC may by rule deem appropriate) or (ii) is an adviser to a registered investment company. [21]

The Private Fund Advisers Act maintains the $25 million threshold, but modifies § 203A of the Advisers Act to create a new group of "mid-sized" advisers and shifts primary regulatory oversight from the SEC to the state securities authorities for these advisers. [22] An investment adviser that (i) has assets under management between $25 million and $100 million (or such higher amount as the SEC may by rule deem appropriate) and (ii) is required to be registered in the state in which it maintains its principal office and place of business and subject to examination as an investment adviser by such state, is considered a "mid-sized" adviser and is prohibited from registering with the SEC. [23]

The SEC is authorized to deny registration to any applicant that does not meet the criteria for SEC registration, [24] and is directed to cancel the registration of any adviser that no longer meets the criteria for registration. [25] The SEC has the power to exempt investment advisers from the prohibition on SEC registration if the application of the prohibition would be "unfair, a burden on interstate commerce, or otherwise inconsistent with the purposes" of § 203A. [26] Rule 203A-2 under the Advisers Act exempts six types of advisers from the prohibition on SEC registration, and the SEC has adopted rule amendments to these exemptions:

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- nationally recognized statistical rating organizations ("NRSROs");
- pension consultants that provide investment advice to certain employee benefit plans with respect to assets having an aggregate value of at least $200 million; [27]
- any adviser that directly or indirectly controls, is controlled by or is under common control with an investment adviser that is eligible to register (and is, in fact, registered) with the SEC;
- newly formed investment advisers that have a reasonable expectation that, within 120 days, they will become eligible to register with the SEC;
- any adviser that is required to register as an investment adviser in 15 or more states; [28] and
- certain investment advisers that provide advisory services primarily through the Internet. [29]

Under § 203A(a)(1) of the Advisers Act, advisers that are not regulated or required to be regulated as investment advisers in the state in which they have their principal office and place of business must register with the SEC regardless of the amount of assets they have under management. This provision makes clear that the SEC will retain regulatory responsibility for an adviser in a state that has not enacted an investment adviser statute and for foreign advisers doing business in the United States.

A mid-sized adviser that relies on a state law registration exemption, or is otherwise "not required to be registered in a state," must register with the SEC unless another exemption applies. [30] Most states require registration unless the adviser has both no place of business in the state and relatively few clients in the state (following the national *de minimis* standard set forth in Section 222 of the Advisers Act). A small handful, including New York and New Jersey have a

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de minimis exemption regardless of whether an adviser has an office in the state. [31] However, if the state securities authority does not conduct compliance examinations, then the mid-sized adviser must register with the SEC. [32] The SEC has surveyed each state and made available a list of those non-examining states on its website. Notably, New York does not conduct examinations and as such, mid-sized advisers in New York are required to register with the SEC. [33]

In order to facilitate transition of mid-sized advisers to state regulation, the SEC amended Rule 203A-1. [34] If any SEC-registered adviser files an annual updating amendment to its Form ADV reporting it is not eligible for SEC registration, Rule 203A-1 requires such adviser to withdraw from SEC registration within 180 days of its fiscal year end. [35] During the transition period while the adviser is registered with both the SEC and the state securities authority, the Advisers Act and applicable state law would apply to the adviser's advisory activities. [36] Revised Rule 203A-1 also requires any state-registered adviser to apply for registration with the SEC within 90 days of filing an annual updating amendment to its Form ADV reporting eligibility for SEC registration and no reliance on an exemption. [37]

The Coordination Act gives the SEC primary responsibility for the regulation of advisers that remain registered with the SEC by preempting certain state laws with respect to those advisers, and the Dodd-Frank Act leaves this unchanged. The Coordination Act provides that no state laws regulating investment advisers or supervised persons of investment advisers shall apply to any person (i) that is registered under § 203 of the Advisers Act as an investment

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adviser or a supervised person of an investment adviser, except that a state may license, register or otherwise qualify any investment adviser representative who has a place of business located within that state, [38] or (ii) that is not registered under § 203 because that person is excepted from the definition of investment adviser under § 202(a)(11) of the Advisers Act. [39]

The Coordination Act also added § 222 to the Advisers Act. Section 222(b) provides that no state may enforce any law or regulation that would require an investment adviser to maintain any books or records in addition to those required under the laws of the state in which it maintains its principal office and place of business [40] if the investment adviser (i) is registered or licensed as such in the state in which it maintains its principal office and place of business and (ii) is in compliance with the applicable books and records requirements of the state in which it maintains its principal office and place of business. [41] Section 222(c) sets forth a similar rule regarding minimum net capital and bond posting requirements for investment advisers. Section 222(d) provides that no state may require an investment adviser to register with the securities commissioner of the state or to comply with such state's investment adviser law (except antifraud provisions) if the investment adviser (i) does not have a place of business located within the state, and (ii) during the preceding 12-month period, has had fewer than six clients who are residents of that state. [42]

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The Coordination Act preserves state authority over SEC-registered advisers in three areas. First, states may investigate and bring enforcement actions against SEC-registered advisers with respect to fraud and deceit. [43] Second, states may require SEC-registered advisers to file, for notice purposes only, documents filed by such advisers with the SEC. [44] Third, states may require SEC-registered advisers to continue paying state filing, registration and licensing fees. [45]

[b] Consequences of Registration

A foreign adviser who registers under the Advisers Act may well expect that the Advisers Act's requirements will apply to its activities in the United States, but may not appreciate that in the SEC's view the Advisers Act may be applicable to all of its activities, including those relating exclusively to offshore clientele. The impact on offshore business operations can include:

- requirements to deliver disclosure documents;
- limitations on principal transactions between an advisory client and an adviser or its affiliates;
- requirements to adopt, maintain and enforce a compliance program and a code of ethics;
- general antifraud prohibitions;
- reporting requirements with respect to advisers to "private funds" and "venture capital funds"; [46] and
- application of the SEC's recordkeeping and oversight requirements, which can entail disclosure of customer identities, if the SEC so determines in the case of enforcement proceedings. [47]

[c] Section 203(d)

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The SEC's position had historically been that if an adviser located outside the United States chose to register, the Advisers Act applied to all of its activities wherever conducted. This position was based on a 1970 amendment to the Advisers Act adding § 203(d). The amendment stated that registered advisers were prohibited from certain acts, practices or courses of conduct irrespective of whether they used the "mails or any means or instrumentality of interstate commerce." [48] Although the legislative history indicates that the addition of § 203(d) was intended to serve an evidentiary purpose—to eliminate the often burdensome requirement of showing that the adviser had used jurisdictional means in connection with its U.S. activities [49]—the SEC had taken the position that the addition of this provision permitted the SEC to apply the provisions of the Advisers Act to the wholly foreign activities of a registered non-U.S. investment adviser. [50]

The apparent conflict between the SEC's position and the legislative history of § 203(d) [51] engendered a good deal of criticism by the private bar and market participants alike as contradicting the SEC's initiatives to promote internationalization of securities markets, such as Regulation S, [52] that are premised on a territorial approach and a desire to avoid extraterritorial extension of the regulatory (as opposed to antifraud) provisions of the U.S. securities laws in situations free of significant U.S. consequences. [53]

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In connection with its comprehensive study of the Investment Company Act and the Advisers Act, including a request for comment on the practicality of its extraterritorial application of Advisers Act, [54] the staff concluded that existing interpretations of the Act's reach required revision. In particular, in the 1992 Report, the staff endorsed a narrower, territorial approach to regulation of advisers based on a more traditional "conduct" and "effects" test. According to this approach, "the Advisers Act would apply to activities where a sizable amount of advisory services takes place *in the United States* or where the advisory services have effects *in the United States*." [55] This approach is consistent with the Dodd-Frank Act and related SEC rulemaking, both of which focus on advisers with a principal office and place of business in the United States and advisers with clients in the United States. However, the new exemptions from registration under the Private Fund Advisers Act as applied to foreign advisers focus also on the location of investors in private funds managed by the adviser and may require filings by a foreign adviser even if the foreign adviser has no place of business in the United States and no U.S. clients, if the foreign adviser has U.S. investors in the non-U.S. private funds it manages. *See* § 16.03[3] *infra*.

More difficult questions are raised by a multinational registered adviser and its non-U.S. clients, particularly where personnel from both U.S. and foreign offices provide services to a single client. The staff indicated that where the foreign client deals exclusively with personnel outside the United States and where the adviser has a policy that portfolio decisions for that client be in fact formulated by the non-U.S. office, the Advisers Act should not apply. [56] Advisers Act protections would, in contrast, seem appropriate in the case of foreign clients seeking advice regarding the U.S. market and employing principally the U.S.-based personnel of the adviser. [57]

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The staff first implemented certain elements of its revised interpretation of the jurisdictional reach of the Advisers Act in *Unibanco*, [58] in which it concluded that the registered foreign advisory subsidiary of a foreign bank need not comply with the Advisers Act with respect to its non-U.S. clients. [59] Relief was granted based in part on undertakings made by both the bank and its subsidiary to maintain books and records in compliance with SEC requirements that would "clearly reflect the investment advice given to [the subsidiary's] clients." [60] These undertakings reflect the staff's interest, first articulated in the 1992 Report, in ensuring that activities involving non-U.S. clients do not adversely affect U.S. clients or the integrity of the U.S. markets. [61]

[2] Subsidiaries and Affiliates

Many foreign entities wishing to conduct an advisory business with U.S. clients have organized separate entities to isolate the provision of those services that would require registration under the Advisers Act. Although the staff suggested in the 1992 Report that the "conduct" and "effects" test would result in diminished need by foreign advisers to create special subsidiaries to isolate their U.S. advisory activities, it recognized that for tax, internal policy or other reasons some advisers may nevertheless continue to operate their U.S. advisory business through a separate subsidiary. In such situations, the issue arises whether the new subsidiary entity is, in fact, the "investment adviser," or whether the offshore parent is merely doing indirectly what it could not do directly without registration, thereby violating § 208(d) of the Advisers Act. [62] The SEC staff has taken the position that the parent remains subject to the registration obligation if the subsidiary, rather than being the true adviser, is only an undercapitalized "shell" or alter ego established (i) to shield the parent from regulatory scrutiny and liability or (ii) to permit the parent to profit by trading

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based on recommendations made by the controlled entity to its clients (a practice sometimes known as "scalping"). [63]

Prior to the 1992 Report and *Unibanco*, the staff's position regarding integration of advisory entities was best articulated in its no-action letter *Richard Ellis, Inc.* ("Richard Ellis"). [64] In *Richard Ellis*, the staff indicated that a subsidiary may be considered independent of its parent for purposes of the Advisers Act if the subsidiary:

- is adequately capitalized;
- has a buffer (such as a board of directors with a majority of members independent of the parent) between the subsidiary's personnel and the parent;
- does not have personnel who participate directly in rendering advice to both the subsidiary's clients and the parent's clients;
- decides by itself what investment advice to communicate to, or use on behalf of, its clients, and has and uses sources of investment information that are not limited to its parent; and
- keeps its investment advice confidential until communicated to its clients.

A registered advisory subsidiary of an unregistered entity could nonetheless have a significant degree of shared personnel with its parent or other affiliate without subjecting the unregistered entity to the Advisers Act registration requirement. The registered adviser could also receive investment research services, including general economic or market analyses and advice, from its unregistered parent or other affiliate as long as (i) the parent or other affiliate is not the only source of the service, (ii) the service does not purport to meet the investment needs of a particular client or clients of the registered adviser or to recommend the purchase or sale of specific securities and (iii) the research or advice is not passed directly on to the clients of the registered adviser. The staff had also indicated that other support services and personnel, such as computer facilities and marketing personnel not otherwise involved in negotiating advisory contracts, could be shared between an investment adviser subsidiary and its parent

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and other affiliates without subjecting the parent and affiliates to registration under the Advisers Act. [65]

In the 1992 Report, the staff concluded that the SEC should "recognize separateness if the affiliated companies are separately organized (*i.e.*, two separate entities), and if the registered entity is staffed with personnel (whether physically located in the United States or abroad) who are capable of providing investment advice." [66] The staff nevertheless emphasized that advisory and supervisory personnel of the unregistered entity involved in advisory services provided to U.S. persons should be within the SEC's jurisdiction and that the unregistered entity should be subject to SEC access for monitoring purposes to ensure compliance with the Advisers Act.

The staff's view on the subject is exemplified in *Thomson Advisory Group, L.P.* [67] There the staff made clear that the concerns of §§ 203(a) and 208(d) of the Advisers Act are adequately addressed when (i) the unregistered affiliates of a registered adviser do not themselves provide investment advice (the affiliates' activities were limited to activity as general partners of investment partnerships), (ii) the unregistered affiliates and each of their employees are deemed "associated persons" [68] of the registrant when they have access to the investment recommendations of the registered adviser or information concerning the recommendations prior to the effective dissemination of the recommendations and (iii) the SEC has access to the unregistered affiliates' books and records to the extent necessary to examine the business of the registered adviser. [69]

As mentioned above in § 16.02[1][c], the staff originally implemented this approach in *Unibanco* where it agreed that the foreign parent of a foreign-domiciled registered investment adviser would not be subject to Advisers Act registration. [70] No-action relief in *Unibanco* was conditioned on several undertakings made by the parent to ensure SEC jurisdiction over the parent's operations to the extent relevant to the SEC's supervision of the registered advisory subsidiary. These conditions included, first, the appointment by the unregistered parent of an agent to accept service of process in SEC enforcement proceedings,

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as well as other proceedings arising out of or relating to the activities of its subsidiary or "any related securities transactions"—a term the staff stated would be construed broadly. [71] Second, the parent agreed to maintain books and records with respect to "related securities transactions" in English and in accordance with certain SEC rules and to cause its subsidiary to comply with Advisers Act recordkeeping requirements. Third, the parent agreed that its personnel involved in U.S. advisory activities would become "associated persons" of the subsidiary. [72] Finally, the parent agreed that it would produce its employees in connection with any SEC proceeding and authorize them to testify regarding their knowledge of the activities of the advisory subsidiary and "related securities transactions." Employees would be authorized to provide information relating to customers of the parent only with the consent of the parent, although the parent's agreement not to contest SEC proceedings otherwise than under U.S. law did not extend to any contest relating to customer identities. [73]

In subsequent no-action letters, the SEC staff has confirmed the position taken with respect to a parent and its SEC-registered subsidiary in *Unibanco* and has extended its approach to registered and unregistered affiliated companies. In *The National Mutual Group*, [74] the staff concluded that, subject to satisfaction of conditions substantially similar to those set out in *Unibanco*, each of several affiliated companies domiciled outside the United States could register under the Advisers Act without the need to comply with specified provisions of the Advisers Act in the case of its non-U.S. clients, including the "brochure" rule, prohibitions against performance fees and agency cross and principal transactions with affiliates, compliance with Advisers Act limitations on payments for client solicitations and certain recordkeeping requirements. The SEC staff also confirmed that it would not recommend enforcement action against any company within *The National Mutual Group* if it failed to enforce any policy or procedure required by or established pursuant to § 204A of the Advisers Act [75] or for other actions that may be deemed to violate the antifraud provisions of the Advisers

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Act to the extent that the action or omission in question would involve no conduct, or would have no effects, in the United States, or would have no effects on the U.S. clients of the company. [76] In addition, guidance that the so-called "substantive" requirements of the Advisers Act do not apply to a registered offshore adviser and its relationship with its non-U.S. clients was subsequently affirmed more recently in rule releases. [77] The "substantive" provisions the SEC staff has stated do not apply to the non-U.S. clients of an SEC-registered foreign adviser include the "compliance rule, custody rule, and proxy voting rule," "certain provisions that would otherwise be required by section 205 … section 206(3)'s restrictions … rules governing adviser advertising, or cash solicitations.…" [78] Further, the SEC staff confirmed such an adviser is "not require[d] to deliver a written disclosure brochure to its offshore clients (or to any investors in an offshore private fund it advises) under rule 204-3, although the adviser does have a fiduciary duty to provide those clients with full and fair disclosure of conflicts of interest." [79] In addition, a registered offshore adviser, with respect to its non-U.S. clients, "will not be required to adopt a code of ethics but must retain its access persons' personal securities reports that would otherwise be required under such a code." [80]

Furthermore, in *Mercury Asset Management*, [81] the staff concluded that a foreign-domiciled SEC-registered adviser need not comply with the Advisers Act in the case of its non-U.S. clients and that the adviser's affiliates need not register under the Advisers Act solely by reason of providing research or other advisory services to the U.S. clients of the registered adviser through the registered adviser (*e.g.*, dual-hatted employees). While not withdrawing the position regarding subsidiaries in *Richard Ellis*, the staff stated its view that affiliated companies are separate if:

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> they are separately organized (*i.e.*, two distinct entities); the registered entity is staffed with personnel (whether physically located in the United States or abroad) who are capable of providing investment advice; all persons involved in United States advisory activities are deemed "associated persons" of the registrant; and the [SEC] has access to trading and other records of each affiliate involved in United States advisory activities, and to its personnel, to the extent necessary to monitor and police conduct that may harm United States clients or markets. [82]

Among the specific conditions to the relief granted in *Mercury Asset Management* was a requirement that the registered adviser list on its Form ADV (in addition to its directors) each of its investment managers expected to formulate investment advice for U.S. clients, as well as the names of each other individual and affiliate of the adviser involved in the formulation of such advice. The SEC also required that the registered adviser not hold itself out as such to its non-U.S. clients so as not to foster any expectation that the adviser's activities were governed by U.S. law. Each of the adviser's unregistered advisory affiliates was required to provide advisory services to U.S. persons solely through the registered adviser and to submit to the jurisdiction of the SEC to the extent previously required in *Unibanco*.

In *Kleinwort Benson Investment Management Ltd.*, [83] the staff concluded that certain foreign advisory affiliates of a U.S.-domiciled registered adviser need not register under the Advisers Act if they share certain portfolio managers with the registered adviser, subject to specific conditions substantially similar to those required in *Mercury Asset Management*. In a departure from prior practice, however, the staff did not require certain affiliates of the registered adviser whose activities were confined to publication of research reports to make the undertakings required of the other foreign affiliates. The staff noted that the materials received from the research affiliates would not be prepared specifically for the registered adviser's clients, and information barriers had been implemented to prevent the affiliates from obtaining information about the registered adviser's trade recommendations. [84]

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In *ABN AMRO Bank N.V.*, [85] the staff concluded that even though the adviser and its affiliates were restricted by Dutch law from making certain undertakings made in *Unibanco* and its progeny, they could still share personnel and provide certain services if certain substitute undertakings were made. Under Dutch law, ABN AMRO Bank was unable to make undertakings with respect to (i) providing the SEC staff with access to staff trading records and (ii) the availability of personnel for questioning by the staff. ABN AMRO Bank undertook, however, (a) to make a good faith effort to obtain written authorizations to provide staff trading records, (b) to make available for SEC inspection redacted staff trading records for those staff for which an authorization was not in effect and (c) to assist the SEC in enlisting the assistance of the Dutch regulatory authorities if the SEC determined it required information not in the trading records. [86]

Although the above no-action letters for the most part involved the relationship of U.S. based SEC-registered advisers with their foreign affiliates, the SEC generally has not addressed the applicability of the Advisers Act to the non-U.S. clients of a foreign unregistered adviser that is controlled by a U.S. person, where the U.S. person either is itself, or also controls, a U.S.-registered adviser. The staff stated in the 1992 Report that whether registration of the foreign adviser should be required in these circumstances is a difficult question, the resolution of which could turn on whether the non-U.S. client has substantial and direct contact with U.S.-based advisory personnel. [87] This approach was reaffirmed by the Private Fund Advisers Act exemptions to registration under the Advisers Act, which limit exemptions for foreign advisers based on having offices in or assets managed from the United States. Although such contacts can

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raise the specter of the "Barbary Coast" [88] (that is, the United States providing a haven for investment advisers seeking to avoid regulation in any jurisdiction), the better view is that registration of the foreign adviser should not be required either as a matter of law or policy. First, a separate non-U.S. adviser's non-U.S. activities should be relevant to U.S. regulators only insofar as they affect U.S. investors or U.S. markets. Second, the imposition of a registration requirement in these circumstances would place U.S. firms that seek to isolate their non-U.S. activities at a significant disadvantage relative to their foreign competitors. In this regard, the SEC staff has already acknowledged that the location of an adviser's personnel is not a relevant consideration in determining the independence of an advisory entity from its affiliates, [89] a conclusion largely motivated by the staff's concerns about competition and efficiency. [90] Finally, principles of comity and the problems inherent in reconciling U.S. law to often inconsistent provisions of foreign law make registration in such circumstances undesirable and impracticable. Nevertheless, in light of the staff's cautions in the 1992 Report, [91] pending further guidance in this area, it is not altogether clear whether the staff would extend its territorial approach to the Advisers Act in circumstances involving the provision of advisory services to the non-U.S. clients of a foreign adviser that is controlled by a U.S. person.

Notwithstanding the revised approach reflected in the 1992 Report and the *Unibanco* letters, which all post-date *Richard Ellis*, the SEC staff has not withdrawn *Richard Ellis*. It would seem reasonable to conclude that the staff's positions in *Unibanco* and its progeny are not exclusive, such that advisers that are unable or unwilling to accede to *Unibanco*-style procedural conditions [92] may continue to structure their operations to achieve a satisfactory degree of independence in reliance on *Richard Ellis*. Indeed, the SEC staff's position in the 1992 Report suggests that adequate independence can be achieved, without the necessity for the procedural requirements delineated in *Unibanco*, with some relaxation of the *Richard Ellis* requirements (*e.g.*, in the use of common employees providing investment advice, as suggested in *Kleinwort Benson Investment Management Ltd.*). [93] The SEC's adopting release for the final rules implementing the Private Fund Advisers Act generally affirms the *Unibanco* line of no-action letter guidance as applicable to foreign advisers, sanctioning, under certain conditions, interactions between a non-U.S. unregistered adviser and its U.S. registered affiliate. [94] In addition, the adopting release notes the *Richard Ellis* no-action letter providing certain requirements for recognizing the separateness of affiliated entities. [95]

Footnotes

17 *See infra* Note 162.

18 *See, e.g., Vocor International Holding S.A.* (avail. Apr. 9, 1990) (citing *Gim-Seong Seow* (avail. Nov. 30, 1987)); *Double D Management, Ltd.* (avail. Jan. 31, 1983). The staff has taken this position notwithstanding that "means or instrumentality of interstate commerce" is defined to include the facilities of a national securities exchange. § 202(a)(14) of the Advisers Act.

19 National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, Tit. III, 110 Stat. 3416, 3436 (1996) ("NSMIA").

20 The SEC's rules provide that the calculation of assets under management for registration purposes refers to an adviser's "regulatory assets under management," which is described in further detail in § 16.03[3][a][i].

21 § 203A(a)(1) of the Advisers Act and Rule 203A-1(a) thereunder.

22 An adviser with its principal office and place of business outside the United States is permitted to register with the SEC regardless of its assets under management.

23 § 410 of the Dodd-Frank Act.

24 § 203(c) of the Advisers Act.

25 § 203(h) of the Advisers Act.

26 § 203A(c) of the Advisers Act.

27 The value threshold under the former Rule 203A-2 was $50 million. 17 C.F.R. § 275.203A-2.

28 The state registration threshold under the former Rule 203A-2 was 30 or more states. 17 C.F.R. § 275.203A-2.

29 Rule 203A-2 under the Adviser's Act; *see also* SEC Release No. IA-3221 (June 22, 2011); SEC Release No. IA-2091 (Dec. 12, 2002). An adviser is eligible for registration under Rule 203A-2(e) if the adviser provides investment advice to all of its clients exclusively through the adviser's interactive website, except that the adviser may advise fewer than 15 clients through other means during the preceding 12 months.

30 § 410 of the Dodd-Frank Act.

31 *See* N.Y. GEN. BUS. LAW § 359-eee(1)(a)(5) (excluding from the definition of "investment adviser" any "person who sold, during the preceding twelve month period, investment advisory services to fewer than six persons residing in this state, exclusive of financial institutions and institutional buyers …"); N.J. STAT. A NN. § 49:3-56(g)(1), (2) (exempting from registration a person with or without a place of business in the state if the person has had no more than five clients who are New Jersey residents other than certain financial institutions).

32 § 410 of the Dodd-Frank Act. The SEC also adopted Rule 203A-5, which required SEC-registered advisers that no longer qualified for SEC registration under the new assets under management threshold to transition from SEC to state registration by June 28, 2012.

33 SEC, Division of Investment Management, Frequently Asked Questions Regarding Mid-Sized Advisers (June 28, 2011). A mid-sized adviser with a principal office and place of business in Wyoming (which does not require adviser registration) or New York (which does not subject advisers to examination) must register with the SEC regardless of regulatory assets under management unless another exemption applies. "Regulatory assets under management" is described in further detail in § 16.03[3][a][i]. All other states subject state-registered advisers to examination.

34 *See* SEC Release No. IA-3221 (June 22, 2011).

35 Rule 203A-1(b)(2) under the Advisers Act.

36 Rule 203A-1(a)(1) provides a buffer for mid-sized advisers with regulatory assets under management between $90 million and $110 million. Such advisers may, but are not required to, register with the SEC (if below $110 million) or withdraw from SEC registration (if above $90 million).

37 Rule 203A-1(b)(1) under the Advisers Act.

38 Rule 203A-3 under the Advisers Act defines "*investment adviser representative*" as a supervised person of an SEC-registered investment adviser who has more than five clients who are natural persons and more than 10% of whose clients are natural persons.

39 § 203A(b)(1) of the Advisers Act.

40 § 985(c)(4) of the Dodd-Frank Act changed references in § 222 of the Advisers Act from "principal place of business" to "principal office and place of business."

41 § 222(b) of the Advisers Act.

42 § 222(d) of the Advisers Act. The SEC rules implementing the Private Fund Advisers Act amended Rule 222-2 under the Advisers Act, which explains how clients are counted for purposes of the national *de minimis* threshold of § 222(d) of the Advisers Act. The amended Rule 222-2 states that for purposes of the national *de minimis* threshold described in the text above, an adviser may rely on the definition of "client" provided by Rule 202(a)(30)-1 rather than Rule 203(b)(3)-1, which has been rescinded. Rule 202(a)(30)-1, like Rule 203(b)(3)-1, treats as a single client, among others, any natural person and (i) any relative or spouse of the natural person sharing the same principal residence and (ii) all accounts of which such persons are the sole primary beneficiaries. The rule also treats as a single client a corporation, partnership, trust or other legal organization that receives investment advice based on the objectives of the entity (and not its shareholders, partners, beneficiaries or members). *See* SEC Release No. IA-3222 (June 22, 2011). Unlike Rule 203(b)(3)-1, Rule 202(a)(30)-1 does not include a "special rule" providing advisers with the option of not counting as a client any person for whom the adviser provides investment advisory services without compensation. 17 C.F.R. § 275.203(b)(3)-1. *See* § 16.03[3][b][i] for a discussion of determining the number of clients for purposes of the foreign private adviser exemption.

43 § 203A(b)(2) of the Advisers Act.

44 § 307(a) of the Coordination Act.

45 § 307(b) of the Coordination Act.

46 §§ 407 and 408 of the Dodd-Frank Act.

47 See Rule 204-2(c) under the Advisers Act (permitting designation of client identities on an adviser's books by numerical, alphabetical or other code) and § 209(b) of the Advisers Act (granting authority to the SEC to obtain such information under certain circumstances in an enforcement proceeding). However, certain provisions (*e.g.*, limitations on performance fees) do not apply to an adviser's dealings with offshore clients. *See* § 16.06.

48 § 203(d) of the Advisers Act. Section 203(d) provides that:

> Any provision of this title … which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce are used in connection therewith shall also prohibit any such act, practice, or course of business by any investment adviser registered pursuant to this section or any person acting on behalf of such an investment adviser, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

49 H.R. Rep. No. 1382, 91st Cong., 2d Sess. 40 (1970); S. Rep. No. 184, 91st Cong., 2d Sess. 47 (1969).

50 SEC Release No. IC-17534 (June 15, 1990); *Gim-Seong Seow* (avail. Nov. 30, 1987).

51 Among other things, the SEC's continued use, subsequent to the enactment of § 203(d), of a form (applicable solely to advisory conduct arising in any place subject to the jurisdiction of the United States) that registered, nonresident advisers are required to file consenting to service of process in legal actions had suggested that the SEC did not believe that registration alone provides a sufficient jurisdictional nexus to reach the wholly foreign activities of a foreign adviser. *See* Rule 0-2 under the Advisers Act. A senior staff member of the Division of Investment Management of the SEC—the division responsible for administering the Advisers Act—had endorsed this view and the conclusion that the Advisers Act should not apply to the wholly foreign activities of a nonresident adviser. Stanley B. Judd, *International Investment Advisers*, 19 REV. SEC. & COMM. REG. 1 (1986).

52 *See* Chapter 8.

53 *See* Edward F. Greene, Mitchell S. Dupler & Alan B. Cohen, *Jurisdictional Reach of the Investment Advisers Act of 1940*, 4 INSIGHTS 21 (1990); *see also* Stanley B. Judd, *International Investment Advisers*, 19 REV. SEC. & COMM. REG. 6–7 (1986) (suggesting that the SEC's exemptive power under § 206A of the Advisers Act should be exercised to exempt a foreign adviser from prohibitions relating to activities that are permitted under the law of the adviser's domicile). A number of the comment letters received by the SEC in response to the 1990 Concept Release also supported this position. *See, e.g.*, Letter from the American Bar Association (Oct. 18, 1990); Letter from Cleary, Gottlieb, Steen & Hamilton (Oct. 12, 1990); Letter from Davis, Polk & Wardwell (Oct. 10, 1990); Letter from Ropes & Gray (Oct. 9, 1990).

54 1990 Concept Release.

55 1992 Report at 222. The staff noted that the "conduct" and "effects" approach was supported not only by traditional principles relating to the appropriate jurisdictional reach of U.S. law, but also by numerous policy considerations, including comity. For example, the staff noted that the United Kingdom does not apply certain of its advisory regulations to the foreign activities of foreign advisers registered as such under U.K. law. Non-U.S. clients of a non-U.S. adviser would also be less likely to expect that U.S. law would govern the advisory relationship. 1992 Report at 229 n.26.

56 1992 Report at 233.

57 1992 Report at 233.

58 *Unibanco* (avail. July 28, 1992); *see also American Bar Association Subcommittee on Private Investment Entities* (avail. Aug. 10, 2006) (the "ABA Private Investment Subcommittee"); *Royal Bank of Canada* (avail. June 3, 1998); *ABN AMRO Bank N.V.* (avail. July 1, 1997); *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993); *Mercury Asset Management* (avail. Apr. 16, 1993); *The National Mutual Group* (avail. Mar. 8, 1993).

59 SEC rulemaking in response to the Dodd-Frank Act generally affirmed the *Unibanco* line of no-action letters. *See infra* Note 94 and accompanying text.

60 *Unibanco* (avail. July 28, 1992).

61 *Unibanco* (avail. July 28, 1992).

62 Section 208(d) of the Advisers Act provides that "[i]t shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of [the Advisers Act] or any rule or regulation thereunder."

63 *See*, *e.g.*, *Price Waterhouse* (avail. Oct. 1, 1987); *Kenneth Leventhal & Co.* (avail. Feb. 7, 1983); *United Asset Management Corp.* (avail. Nov. 2, 1981); *Richard Ellis, Inc.* (avail. Sept. 17, 1981); SEC Release No. IA-353 (Dec. 18, 1972).

64 *Richard Ellis, Inc.* (avail. Sept. 17, 1981) (involving an indirect subsidiary of a U.K. real estate investment adviser).

65 *Richard Ellis, Inc.* (avail. Sept. 17, 1981); *see also Gartmore Investment, Limited Investors Diversified Services, Inc.* (avail. Oct. 29, 1981); *C.B. International Investment Ltd.* (avail. Oct. 29, 1981); *Prudential Corp. Ltd.* (avail. Nov. 6, 1981).

66 1992 Report at 233–34.

67 *Thomson Advisory Group, L.P.* (avail. Sept. 26, 1995).

68 *See infra* Notes 72 and 426. Generally, an adviser's associated persons will be subject to the adviser's policies and procedures as if they were employees of the adviser.

69 *Thomson Advisory Group, L.P.* (avail. Sept. 26, 1995); *see also John W. Henry & Co., Inc.* (avail. Sept. 20, 1996); *Lazard Freres Asset Management* (avail. Feb. 12, 1996).

70 *Unibanco* (avail. July 28, 1992).

71 *Unibanco* (avail. July 28, 1992). The SEC staff has approved a specific form of appointment of an agent for these purposes. *See Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993); *Mercury Asset Management* (avail. Apr. 16, 1993).

72 § 202(a)(17) of the Advisers Act. A registered adviser has certain supervisory and other obligations with respect to its associated persons under §§ 203(e)(6) and 204A, which require, for example, implementation of policies and procedures preventing the misuse of material nonpublic information. Violations of these obligations can lead to regulatory proceedings against the adviser, including monetary penalties.

73 *Unibanco* (avail. July 28, 1992).

74 *The National Mutual Group* (avail. Mar. 8, 1993).

75 § 204A of the Advisers Act requires investment advisers, including state-registered advisers and unregistered advisers (other than those relying on exemptions in § 203(b) of the Advisers Act) to establish, maintain, and enforce policies and procedures to prevent the misuse of material nonpublic information. *See* § 16.13 for further discussion of the obligations of registered investment advisers regarding such policies and procedures.

76 *The National Mutual Group* (avail. Mar. 8, 1993).

77 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,072–72,073 (Dec. 10, 2004). In its adopting release for the final rule implementing the new Dodd-Frank exemptions from the registration requirements of the Advisers Act, the SEC said that it does not “apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the [SEC] and that nothing in that final rule "is intended to

withdraw any prior statement of the [SEC] or the views of the staff as expressed in the *Unibanco* letters." SEC Release. No. IA-3222, 76 Fed. Reg. 39,646, 39,681 (July 6, 2011). Non-U.S. advisers with no U.S. clients may still be required to register with the SEC if, for instance, they provide advisory services from a place of business in the United States, even if their principal place of business is offshore.

78 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 n. 221 (Dec. 10, 2004).

79 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 (Dec. 10, 2004).

80 Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 (Dec. 10, 2004).

81 *Mercury Asset Management* (avail. Apr. 16, 1993).

82 *Mercury Asset Management* (avail. Apr. 16, 1993).

83 *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993).

84 *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993). The *Unibanco* letters generally permit a registered adviser and its participating affiliate to share personnel and other resources under certain conditions. For example, in the *Murray Johnstone* no-action letter, the permitted shared personnel included directors, officers, and employees, so long as any of these personnel participating in the advisory business of the U.S. registered adviser or having access to information concerning securities recommended to its U.S. clients were deemed "associated persons" of the U.S. registered adviser. *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994).

85 *ABN AMRO Bank N.V.* (avail. July 1, 1997).

86 *ABN AMRO Bank N.V.* (avail. July 1, 1997). In *Royal Bank of Canada*, the staff reaffirmed the *Unibanco* position with regard to a group of affiliated entities under the Royal Bank of Canada umbrella and added that it would not recommend enforcement action if certain foreign trust company affiliates delegated investment discretion over the assets held by certain offshore trusts to a registered investment adviser affiliate or an unaffiliated registered investment adviser. *Royal Bank of Canada* (avail. June 3, 1998).

87 1992 Report at 233. The SEC staff previously took the position that if a foreign affiliate of a U.S.-domiciled registered adviser had no U.S. business, registration under the Advisers Act was not required, even where both entities were controlled by a U.S. person and without regard to the degree of independence between the registered entity and the foreign affiliate. *Double D Management, Ltd.* (avail. Jan. 31, 1983); *see also BOH Investment Management Co.* (avail. Jan. 2, 1987); *TAC America Ltd.* (avail. July 25, 1984). In a subsequent no-action letter, however, the staff appeared to cast doubt on the continued viability of these letters, at least in extreme circumstances. *H.P. Hambrick Co., Inc.* (avail. Oct. 14, 1988) (in refusing to grant relief, SEC staff noted that an issue was raised under § 208(d) where a U.S. resident was providing advisory services to foreign clients through a wholly owned offshore, unregistered entity, "particularly if the individual also provides advice to U.S. clients through another wholly-owned corporation registered as an adviser with the Commission").

88 *SEC v. Kasser*, 548 F.2d 109, 116 (3d Cir. 1977), *cert. denied, Churchill Forest Industries Ltd. v. SEC*, 431 U.S. 938 (1977); *see also Morrison v. National Australia Bank, Ltd.* 561 U.S. 247, 270 (2010); *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975).

89 1992 Report at 233–34.

90 1992 Report at 226.

91 *See supra* text accompanying Note 57.

92 Many offshore advisers may, for example, be reluctant to submit their unregistered advisory activities to the level of SEC scrutiny implied by the *Unibanco* conditions, particularly to the extent such scrutiny risks disclosure of customer identities. Although Rule 204-2(d) under the Advisers Act permits client identities to be indicated on an adviser's books by numerical, alphabetical or other similar code, ultimately that information could be obtained by the SEC in an enforcement proceeding. *See* § 210(c) of the Advisers Act.

93 *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993).

94 SEC Release No. IA-3222 (June 22, 2011). The adopting release notes, however, that the *Unibanco* letters

were developed by the SEC staff in the context of the *de minimis* exemption, which was repealed by the Dodd-Frank Act. The release states that, while nothing in the newly adopted rules is intended to withdraw any prior statement of the SEC or the views of the staff as expressed in the *Unibanco* letters, the SEC expects that the staff will provide guidance, as appropriate, based on facts that may be presented to the staff regarding the application of the *Unibanco* letters in the context of the new foreign private adviser exemption and the private fund adviser exemption. *See*, *e.g.*, *Zenkyoren Asset Management of America, Inc.* (avail. June 30, 2011) (granting no-action to a wholly owned subsidiary of a Japanese insurance "federation" advising only the parent via funds in which the parent is the only investor).

95 SEC Release No. IA-3222 (June 22, 2011). The SEC also mentions several times in the adopting release § 208(d) of the Advisers Act (the prohibition against doing anything indirectly that the adviser would not be permitted to do directly) and the possibility of conflating entities that, while separately organized, are "operationally integrated" or otherwise appear to be in contravention of § 208(d) of the Advisers Act. *See In the Matter of TL Ventures Inc.*, SEC Release No. IA-3859 (June 20, 2014) (SEC charged that two affiliated exempted (one venture capital, one private fund) fund advisers were not operationally independent and should have been regarded as a single advisory organization in determining whether to rely on registration exemptions).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.03, REGISTRATION REQUIREMENT

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 § 16.03 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Any person, regardless of whether resident in or organized under the laws of the United States, who for compensation provides, in or from the United States, investment advisory services concerning securities, must register with the SEC as an investment adviser and comply with other provisions of the Advisers Act unless an exclusion or exemption is available. [96]

[1] Investment Adviser Defined

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The Advisers Act provides that an "*investment adviser*" is:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.… [97]

Whether a person providing securities advisory services will satisfy this definition depends on all of the facts and circumstances.

[a] Providing Advice

It is clear that a person who offers advice on the value of specific securities, or issues reports including recommendations on specific securities, satisfies the first element of the definition of investment adviser. [98] Questions have

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been raised whether a database service that provides information regarding market conditions, industry sectors and the like would constitute an "analysis or report concerning securities" so as to require registration under the Advisers Act. In no-action correspondence, the SEC staff has taken the position that information relating to securities does not constitute an analysis or report within the meaning of § 202(a)(11) of the Advisers Act if (i) the information is readily available to the public in its raw state, (ii) the categories of information are not highly selective and (iii) the information is not organized or presented in a manner that suggests the purchase, holding or sale of any securities. [99] The staff has, on the other hand, refused to grant no-action relief where the information to be provided in the database relates to "closely held businesses which may expect to raise capital in future transactions exempt from the registration requirements of applicable securities laws." [100]

The SEC staff has also stated that persons who, as part of a regular business, provide advice or issue reports concerning securities in general or the relative value of investing in securities as compared to other types of investments would satisfy the definition of investment adviser, although financial planners who provide integrated financial services may make general recommendations regarding asset allocation among a variety of investments, including securities, without becoming subject to registration as an adviser. [101] Services for matching entrepreneurs with potential investors are, by contrast, generally not subject to registration if participants pay only an initial administrative fee and a periodic renewal fee to defray the costs of maintaining the database and the service does not participate in negotiations between the entrepreneurs and investors. [102]

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For many years, the staff also took the position that persons receiving compensation for referring clients to registered investment advisers were themselves subject to registration as investment advisers, unless they were in the employ or otherwise under the supervision and control of a registered investment adviser. [103] This position reflected the staff's view that conflicts of interest arising in the context of paid solicitation activities are inherently fraudulent and not susceptible to cure by disclosure. [104] The staff clarified its position with the adoption of Rule 206(4)-3 under the Advisers Act, which prohibits payment of cash fees for client solicitation otherwise than in accordance with the terms of the rule. [105]

[b] Engaging in a Business

Although the "business" component of the definition of investment adviser is stated somewhat differently in the Advisers Act depending on whether the person is providing advice or issuing reports, the SEC staff has stated its intention to interpret the requirement in the same fashion for both activities. [106] Satisfaction of the "business" component does not require that the person engage exclusively in securities advisory activities or that the activities be the person's principal line of business, but only that they constitute "a business activity occurring with some regularity." [107] In the case of financial planners who provide integrated investment and retirement planning services, the SEC staff has stated that it would consider a person to be "in the business" of providing advice if the person:

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(i) holds himself out as an investment adviser or as one who provides investment advice;

(ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the investment advice; or

(iii) on anything other than rare, isolated and nonperiodic instances, provides specific investment advice. [108]

The staff has also stated its intention to consider other financial services activities offered to clients in determining the presence of a business, such that a financial planner who limits his planning activities to general recommendations as to allocation of portfolio assets, but who also gives investment advice as to specific securities in his capacity as a registered representative of a broker-dealer, would be considered to be "in the business" of providing advice. [109]

The staff has also made clear that an employer that provides investment-related information to its employees who participate in the employer's defined contribution plan would not be an "investment adviser" as defined in the Advisers Act. [110] Although this exclusion applies regardless of the type of investment-related information provided by the employer, the exclusion only applies to employers and not to others who may provide investment-related information to plans or plan participants. [111]

In the case of publications, the staff has taken the position that the publication of an isolated book, pamphlet or article would not constitute the conduct of a "business," and thus generally would not subject the author or publisher to registration, if no specific recommendations of securities or issuers were made in the publication and if the publication were not part of a series or intended to be supplemented. [112]

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The staff's interpretive advice did not extend, however, to the licensing or use, particularly as part of computer programs or models, of mathematical or investment formulas to assist clients in making investment decisions. [113] In this connection, the staff has distinguished between mathematical formulas and computer models that are mere arithmetic tools, which would fail the "advice" component of the investment adviser definition, and those that may be used to make investment decisions. Thus, if a computer model generates information related to actual historical prices of securities or a client's particular financial and investment circumstances and suggests the purchase or sale of a category of securities or a particular security, the model would probably not be characterized as an arithmetic tool. [114]

[c] Receiving Compensation

The compensation component of the "adviser" definition is interpreted broadly by the SEC staff. [115] The receipt of any direct or indirect economic benefit, including commissions for directed brokerage, [116] is

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sufficient. [117] The compensation need not be paid directly by the client if the compensation or other benefit received relates to the advisory services rendered. [118] The fact that a person does not charge a separate fee for advisory services will not be dispositive of the compensation question, if the fee relates to a variety of services, including securities advice. [119] Additionally, although an adviser does not meet the definition of "investment adviser" unless it receives compensation for providing advice to others, once an adviser meets the definition by receiving compensation from one client, the Advisers Act applies to the relationship between the adviser and all of its advisory clients, including clients from which the adviser does not receive compensation. [120]

[2] Exclusions

The Advisers Act excludes certain entities from the definition of "investment adviser" and exempts certain investment advisers from its registration requirements. In most cases, entities are excluded or exempted because their activities are separately regulated under U.S. laws or because those activities are not considered to raise risks for investors requiring the protections afforded by the Advisers Act. The principal difference between exclusion and exemption is that persons exempt (but not those that are excluded) from registration remain subject to the restrictions on principal and agency cross-trading and other antifraud provisions of § 206 of the Advisers Act. Both excluded and exempted persons are subject to potential regulation by state and other local securities authorities [121] and remain liable to clients under state common law principles applicable to fiduciaries.

[a] Banks

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Among those persons excluded from the definition of investment adviser are U.S. banks [122] (and bank holding companies as defined by the Bank Holding Company Act of 1956) that are not "investment companies" within the meaning of the Investment Company Act. [123] Foreign banks do not meet the definition of "bank" since they are neither organized under U.S. law nor subject to U.S. regulation, and thus do not qualify for the Advisers Act exclusion. [124] Foreign banks with U.S. banking operations are treated as "bank holding companies" for purposes of U.S. banking law [125] and, although the SEC has yet to address the issue, may also qualify as such for purposes of § 202(a)(11)(A). If so, foreign banks

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may be excluded from regulation under the Advisers Act since, following the SEC's adoption of Rule 3a-6 under the Investment Company Act, such entities are no longer "investment companies." In any event, U.S. bank affiliates and branches (and, in some cases, perhaps agencies) of foreign banks are now typically considered "banks" under the Investment Company Act and are expressly included in the definition of "bank" under the GLB Act. [126] Accordingly, these entities will not be subject to any of the provisions of the Advisers Act, including its antifraud prohibitions.

[b] Broker-Dealers

A broker-dealer, including a foreign broker-dealer engaged in advisory activities permitted by Rule 15a-6 under the Exchange Act, [127] that provides investment advisory services solely incidental to the conduct of its business as a broker-dealer and that receives no special compensation for the services is excluded from the Advisers Act definition of "investment adviser." [128]

The SEC sought, by adopting Rule 202(a)(11)-1 under the Advisers Act, to address the applicability of the Advisers Act to broker-dealers offering certain types of fee-based (as opposed to commission-based) brokerage programs and to further clarify the meaning of the terms "solely incidental" and "special compensation." [129] In particular, the rule aimed to reconcile the increasing use of fixed or asset-based fees charged by broker-dealers for a package of services (including brokerage and incidental advice) with the statutory exclusion. Prior to Rule 202(a)(11)-1, such fees could be considered "special compensation" because they were not commission-based compensation, even if the package of services covered by the fee was commensurate with the services provided in a traditional brokerage arrangement.

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In 2007, the U.S. Court of Appeals for the District of Columbia Circuit vacated Rule 202(a)(11)-1, concluding that the SEC did not have the authority to broaden the exception from the definition of "investment adviser" for broker-dealers provided under § 202(a)(11)(C) of the Advisers Act. [130] The court held that, with § 202(a)(11)(C) of the Advisers Act, Congress unambiguously created a precise exemption from the adviser definition applicable to broker-dealers. Accordingly, "because broker-dealers are already expressly addressed in subsection (C), they are not ‘other persons' under subsection (F)," and the SEC cannot use such authority "to establish new, broader exemptions for broker-dealers." [131] In addition, the court noted that the SEC's general rulemaking authority under § 211(a) of the Advisers Act could not ignore this distinction. [132]

After determining not to appeal the *Financial Planning Association* decision, [133] the SEC proposed a new rule that would reinstate certain interpretative provisions of the vacated rule clarifying what services are considered "solely incidental" to a broker-dealer's business. [134] Under the proposal, a broker-dealer's exercise of investment discretion with respect to a customer account would *not* be considered a service solely incidental to brokerage services unless such discretion were granted by the customer on a "temporary or limited basis." In addition, investment advice provided for a separate fee or under a separate contract would *not* be solely incidental to brokerage services.

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The proposed rule would also reinstate an interpretation of "special compensation" that a broker-dealer would *not* be deemed to have received such compensation solely because it charged one customer a commission, mark-up, mark-down or similar fee for brokerage services that was greater or less than the fee it charged another customer. Under earlier SEC staff interpretations, full-service broker-dealers are potentially subject to the Advisers Act with respect to accounts for which they provide advice incidental to their brokerage services simply because they also offer discount brokerage services for a lower fee to other accounts. [135] The proposed rule also would clarify that broker-dealers are advisers only with respect to those accounts for which they provide services or receive compensation that subjects them to the Advisers Act.

The *Financial Planning Association* decision accelerated the release of a report the SEC had commissioned from the RAND Corporation addressing how the twin regulatory systems for broker-dealers and advisers affect investors. [136] Released in January 2008, the report concluded that, despite high levels of satisfaction, investors "typically fail to distinguish broker-dealers and investment advisers along the lines federal regulations define." [137] The report also surveyed industry practices and found them "very heterogeneous, with firms taking many different forms and offering a multitude of services and products." In a statement accompanying the release, the SEC stated it is studying the results of the report and is considering the potential regulatory implications of its findings. [138]

The Dodd-Frank Act requires the SEC to further consider the regulatory requirements applicable to broker-dealers and advisers through various studies, many of which have been completed and delivered to Congress for further consideration, and additional rulemaking authority. [139] The regulatory regime governing broker-dealers and advisers may be shaped by the findings,

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recommendations and conclusions of the mandated studies. However, as of publication, no new rules have been proposed in light of the studies.

[c] Publishers and Authors

Section 202(a)(11)(D) of the Advisers Act excludes from the definition of investment adviser "the publisher of any *bona fide* newspaper, news magazine or business or financial publication of general and regular circulation." [140] In one of the few instances in which it has addressed the Advisers Act, the U.S. Supreme Court interpreted this exclusion in a case involving an investment adviser who was statutorily barred from registering under the Advisers Act due to his previous disciplinary history. [141] The adviser had published a newsletter containing recommendations for "buying, selling, or holding stocks." On the facts, the Court held that the adviser was not required to be registered because his activities were within the publisher exclusion. [142] The Court based its holding on a finding that

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the newsletter was *bona fide*. As opposed to a "tip" sheet used to tout a security, the newsletter contained only "disinterested commentary and analysis," no "promotional material," and was of general and regular circulation. It was offered to the public at large and was not "timed to specific market activity or to events affecting or having the ability to affect the securities industry." [143] The Court indicated that inclusion of general recommendations concerning specific securities will not vitiate the *bona fides* of a publication so long as the recommendations are not based on the investment objectives of a particular customer. In addition, the Court suggested that a publication would not fail to be of regular circulation merely because the publication schedule was not "consistent." [144]

Although the Court's focus on "impersonal" advisory services creates an exemption that could be of substantial breadth, it should not be read as a means to avoid the antifraud provisions of the Advisers Act. One former SEC staff member has urged that if a publication of general and regular circulation were used as a "tout" or "tip" sheet, it would fail the *bona fides* test and subject the creator of the "tout" or "tip" sheet to the Advisers Act's antifraud provisions and possible SEC enforcement action. [145]

[d] Other Exclusions

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The Advisers Act also excludes from the definition of "investment adviser" certain professionals whose advice is solely incidental to their primary occupation [146] and persons whose advice relates exclusively to securities issued or guaranteed by the U.S. government or its corporate instrumentalities. [147] The Private Fund Advisers Act added a new exclusion for any family office, as defined by the SEC. [148] In addition, the Advisers Act delegates to the SEC the authority to designate other persons as not being within the scope of the definition. [149]

[3] Exemptions

Even if an entity satisfies the definition of "investment adviser," it still may escape most of the Advisers Act provisions if it is eligible for one of the exemptions from registration provided in § 203(b) of the Act. [150] As stated above, an

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exempt adviser nevertheless continues to be subject to the antifraud provisions contained in § 206 of the Advisers Act. [151]

The Private Fund Advisers Act eliminated the most significant exemption from registration provided for in the Advisers Act that was relied upon by many advisers to hedge funds, private equity funds and other pooled investment vehicles, the so-called "*de minimis*" exemption. [152] The *de minimis* exemption was available to an adviser who (i) during the prior 12 months had fewer than 15 clients [153] (none of which is an investment company, or business development company, registered under the Investment Company Act) and (ii) did not "hold himself out generally to the public as an investment adviser." [154] To limit the expanded scope of the Advisers Act following the elimination of the *de minimis* exemption, the Private Fund Advisers Act established several new exemptions, including exemptions for "foreign private advisers," "private fund" advisers with assets under management in the United States of less than $150 million, and "venture capital fund" advisers.

On June 22, 2011, the SEC adopted new rules and rule amendments under the Advisers Act (the "Private Fund Advisers Rules") to implement the Private Fund Advisers Act, including the new exemptions replacing the *de minimis* exemption. [155] The Private Fund Advisers Rules clarify and define terms in the exemptions for foreign private advisers, private fund advisers and venture capital fund advisers.

[a] Private Fund Adviser Exemption

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The Private Fund Advisers Act creates an exemption from registration under the Advisers Act for an adviser that acts solely as an adviser to "private funds" (which is defined as an issuer that would be required to register as an investment company but for § 3(c)(1) or § 3(c)(7) of the Investment Company Act) and has assets under management in the United States of less than $150 million. [156]

[i] *Assets Under Management*

The Private Fund Advisers Rules change the way assets under management are calculated for purposes of adviser registration. The Private Fund Advisers Rules define a term "regulatory assets under management" ("R-AUM") to provide a uniform calculation of an adviser's assets under management when determining an adviser's eligibility for an exemption from registration with the SEC. [157] The calculation includes any proprietary assets, assets managed without receiving compensation [158] and assets of non-U.S. clients, all of which an adviser was permitted to exclude from its calculation of its assets under management under the former rules. [159] In addition, an adviser may not subtract outstanding indebtedness and other accrued but unpaid liabilities, which remain in a client's account and are managed by the adviser. [160] Furthermore, in the case of private funds, the calculation must include uncalled capital commitments and be based on the current market value (or fair value) of fund assets.

[ii] *In the United States*

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The SEC's interpretation of the phrase "in the United States" turns on whether the adviser is a U.S. or non-U.S. adviser. In calculating its R-AUM for purposes of this exemption, a U.S. adviser is required to include all private fund assets in its calculation, whereas a non-U.S. adviser is only required to include the amount of private fund assets it manages *at* a place of business in the United States. [161] Whether an adviser is a U.S. or non-U.S. adviser depends on where that adviser's "principal office and place of business" is located, which is understood to be the executive office of the investment adviser from which the officers, partners or managers of the investment adviser direct, control and coordinate the activities of the investment adviser. [162] The Private Fund Advisers Rules make clear that an adviser has only one "principal office and place of business." [163]

[iii] *Advisers Solely to Private Funds*

Under the Private Fund Advisers Rules, for non-U.S. advisers the condition that such advisers advise solely private funds is deemed fulfilled as long as all of the non-U.S. adviser's clients that are U.S. persons [164] are private funds. The requirement that an adviser advise solely private funds requires that an

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adviser relying on this exemption not advise any managed accounts that do not fit under the definition of private fund. [165]

While advisers who rely on the private fund adviser exemption are exempt from registering under the Advisers Act, they are still required to make certain disclosures to the SEC (as described in § 16.03[3][d] *infra*).

[b] Foreign Private Adviser Exemption

The Private Fund Advisers Act exempts from registration any investment adviser that is a "foreign private adviser," which it defines as an adviser that (i) has no place of business in the United States, (ii) has (a) in total, fewer than 15 U.S. person clients and investors in private funds advised by the adviser [166], and (b) aggregate assets under management attributable to such U.S. clients and investors of less than $25 million, and (iii) neither "holds itself out generally to the public in the United States as an investment adviser" [167] nor acts as an investment adviser to any investment company registered under the Investment Company Act or to an entity that is or has been elected to be treated as a business development company as defined in the Investment Company Act. [168] This

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exemption is similar in concept to the former *de minimis* exemption, except that the foreign private adviser exemption is available only to non-U.S. advisers, both investors and clients are counted for purposes of the exemption and there is an AUM threshold component. Unlike advisers to "private funds" and "venture capital funds," which are subject to reporting requirements despite exemption from registration, exempt foreign private advisers are not subject to reporting requirements.

The Private Fund Advisers Rules broadly define "place of business" as any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts any such activities. [169] This definition captures advisers with any place of business in the United States and is particularly broad when compared with the current application of the Advisers Act, which distinguishes between advisers whose principal places of business are inside or outside the United States. Furthermore, a pure marketing or client service office that involves contacting clients, even if it does not provide any investment advice, will likely be captured by this definition, whereas an office that does not conduct advisory activities or communicate with clients likely would not be captured. [170] This may cause many foreign advisers to be ineligible for this exemption, but they may qualify for the private fund adviser exemption.

[i] *Determining the Number of Clients and Investors*

Each separate person or entity in the United States that receives investment advice from the adviser must be counted as a separate client in determining the availability of the foreign private adviser exemption. As under the prior rules regarding the *de minimis* exemption, "single advisee" treatment is accorded under the Private Fund Advisers Rules to trusts where the only beneficiaries are natural persons, their minor children, relatives and spouses. [171] Similarly, a

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corporation, general partnership, limited partnership, limited liability company, trust (other than of the type referred to in the preceding sentence) or other legal organization that receives investment advice based on its investment objectives rather than the individual objectives of its shareholders, partners, limited partners, members or beneficiaries, is deemed a single client. [172] "Single advisee" treatment will not be accorded, however, where any shareholder, partner, limited partner, member or beneficiary is otherwise an advisory client of the person (or any party related to such person) seeking to rely on it. [173] The Private Fund Advisers Rules also eliminate a "special rule" under the Advisers Act permitting an adviser not to count as a client any person for whom the adviser provides advisory services without receiving compensation. [174]

Unlike the former *de minimis* exemption, the foreign private adviser exemption counts not only U.S. clients but also each U.S. investor in private funds advised by the adviser. The Private Fund Advisers Rules define an "investor" as any person who would be included in determining the number or identity of beneficial owners or qualified purchasers under §§ 3(c)(1) and 3(c)(7) of the Investment Company Act. [175] To avoid double-counting, an adviser (i) does not need to count a private fund as a client if the adviser counted the investors in

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that private fund as investors with respect to that private fund for purposes of determining the availability of the exemption and (ii) is able to treat as a single investor any person who is an investor in two or more private funds advised by the investment adviser. [176] The Private Fund Advisers Rules do not include "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act) in the definition of "investor"; thus, a non-U.S. adviser need not count U.S. knowledgeable employees toward the 14 U.S. client and investor in private fund limit. [177]

[ii] *Holding Out to the Public*

A key component of the former *de minimis* exemption from registration as an investment adviser was the prohibition against the adviser's holding itself out to the public as an investment adviser. [178] Under the Private Fund Advisers Act, the same prohibition against "holding out" applies to foreign advisers relying on the foreign private adviser exemption but extends only to the adviser's activities in the United States—thus a foreign private adviser cannot hold itself out to the public in the United States as an investment adviser. [179] The SEC staff has taken a broad view of the types of activities that constitute "holding out to the public." The staff has repeatedly stated that if an adviser, by word of mouth or otherwise, lets it be known to the public that he is willing to take on new clients, or uses the term "investment adviser" or "investment counselor" on business cards, on stationery, or in a telephone or building directory, the staff will deem the adviser to have held himself out to the public as an investment adviser. [180] The SEC staff has also stated that participation in a "mini-account" or similar investment advisory program [181] and using a publicly available electronic medium, such as an Internet site, to provide information about the adviser's U.S. activities would be

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deemed "holding out" to the public. [182] In addition, the retention of a client referral service would in most, if not all, cases constitute *per se* "holding out" to the public. [183] As a practical matter, the difficulties of establishing an advisory business (other than as a private fund adviser, which regularly relied on the now rescinded *de minimis* exemption from Advisers Act registration, which included the same "holding out" criterion as noted below) without some kind of "holding out" to the public had substantially reduced the utility of the exemption.

Where entities act as advisers to private limited partnerships or other investment vehicles, the SEC departed from the harsh guidelines otherwise governing the "holding out" element. In response to concerns that the disclosure of an adviser's name in any offering document used to market limited partnership interests might constitute "holding out to the public," the SEC had included in Rule 203(b)(3)-1 under the Advisers Act a statement that a nonpublic offering of limited partnership interests in an entity for which a person acts as adviser is not "holding out to the public" by that person. [184] The same principle would appear to apply in the case of other passive investment vehicles.

[c] Venture Capital Fund Adviser Exemption

Advisers solely to venture capital funds are exempt from registration with the SEC under the Private Fund Advisers Act. The Private Fund Advisers Rules define a venture capital fund as a private fund that (i) holds no more than 20% of the fund's capital commitments in "non-qualifying investments" (other than short-term holdings), [185] (ii) does not borrow, provide guarantees or otherwise

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incur leverage in excess of 15% of the fund's capital contributions and committed capital (other than limited short-term borrowing), and any such borrowing or leverage (excluding certain guarantees by the fund of qualifying portfolio obligations) is for a non-renewable term of no longer than 120 calendar days, (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances, (iv) represents itself as pursuing a venture capital strategy to investors, and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company. [186] A non-U.S. adviser may rely on the venture capital fund exemption if all of its clients, whether U.S. based or otherwise, are venture capital funds. [187]

The Private Fund Advisers Rules define "qualifying investment" generally as any equity security acquired directly from a "qualifying portfolio company" and certain equity securities exchanged for the directly acquired securities, and "qualifying portfolio company" as one that (i) is not a reporting or foreign traded company and does not have a control relationship with such a company, (ii) does not incur leverage in connection with the investment by the private fund and distribute the proceeds of any such borrowing to the private fund in exchange for the private fund investment, and (iii) is not itself a fund (*i.e.*, is an operating company). [188]

The definition of "venture capital fund" includes a grandfathering provision for any private fund that (i) represented to investors and potential investors at the time the fund offered its securities that it is a venture capital fund, (ii) has sold securities to one or more investors prior to December 31, 2010, and (iii) does not sell any securities to, including accepting any additional capital commitments from, any person after July 21, 2011. [189] Venture capital fund advisers that meet these requirements are not required to register with the SEC under the Private Fund Advisers Rules. These advisers, however, are still required to make certain disclosures to the SEC (as described in § 16.03[3][d] below).

No exemption from registration may be used for purposes of evading the application of the Advisers Act. [190] Accordingly, the activities of an unregistered adviser and a related registered adviser, or two or more related unregistered

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advisers, may be collapsed if the advisers do not have sufficiently distinct operations to permit the unregistered advisers to qualify separately for the exemptions relied upon. [191]

[d] Exempt Adviser Reporting Requirements

The Private Fund Advisers Act requires the SEC to determine reporting requirements as necessary and appropriate for advisers exempt from registration under the exemptions for advisers to venture capital funds and private funds ("Exempt Reporting Advisers"). [192] The reporting requirements, however, do not apply to exempt foreign private advisers. [193]

Under the Private Fund Advisers Rules, Exempt Reporting Advisers are required to complete a limited subset of the SEC's revised Form ADV. As a result, the Form ADV serves as both a registration and a reporting form, with the reporting section to be made publicly available on the SEC's website. [194] Exempt Reporting Advisers are required to file their initial Form ADV within 60 days of relying on an exemption that requires reporting. [195]

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Rule 204(b)-1 under the Advisers Act requires that SEC-registered investment advisers report systemic risk information to the SEC on Form PF if they advise at least $150 million in assets of one or more private funds. [196] Form PF elicits non-public information about private funds and their trading strategies the public disclosure of which, in many cases, could adversely affect the funds and their investors. The SEC does not intend to make public Form PF information identifiable to any particular adviser or private fund, although the SEC may use Form PF information in an enforcement action. The SEC requires Form PF to be filed each year, or in the case of certain "large private fund advisers" managing over an aggregate of $1 billion in private fund assets, each quarter.

[e] Other Exemptions

Section 203(b) of the Advisers Act currently provides for six other exemptions: (i) the "intrastate" exemption for advisers (other than advisers to private funds) operating exclusively within a single state whose advice is limited to nonexchange traded—or listed—securities, (ii) an exemption for advisers whose only clients are insurance companies, (iii) an exemption for certain advisers who are charitable organizations and provide advice only to charitable organizations, (iv) an exemption for certain advisers whose only clients are church-sponsored employee pension plans, (v) an exemption for certain registered CTAs performing limited securities advisory activities; and (vi) an exemption for certain advisers to small business investment companies that are regulated by the Small Business Administration. [197]

With respect to the intrastate exemption, the staff has taken the position that an adviser providing advice on the unlisted securities issued by a mutual fund that invests in exchange-listed securities would not satisfy the second element of the exemption. [198] For purposes of determining whether a client is a resident of a state, the staff has generally found that a corporation that is incorporated and domiciled [199] or has its principal place of business within a state [200] will qualify as a "resident" for purposes of the exemption.

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The exemption for registered CTAs, part of which was enacted as part of the Commodity Futures Modernization Act ("CFMA"), [201] applies to a registered CTA whose business does not consist "primarily of acting as an investment adviser" and who does not act as an investment adviser to a registered investment company. [202] There is currently no guidance as to the level of securities advisory activity that would cause a CTA to be acting "primarily" as an investment adviser. The Private Fund Advisers Act added an exemption for registered CTAs that advise private funds, but requires any such adviser whose business after the date of enactment of the Private Fund Advisers Act becomes predominately the provision of securities-related advice to register with the SEC, unless such adviser could meet another exemption. [203]

Footnotes

96 In addition to its authority to require registration under the Advisers Act, the SEC also has authority to cause the deregistration of any adviser that "is not engaged in business as an investment adviser." § 203(h) of the Advisers Act. As noted above, persons providing investment advice with respect to security futures products, which are defined as both securities and futures contracts, may be required to register as CTAs. U.S. Regulation of the International Securities and Derivatives Markets, Twelfth Edition, Derivatives Markets, § 8.07. In September 2013, the SEC also adopted rules that provide a means for entities that qualify as "municipal advisors" under § 975 of the Dodd-Frank Act to fulfill the Dodd-Frank Act's requirement that such entities register with the SEC to be able to provide advice to or solicit municipal entities (unless an exception applies). Municipal advisors are deemed under the Exchange Act to have a

statutory fiduciary duty to any municipal entity they advise. *See* SEC Release No. 34-70462 (Sept. 20, 2013); *see also* Rules 15Ba1-1 through 15Ba1-8 and 15Bc4-1 under the Exchange Act. The Dodd-Frank Act's definition of "municipal adviser" excludes any adviser registered under the Advisers Act and any CTA registered under the CEA or persons associated with a CTA who provide advice with respect to swaps. *See* § 15B(e)(4)(C) of the Exchange Act; *see also* SEC Release No. 34-63576 (Dec. 20, 2010)

97 § 202(a)(11) of the Advisers Act. A person's status as an investment adviser may also in certain circumstances depend on other laws. For example, § 2(c)(20) of the Investment Company Act defines an "investment adviser" to an investment company, in some respects more broadly than the Advisers Act, as:

> (A) any person … who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and
>
> (B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person.

§ 2(A)(20) of the Investment Company Act.

98 § 761 of the Dodd-Frank Act amended the definition of "security" under the Securities Act and the Exchange Act to include security-based swaps. Although the Advisers Act was not similarly amended, given the SEC Division of Investment Management's expansive views on what constitutes a "security" for Advisers Act purposes, a person who offers advice with respect to security-based swaps is likely to be considered to satisfy this first element. The fact that a person only offers securities advice to registered investment advisers or any other subgroup of the general public will not allow such person to avoid registration as an investment adviser. *David Parkinson, Ph.D.* (avail. Oct. 19, 1995).

99 *Charles Street Securities* (avail. Feb. 27, 1987); *see also Angel Capital Electronic Network* (avail. Oct. 25, 1996) (compilation of small corporate stock offerings arbitrarily ordered and derived from information publicly available or readily available from the issuers would not subject provider to registration); *Missouri Innovation Center, Inc.* (avail. Oct. 17, 1995) (newsletter describing securities offerings in the state of Missouri derived from publicly available information and organized alphabetically with no buy or sell recommendations would not subject provider to registration); *Investex Investment Exchange Inc.* (avail. Apr. 9, 1990) (compilation of limited partnerships and related monthly newsletter describing limited partnerships would not subject provider to registration); *NoLoad Mutual Fund Association, Inc.* (avail. Dec. 31, 1984) (compilation of statistical performance data of mutual funds derived from publicly available information and organized alphabetically with no buy or sell recommendations would not subject provider to registration); *Richard Daniels* (avail. Dec. 12, 1984) (monthly newsletter compiling information derived from official records relating to Arizona limited partnerships would not subject provider to registration).

100 *J.D. Manning, Inc.* (avail. Jan. 21, 1986); *see also Butcher & Singer, Inc.* (avail. Jan. 2, 1987).

101 *See, e.g.*, SEC Release No. IA-1092 (Oct. 8, 1987) (citing *Richard K. May* (avail. Dec. 11, 1979)) (revising and updating the staff's earlier interpretive positions taken in SEC Release No. IA-770 (Aug. 13, 1981)); *see also Pauline Wang* (avail. Mar. 21, 1980); *Hayes Martin* (avail. Feb. 15, 1980).

102 *See*, *e.g.*, *Angel Capital Electronic Network* (avail. Oct. 25, 1996); *Capital Resources Network* (avail. Apr. 23, 1993). The operator of an Internet bulletin board that acts as a passive medium for participants to obtain information about other participants interested in buying or selling the stock of certain companies need not register as an investment adviser where the operator is not providing investment advice. *Internet Capital Corp.* (avail. Jan. 13, 1998).

The staff has also indicated that a company may establish an electronic bulletin board to facilitate the purchase and sale of its common stock without becoming subject to registration as an investment adviser so long as the company does not receive compensation for creating or maintaining the bulletin board, is not involved in any purchase or sale negotiations arising from the bulletin board and does not give advice regarding the merits or shortcomings of any particular trade. *Perfect Data Corp.* (avail. Aug. 5, 1996).

103 *See*, *e.g.*, *Rhodes, King, Ruman & Farber* (avail. Nov. 2, 1972); *see also* SEC Release No. IA-1092 (Oct. 8, 1987).

104 *See*, *e.g.*, *Argus Securities Management Corp.* (avail. July 1, 1971).

105 *See* § 16.08[3] for a discussion of Rule 206(4)-3 under the Advisers Act.

106 SEC Release No. IA-1092 (Oct. 8, 1987).

107 SEC Release No. IA-1092 (Oct. 8, 1987), 52 Fed. Reg. 38,400, 38,402 (Oct. 16, 1987); *cf. Technology Capital Network, Inc*. (avail. June 5, 1992) (matching service identifying prospective investors in venture capital enterprises was not subject to registration where, *inter alia*, only an annual subscription fee was charged such that service did not constitute an analysis or report issued "as part of a regular business"); *Capital Resources Network* (avail. Apr. 23, 1993).

108 SEC Release No. IA-1092 (Oct. 8, 1987).

109 SEC Release No. IA-1092 (Oct. 8, 1987).

110 *See Employer Sponsors of Defined Contribution Plans* (avail. Dec. 5, 1995).

111 *See Employer Sponsors of Defined Contribution Plans* (avail. Feb. 22, 1996).

112 SEC Release No. IA-563 (Jan. 10, 1977). This release nevertheless clarifies that, to avail itself of the staff's interpretation, a publisher must not be engaged in any other advisory activities that would otherwise bring the publisher within the definition of investment adviser. An additional requirement previously imposed by the staff in no-action responses—that the publication not contain any investment formulas—was abandoned by the staff because of the difficulty of differentiating "essentially mechanical formulae or guidelines [from] those more general investment philosophies, techniques or analytical approaches for which registration under the [Advisers] Act has not normally been required in the absence of other factors." *See* 42 Fed. Reg. 2953, 2953 (Jan. 14, 1977).

113 *See*, *e.g.*, *Marakon Systems, Inc.* (avail. Sept. 6, 1982); *Syrus Associates, Ltd.* (avail. Oct. 23, 1981). In *Syrus Associates, Ltd.*, the staff clarified in taking this position that the seller or other provider of the formula or model must not provide any information or assistance in preparing data or assumptions for use with the formula or model. *See also Wilson Associates* (avail. May 25, 1988); *cf. Datastream International, Inc.* (avail. Mar. 15, 1993).

114 *See*, *e.g.*, *Computer Language Research, Inc.* (avail. Dec. 26, 1985); *Monchik-Weber Associates, Inc.* (avail. Oct. 23, 1981); *TMI Investment Systems Corp.* (avail. Apr. 15, 1978). *But see*, *e.g.*, *Innosearch Corp.* (avail. Sept. 12, 1985) (computer tool used to evaluate "hypothetical" options contracts); *Warren P. Humphreys* (avail. July 23, 1984) (program indicated whether "stocks" would fall or rise in price).

115 The principal source of elaboration regarding the compensation issue is the exclusion from the definition of investment adviser for any broker or dealer that provides advice solely incidental to its business and not for special compensation, which was the subject of scrutiny both by the SEC and by the broker-dealer community in the wake of U.S. deregulation of commission rates in 1975. The broker-dealer exclusion is discussed in § 16.03[2][b].

An adviser's receipt of compensation may also raise the converse question, that is, whether the adviser must register as a broker-dealer. The SEC staff has taken the position that where, *inter alia*, fees charged by an adviser are not based on transactions effected for the accounts of advisory clients and the adviser does not have actual custody of client funds (even though it may have full discretionary authority with respect to such funds), the adviser need not register as a broker-dealer. *See*, *e.g.*, *Robert R. Jones* (avail. Nov. 14, 1984); *Kirr, Marbach & Co.* (avail. Feb. 6, 1977); *First Atlantic Investment Advisory Corp.* (avail. Mar. 22, 1974); *Fundamental Advisors, Inc.* (avail. Dec. 4, 1971); *Mecs, Ph.D., B.M.* (avail. Dec. 6, 1970);

see also Chapter 14 for a discussion of U.S. regulation of broker-dealers.

116 "Directed brokerage" refers to the practice of advisory clients to direct their brokerage transactions to a particular broker either as payment for the advisory fees of an affiliated adviser (or as payment for some other service that the broker renders to the adviser, whether or not affiliated) or other expenses of the client or to achieve a favorable commission rate. *See* § 16.09 for a discussion of fiduciary obligations in the context of directed brokerage and "soft dollar" transactions.

117 The staff has refused to grant no-action relief to an individual who proposed not to charge any fees, but instead would ask only for a voluntary commission. *Russell H. Smith* (avail. May 2, 1996).

118 SEC Release No. IA-1092 (Oct. 8, 1987) (citing *Warren H. Livingston* (avail. Mar. 8, 1980)).

119 SEC Release No. IA-1092 (Oct. 8, 1987) (citing *Warren H. Livingston* (avail. Mar. 8, 1980)); *see also United States v. Elliott*, 62 F.3d 1304 (11th Cir. 1995) (holding that defendants were compensated for providing investment advice, despite the fact that plaintiffs did not pay a discrete fee specifically earmarked as payment for investment advice); *Independent Drug Wholesalers Group, Inc.* (avail. Apr. 16, 1992) (no-action relief denied to president of a trade association who proposed to provide to members of the association, free of charge, recommendations regarding stock of pharmaceutical companies based on information in the association's possession regarding sales of specific drugs in part because he would receive indirect compensation in the form of his salary paid out of association members' dues).

120 *See* SEC Release No. IA-3222 (June 22, 2011).

121 *See* § 16.14 for a discussion of state regulation of investment advisers.

122 The Advisers Act defines "*bank*" as:

> (A) a banking institution organized under the laws of the United States or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act, (B) a member bank of the Federal Reserve System, (C) any other banking institution, savings association, as defined in section 2(4) of the Home Owners' Loan Act, or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of [the Advisers Act], and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

§ 202(a)(2) of the Advisers Act.

123 The definition of "investment adviser" was, however, amended by the Gramm-Leach-Bliley Act (the "GLB Act") to include any bank or bank holding company "to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company." Nevertheless, "if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser." GLB Act, Pub. L. No. 106-102, 113 Stat. 1338, 1399 (1999).

124 While the definition of "bank" in § 2(a)(5) of the Investment Company Act used to be substantially identical to that provided in the Advisers Act, the GLB Act amended the definition in the Investment Company Act to strike clause (A), which read, as in the Advisers Act definition, "a banking institution organized under the laws of the United States," and inserted a new clause (A), which now reads "a depository institution (as

defined in § 3 of the Federal Deposit Insurance Act) or a branch or agency of a foreign bank (as such terms are defined in § 1(b) of the International Banking Act of 1978)." § 2(a)(5)(A) of the Investment Company Act. For a discussion of foreign banks and the "bank" exception under the Investment Company Act, see § 15.05[2].

125 Although these entities do not technically meet the definition of a "bank holding company" under the Bank Holding Company Act, they are nevertheless deemed bank holding companies under the Bank Holding Company Act. 12 U.S.C. § 3106 (2010).

See also § 202(a)(2)(C) of the Advisers Act.

126 *See also* § 202(a)(2)(C) of the Advisers Act.

127 *See*, *e.g.*, *Charterhouse Tilney* (avail. July 15, 1993) (no-action relief granted to foreign broker-dealer that proposed to (i) provide research reports to major U.S. institutional investors and to effect transactions in the securities discussed in the research reports with or for these investors and (ii) distribute those reports to U.S. persons other than major institutional investors through its U.S. registered broker-dealer affiliate); *Brown Shipley Stockbroking Limited* (avail. Dec. 6, 1989) (explaining that a foreign broker-dealer not registered with the SEC generally would be required to register as an investment adviser (absent an available exemption or exception from registration) where the foreign broker-dealer sought to manage the investment portfolios of U.S. residents).

128 § 202(a)(11)(C) of the Advisers Act. This exclusion for broker-dealers would also cover a futures commission merchant that has notice-registered as a broker-dealer for the limited purpose of effecting transactions in securities futures products. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, § 4.07.

129 *See* SEC Release No. IA-2376 (Apr. 12, 2005); *see also Securities Industry Association* (avail. Dec. 16, 2005).

130 *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

131 *Financial Planning Association v. SEC*, 482 F.3d 481, 488 (D.C. Cir. 2007). As the opinion notes, following an amendment to § 202(a)(11) of the Advisers Act by the Credit Rating Agency Reform Act of 2006, subsection (F) was redesignated as subsection (G). The opinion refers to the former designation. *Financial Planning Association v. SEC*, 482 F.3d 481, 483 n.1 (D.C. Cir. 2007).

132 *Financial Planning Association v. SEC*, 482 F.3d 481, 493 (D.C. Cir. 2007).

133 Press Release, SEC, SEC Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts (May 14, 2007). To facilitate the transition of non-advisory fee-based accounts, the SEC sought a 120-day stay of the decision, and provided a temporary alternative method for advisers to comply with certain requirements of the Advisers Act related to principal transactions with advisory clients for whom the adviser does not have discretion, SEC Release No. IA-2653 (Sept. 24, 2007). The sunset period for this temporary alternative method has been extended to December 31, 2016. SEC Release No. IA-3984 (Dec. 23, 2014); *see infra* Note 270.

134 SEC Release No. IA-2652 (Sept. 24, 2007). The SEC removed the proposed rule from the unified regulatory agenda in 2012, but stated that it may consider the reforms at some future point. *See* SEC, The 2012 Regulatory Plan and the Unified Agenda of Federal Regulatory and Deregulatory Actions, RIN 3235-AJ97 http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201210&RIN=3235-AJ97. If reconsidered and adopted, the new interpretations would be codified as Rule 202(a)(11)-1, replacing the vacated rule.

135 *See* SEC Release No. IA-626 (Apr. 27, 1978); SEC Release No. IA-2 (Oct. 28, 1940).

136 *See* Press Release, SEC, SEC Seeks Time for Investors and Brokers to Respond to Court Decision on Fee-Based Accounts (May 14, 2007); Press Release, SEC, SEC Awards Contract for Study to Compare Roles of Investment Advisers, Broker-Dealers (Sept. 26, 2006).

137 Angela A. Hung, *et al.*, *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (RAND Corp. 2008).

138 Press Release, SEC, SEC Publishes Text of RAND Report on Investment Adviser, Broker-Dealer

Industries (Jan. 3, 2008); *see* Andrew J. Donohue, Director, SEC Division of Investment Management, Remarks at the Tenth Annual Investment Adviser Compliance Best Practices Summit (Mar. 21, 2008); *see also* the Advisers and Broker-Dealer Study (citing the RAND report among other SEC-commissioned studies to support the need for uniform treatment of retail investors by broker-dealers and investment advisers).

139 *See*, *e.g.*, § 913 of the Dodd-Frank Act (requiring the SEC to conduct a study concerning the obligations of broker-dealers and investment advisers and authorizing the SEC to promulgate rules concerning, among other things, the legal or regulatory standards of care for broker-dealers, investment advisers and persons associated with these intermediaries for providing personalized investment advice about securities to retail customers) and related Advisers and Broker-Dealer Study (*see supra* Note 8) (while the SEC's Investor Advisory Committee has recommended an enhanced standard of care for broker-dealers, the SEC has not yet proposed any new rules in the area, though Chair White testified before Congress in 2016 on the SEC's 2017 budget request that she "expect[s] to continue to develop support from [her] fellow Commissioners for a uniform fiduciary duty for investment advisers and broker-dealers"); § 914 of the Dodd-Frank Act (requiring the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers) and related SEC Study on Enhancing Investment Adviser Examination (Jan. 2011); § 919 of the Dodd-Frank Act (authorizing the SEC to issue rules designating documents or information that shall be provided by a broker or dealer to a retail investor before the purchase of an investment product or service by the retail investor) and related SEC Study and Recommendations on Improved Investor Access to Registration Information About Investment Advisers and Broker-Dealers (Jan. 2011). Separate FINRA proposals to address the study's recommendations by requiring broker-dealer websites to include links to BrokerCheck in different ways were made and withdrawn through the period from 2012 to 2014. *See* FINRA Regulatory Notice 12-10 (Feb. 2012); SEC Release No. 34-68700 (Jan. 18, 2013); FINRA Regulatory Notice 14-19 (Apr. 2014). FINRA proposed a requirement to include a link to BrokerCheck to be "readily apparent" on member websites intended to be viewed by retail investors or that include a professional profile of one or more registered persons who conduct business with retail investors. SEC Release No. 34-75377 (July 7, 2015). The SEC approved the requirement, amending FINRA Rule 2210, in 2015, and the requirement's effective date was in June 2016. *See* SEC Release No. 34-76105 (Oct. 8, 2015); FINRA Rule 2210(d)(8). On February 3, 2017, President Trump directed the Secretary of Labor to reexamine the Fiduciary Duty Rule. *See* Presidential Memorandum on Fiduciary Duty Rule (Feb. 3, 2017).

140 The SEC staff has also found that the exclusion may extend in certain circumstances to video information services, *Reuters Information Services, Inc.—TV 2000* (avail. Jan. 17, 1991), and to telephonic market timing services, *Charles L. Simpson* (avail. July 7, 1992).

141 *Lowe v. SEC*, 472 U.S. 181 (1985).

142 Although the Court decided the case on statutory grounds, First Amendment concerns played a role in its reasoning. The Court noted that:

> [T]he legislative history [of the Advisers Act] demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice, including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of nonpersonalized publishing activities.

Lowe v. SEC, 472 U.S. 181, 204 (1985).

In a concurring opinion, in which Chief Justice Burger and Justice Rehnquist joined, Justice White rejected the majority's statutory construction, concluding that the definition of investment adviser could encompass publishers of impersonal investment advice, but that First Amendment principles would not permit the blanket injunctive relief at issue in *Lowe*. *Lowe v. SEC*, 472 U.S. 181, 211 (1985).

143 *Lowe v. SEC*, 472 U.S. 181, 206–09 (1985). The staff of the SEC has suggested, for example, that a "900 number" service providing telephonic recorded stock tips may qualify for the publishers' exclusion under *Lowe*. *Mary Lee Botsaris—900 Stock Tip Number* (avail. Mar. 25, 1993).

144 *Lowe v. SEC*, 472 U.S. 181, 209 (1985).

145 David Ferber, *The Narrow Holding of the Lowe Case*, 19 REV. SEC. & COMM. REG. 29 (1986); *see also SEC v. Wall Street Publishing Institute, Inc*., 851 F.2d 365 (D.C. Cir. 1988), *cert. denied*, 489 U.S. 1066 (1989); SEC Litigation Release No. 10813 (July 8, 1985).

In ruling on a motion to dismiss, one court has held that an individual who maintained a website which touted certain stocks and e-mailed his stock picks to subscribers could be considered an investment adviser. *SEC v. Park*, 99 F. Supp. 2d 889 (N.D. Ill. 2000). The court rejected the argument that the service was not personalized and found that the SEC had alleged facts sufficient to show that the defendant may not fall within the publisher's exemption for registration under the Advisers Act.

146 § 202(a)(11)(B) of the Advisers Act excludes "any lawyer, accountant, engineer or teacher whose performance of such services is solely incidental to the practice of his profession."

147 § 202(a)(11)(E) of the Advisers Act. The SEC staff has questioned the availability of the exclusion for advice regarding U.S. government securities where an adviser proposed to advise as to repurchase agreements. *J.Y. Barry Arbitrage Management Inc*. (avail. Oct. 18, 1989) (citing SEC Release No. IC-10666 (Apr. 18, 1979) and *The Prospect Group* (avail. Nov. 29, 1988)). The staff based its conclusion on its position that a repurchase agreement should be viewed as a loan rather than a sale and repurchase of securities, so that the repurchase agreement would constitute an evidence of indebtedness. Under SEC rules, advisers to municipalities are regulated under the Exchange Act. *See supra* Note 96.

148 § 409 of the Dodd-Frank Act. The SEC adopted a new Rule 202(a)(11)(G)-1 under the Advisers Act to define family offices that are excluded from the definition of "investment adviser" under the Advisers Act. Rule 202(a)(11)(G)-1 largely codifies the exemptive orders that the SEC has issued to family offices. Each of these exemptive orders reflected the specific factual situation presented by the family office applicant. *See* SEC Release No. IA-3220 (June 22, 2011); SEC, Division of Investment Management Responses to Questions About the Family Office Rule (Apr. 27, 2012).

149 § 202(a)(11)(H) of the Advisers Act; *see, e.g.*, SEC Release No. IA-2013 (Feb. 7, 2002); SEC Release No. IA-1970 (Aug. 27, 2001).

150 § 203(b) of the Advisers Act exempts, among other persons:

> (1) any investment adviser, other than an investment adviser who acts as an investment adviser to any private fund, all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange; (2) any investment adviser whose only clients are insurance companies; [or] (3) any investment adviser that is a foreign private adviser.

A person seeking to provide advice on an exempt basis with respect to the trading of security futures products requires an exemption from both the Advisers Act and the CEA. Although currently there is considerable overlap between exemptions under both statutes, the exemptions are not entirely coextensive. In 2012, the SEC adopted rules that eliminated certain exemptions from the CEA and created a number of new requirements for persons registered under the CEA. *See supra* Note 7.

151 *See* discussion at §§ 16.07 and 16.08.

152 The Private Fund Advisers Act was Congress's solution to the question of hedge fund regulation. The SEC sought to expand its regulation of hedge funds by adopting a new rule and several rule amendments that took effect in 2005. Hedge Fund Release. The Hedge Fund Release effectively required many hedge fund advisers to register as investment advisers under the Advisers Act by changing the manner in which they counted their clients for purposes of determining the availability of the *de minimis* exemption. In June 2006, the U.S. Court of Appeals for the District of Columbia Circuit vacated the rule and the related rule amendments, concluding that the SEC had acted arbitrarily in determining that the investors in a hedge fund would be deemed clients of an adviser for purposes of the *de minimis* exemption when only the fund itself would be considered the adviser's client for other purposes under the Advisers Act. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). The SEC then embarked on an aggressive agenda through rulemaking and staff guidance to address the consequences of this decision. *See* Rule 206(4)-8 under the Advisers Act.

153 For purposes of determining clients under the *de minimis* exemption, no shareholder, partner or beneficial owner of a client entity was considered a client unless such person was a client of the adviser separate and apart from its status as shareholder, partner or beneficial owner. The Private Fund Advisers Act maintained the interpretive provisions for determining who are clients.

154 15 U.S.C. § 80b-3(b)(3) (2006).

155 SEC Release No. IA-3221 (June 22, 2011); SEC Release No. IA-3222 (June 22, 2011).

156 § 402(a) of the Private Fund Advisers Act.

157 R-AUM is reported on Part 1 of Form ADV.

158 In response to commenters citing the statutory definition of investment adviser (which includes a "for compensation" qualifier), the SEC noted in its adopting release that "[a]lthough a person is not an ‘investment adviser’ for purposes of the Advisers Act unless it receives compensation for providing advice to others, once a person meets that definition (by receiving compensation from *any* client to which it provides advice), the person is an adviser, and the [Advisers] Act applies to the relationship between the adviser and any of its clients (whether or not the adviser receives compensation from them)." SEC Release No. IA-3221 (June 22, 2011), 76 Fed. Reg. 42,950, 42,955 (July 19, 2011). Presumably the SEC is only referring to an adviser's *advisory* clients in this context (as opposed to all of the adviser's clients, including non-advisory clients), *i.e.*, if the adviser receives compensation from any one client to which it provides advice then it is an adviser to each client *to which it provides advice* whether or not compensation is received.

159 *See* Rule 202(a)(30)-1(c)(1) under the Advisers Act; Form ADV, Instruction 5.b(1) to Part 1A.

160 *See* Form ADV, Instruction 5.b(1) to Part 1A.

161 For clarification purposes, in its adopting release the SEC changed this wording from the proposal that said "*from* a place of business in the United States" to more clearly reflect a focus on the location at which management is conducted. The SEC also made clear in its adopting release that, for non-U.S. advisers, the analysis likely will not turn on whether the non-U.S. adviser has a place of business in the United States but on whether the adviser manages assets, or has "assets under management," at such a U.S. place of business. "Assets under management" are securities portfolios for which the adviser provides "continuous and regular supervisory or management services." The SEC confirmed that, while this is an inherently factual determination, it would not view providing research or due diligence at a U.S. place of business to be managing assets in the United States if a person outside the United States makes an independent investment decision and implements those decisions. SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 42,950, 42,955 (July 19, 2011). Presumably, marketing or other client services offices that do not engage in "management" of assets would also be excluded from the calculation of assets under management in the United States for such non-U.S. advisers.

162 Given the focus on assets under management in the United States for a non-U.S. adviser, many non-U.S. advisers may be able to rely on the private fund adviser exemption instead of the foreign private adviser exemption.

163 *See* § 16.03[3][b] for discussion of the meaning of "place of business."

164 The Private Fund Advisers Rules refer to the definition of a U.S. person in Regulation S. *See* § 8.02 for a discussion of Regulation S and related definitions.

165 SEC Release No. IA-3222 (June 22, 2011). The adopting release states that whether a single-investor fund could be a "private fund" for purposes of the exemption depends on the facts and circumstances. The release notes the SEC's concern that an adviser simply could convert client accounts to single-investor funds—which would be tantamount to separately managed accounts—in order to avoid registering under the Advisers Act. The SEC references § 208(d) of the Advisers Act as anticipating "these and other artifices" and thus prohibiting a person from doing indirectly anything that it would be unlawful to do directly. Although the release acknowledges that there are circumstances in which it may be appropriate for an adviser to treat a single investor fund as a private fund for purposes of the rule, these are likely to be limited—such as where a fund that seeks to raise capital from multiple investors has only a single, initial investor for a period of time or where all but one of the investors in a multi-investor fund have redeemed their interests. 76 Fed. Reg. 39,646, 39,667–39,668 (July 6, 2011).

166 "In the United States" refers to the definition of a U.S. person as provided for in Regulation S. *See supra* Note 164.

167 In the context of the *de minimis* exemption, at least one commentator had suggested that an adviser that offers services to more than 14 persons is not exempt regardless of the actual number of clients, because it would be making a public offering of its advisory services. *See* Tamar Frankel & Ann Taylor Schwing, 2 THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 10.02[B] (2d ed. 2001).

168 § 402(a) of the Private Fund Advisers Act. The exemption would thus potentially be available to an adviser providing advice to entities excluded from the definition of investment company specified in § 3(c) of the Investment Company Act. *See*, *e.g.*, *Bache & Co. (Pan America), Inc.* (avail. Sept. 19, 1976). For a description of the types of entities required to register under the Investment Company Act, *see* § 15.03.

169 Rule 202(a)(30)-1(c)(4) under the Advisers Act.

170 The SEC clarified in the adopting release that while a "place of business" as defined would include any office where the adviser regularly communicates with U.S. or non-U.S. clients or regularly conducts research, it would likely not include a place of business used solely for administrative or back office activities if such activities are not "intrinsic to providing investment advisory services" and do not involve communicating with clients. *See* SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 39,646, 39,679 (July 6, 2011); *see also supra* Notes 161–163 and accompanying text. Even with this clarification, determining whether an operation or office in the United States will count as a "place of business" for purposes of this exemption will be a fact-intensive and difficult analysis, especially given the breadth of activities one can conduct in an office and the ambiguity inherent in the standard the SEC has cited (*i.e.*, "intrinsic to providing advice").

171 Rule 202(a)(30)-1(a)(1) under the Advisers Act; *see also supra* Note 42.

172 Rule 202(a)(30)-1(a)(2) under the Advisers Act. The staff has also indicated that an investment adviser that advised funds through a two-tiered investment structure, where a top-tier fund would invest in several underlying investment funds, need not count the underlying funds as clients for purposes of § 203(b)(3). *See Willkie Farr & Gallagher* (avail. Oct. 30, 1998).

173 Even if "single advisee" treatment is unavailable with respect to a limited partner that is otherwise an advisory client, such treatment may still be available with respect to other limited partners complying with the rule. Rule 202(a)(30)-1(b)(1) under the Advisers Act. Under the prior rules regarding the *de minimis* exception, the SEC has declined to expand this treatment to include general partnerships on the theory that it was intended to establish parity of treatment between limited partnerships and corporate vehicles for passive investment—a function not, in the SEC's view, typically served by the general partnership form.

SEC Release No. IA-983 (July 12, 1985).

174 SEC Release No. IA-3222 (June 22, 2011). The SEC also determined to include in the calculation of assets under management assets managed without compensation, noting that if an adviser receives compensation from any one client to which it provides advice, then it is an adviser to each advisory client whether or not compensation is received. *See supra* Note 158.

175 Rule 202(a)(30)-1(c)(2) under the Advisers Act. The adopting release clarifies that an adviser must look through nominee and similar arrangements, total return swaps or similar instruments, as well as through master-feeder structures, to the beneficial owners. The SEC introduced a reasonableness standard for this determination, *i.e.*, the adviser may treat as an investor a person the adviser reasonably believes is the actual investor. The same standard may be used in determining if a particular investor is "in the United States." The SEC noted that because private fund advisers already need to "look through" and count investors for purposes of their Investment Company Act exemption, this provides no additional burden to advisers who argue that they may not know the identity or location of each investor. SEC Release No. IA-3222 (June 22, 2011), 76 Fed. Reg. 39,646, 39,678 (July 6, 2011).

176 Rules 202(a)(30)-1(b)(4) and 202(a)(30)-1(c)(2) under the Advisers Act.

177 *See* Rule 202(a)(30)-1(c)(2) under the Advisers Act. Proposed Rule 202(a)(30)-1(c)(1)(i), by reference to Rule 3c-5 under the Investment Company Act, would have counted "knowledgeable employees" as investors for purposes of the foreign private fund adviser exemption. *See* SEC Release No. IA-3111 (Nov. 19, 2010).

178 *See*, *e.g.*, *Alexander, Holburn, Beaudin & Lang* (avail. Aug. 13, 1984).

179 Section 202(a)(30)(D); *see also infra* Note 184.

180 *See, e.g., Mr. R. Bate* (avail. June 28, 1988); *The Gordian Cos., Inc.* (avail. Aug. 20, 1987); *Executive Group* (avail. July 9, 1984); *System Dynamics* (avail. June 21, 1983); *Benedict A. Stanonis* (avail. May 20, 1982); *Bruce O. McCracken* (avail. May 29, 1981); *David Streetman* (avail. Aug. 17, 1979); *Ronald F. Bentley* (avail. Jan. 24, 1978); *ONB Securities, Inc.* (avail. Dec. 17, 1978).

181 SEC Release No. IC-21260 (July 27, 1995), 60 Fed. Reg. 39,574, 39,575 n.8 (Aug. 2, 1995); *Resource Bank & Trust* (avail. Mar. 29, 1991).

182 SEC Release No. 33-7288 (May 9, 1996). An unregistered adviser's Internet site should also be properly legended to indicate that the adviser's services are not available, and are not being offered, to U.S. investors. SEC Release No. IA-1710 (Mar. 23, 1998). The SEC staff has also indicated that an investment adviser that posted information on an Internet site about private funds, whether structured as domestic or foreign partnerships, limited liability companies, trusts or other entities, would not be "holding out" to the public if the operator of the Internet site used procedures designed to limit access to the Internet site information to a select group of accredited investors. *Lamp Technologies, Inc.* (avail. May 29, 1998). In addition, the SEC staff has indicated that it would not recommend enforcement action against advisers relying on the § 203(b)(3) exemption if they provided information to a data service provider that only distributed the information exclusively to the institutional sales and trading desks of broker-dealers. *Thomson Financial Inc.* (avail. July 10, 2002).

183 SEC Release No. IA-688 (July 12, 1979).

184 Rule 203(b)(3)-1(c) under the Advisers Act. The Private Fund Advisers Act rescinded Rule 203(b)(3)-1; however, Rule 202(a)(30)-1 was adopted at the same time and covers substantially the same ground but in the context of the foreign private adviser exemption, which is currently the only exemption that refers to not "holding out" as a criterion. SEC Release No. IA-3221 (June 22, 2011).

185 The fund's compliance with the 20% limit is to be calculated at the time any non-qualifying investment is made, based on the non-qualifying investments then held in the fund's portfolio. SEC Release No. IA-3222 (June 22, 2011).

186 Rule 203(l)-1 under the Advisers Act; SEC Release No. IA-3222 (June 22, 2011).

187 SEC Release No. IA-3222 (June 22, 2011).

188 Rule 203(l)-1(c)(3) and (4) under the Advisers Act.

189 Rule 203(l)-1(b) under the Advisers Act.

190 § 208(d) of the Advisers Act prohibits "any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of the [Advisers Act] or any rule or regulation thereunder." *See also supra* Note 66 and accompanying text.

191 A discussion of SEC positions regarding the integration of advisory activities of different entities for purposes of the Advisers Act registration requirement is included at § 16.02[2]. *See also Murray Johnstone Holdings Ltd*. (avail. Oct. 7, 1994) (granting no-action relief from integration of several unregistered and registered affiliates for purposes of determining the number of U.S. clients serviced by the group and the applicability of Rule 203(b)(3)-1 where the affiliates were operated separately and independently, notwithstanding certain director interlocks).

192 The SEC noted in the adopting release the possibility of recordkeeping requirements for Exempt Reporting Advisers to be addressed in a future release. *See* SEC Release No. IA-3221 (June 20, 2011).

193 §§ 407 and 408 of the Dodd-Frank Act.

194 The rules require that Exempt Reporting Advisers complete the following seven items in Part 1A of Form ADV: Items 1 (Identifying Information), 2.B (Checkbox regarding Exemption Qualifications), 3 (Form of Organization), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), 11 (Disclosure Information), and the corresponding sections of Schedules A, B, C and D. The Private Fund Advisers Rules do not require Exempt Reporting Advisers to complete and file other items in Part 1A or prepare a client brochure. Items 1, 3 and 10 require basic identification details about an Exempt Reporting Adviser such as name, address, contact information, form of organization and who owns the adviser. Items 6 and 7.A provide details regarding other business activities that the adviser and its affiliates are engaged in. Item 11 requires advisers to disclose the disciplinary history for the adviser and its employees and other advisory affiliates. Exempt Reporting Advisers are also required to complete the newly revised item 7.B, which requires advisers to provide the SEC with basic organizational, operational and investment characteristics of each fund client, the amount of assets held by each fund client, the nature of the fund client's investors and/or owners, the advisory services provided to the fund client, and each fund client's service providers (*i.e.*, auditors, prime brokers, custodians, administrators and marketers). SEC Release No. IA-3221 (June 22, 2011).

195 SEC Release No. IA-3221 (June 22, 2011).

196 *See* SEC Release No. IA-3308 (Oct. 31, 2011).

197 *See supra* Note 150.

198 *Roy Heybrock* (avail. Apr. 5, 1982). *But see Associates in Financial Planning* (avail. Mar. 21, 1977) (granting no-action relief to a company that advised with regard to unlisted mutual fund securities).

199 *See Guardian Investment Services, Inc.* (avail. Sept. 18, 1986).

200 *See, e.g., Crosby Investment Consultants, Inc.* (avail. Oct. 28, 1977) (federally chartered institutions having their principal offices in applicable states were qualifying clients for purposes of the intrastate exemption); *First Federal Savings & Loan Association of Dallas, Texas and F.F. Corp.* (avail. Oct. 2, 1976). *But see Alpha Capital Corp.* (avail. Mar. 3, 1971) (granting no-action relief even where request failed to identify whether corporate advisory clients would be domiciled and have principal place of business within the state).

201 Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (Appendix E), 114 Stat. 2763, 2763A-365 (2000).

202 § 203(b)(6) of the Advisers Act

203 § 403 of the Private Fund Advisers Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 16.04, REGISTRATION PROCESS

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 § 16.04 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Registration under the Advisers Act for those advisers required to register with the SEC is a relatively simple process, requiring the completion of a prescribed application form—Form ADV. [204] Within 45 days after filing, the SEC must either approve the prospective adviser for registration or commence proceedings to determine whether registration ought to be denied. [205] The Advisers Act requires no showing of competence by personnel, such as the passing of an examination, nor does it impose any minimum capital requirements for a registered adviser. [206] It does, however, contain certain "statutory disqualifications"

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from registration, which include: (i) the making of false and misleading statements to the SEC under the Advisers Act, [207] (ii) criminal convictions and violations relating to any of the federal or state securities or commodities laws, [208] (iii) criminal convictions relating to any felony, [209] and (iv) convictions for substantially equivalent crimes and violations of substantially equivalent foreign laws. [210]

In addition to complying with the basic registration requirements, foreign advisers must also file with the SEC an irrevocable consent to service of process and a power of attorney appointing the SEC as agent to receive process, pleadings and other papers in connection with any civil suit or action arising out of the adviser's business, in any place subject to the jurisdiction of the United States, and based upon the Advisers Act, the Securities Act, the Exchange Act, the Trust Indenture Act, the Investment Company Act or any rule or regulation under any of those statutes. [211]

The application for registration as an investment adviser on Form ADV consists of two parts. Part 1 requires a description of the adviser and other information primarily relating to the basics of the adviser's business and the adviser's disciplinary history and ownership, including persons or entities having a controlling influence over its policies. In the case of an adviser in corporate form, the identity of owners of 5% or more of the common stock (voting) of the applicant and the owners of 25% or more of such owners up the ownership chain, unless an indirect owner is subject to the reporting requirements of the Exchange Act, is required to be disclosed. [212] In the case of advisers or their owners that are organized as limited liability companies or limited partnerships, disclosure of

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those persons that have contributed or have the right to receive upon dissolution 5% (in the case of a direct owner) or 25% (in the case of an indirect owner) of such entity's capital is required, resulting in persons with only an economic interest (no voting rights) being subject to disclosure. This requirement may raise issues for foreign advisers with complex and confidential holding company ownership structures, particularly since foreign parents of such advisers are often not Exchange Act reporting companies. Although the SEC staff has not published any no-action or other guidance with respect to this requirement, it has demonstrated a willingness in isolated cases to explore compromise disclosure with an applicant.

The Private Fund Advisers Rules require additional information to be provided on Part 1 of Form ADV. The rules amended Form ADV to require advisers to provide supplemental information about three areas of operation: (i) private funds advised, (ii) advisory activity, including business practices, and (iii) non-advisory activity, including financial industry affiliations. [213]

Part 2 of Form ADV describes in detail the services provided by the adviser and its primary policies affecting its relationship with its clientele, with emphasis on disclosure of conflicts of interest. Part 2 requires, among other things, details regarding: material changes to the brochure since the last annual update, a description of the adviser's business; the adviser's fee schedule; the amount of assets under management and how such amount is calculated; side-by-side management of performance-based and nonperformance-based fee accounts; the types of clients it advises; the types of securities about which it provides advice; the investment strategies it uses in formulating advice and the risks related thereto; its disciplinary history; its brokerage placement practices; affiliations the adviser may have with other market participants (including broker-dealers, commodity trading advisers, banks and insurance companies); custody of client funds and securities; and the adviser's code of ethics (including a statement that the adviser will furnish a copy of its code of ethics to any client or prospective client upon request). In addition, an adviser that requires its clients to prepay more than $1,200 in fees (per client) six or more months in advance must file with its Form ADV an audited balance sheet for its most recent fiscal year (prepared in accordance with, or reconciled to, U.S. generally accepted accounting principles ("GAAP")). [214] All disclosures in Part 2 of Form ADV must be written in "plain English." [215]

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Form ADV must be promptly amended in the event of material changes in certain information or upon any changes, regardless of materiality, in other information included in the form. [216] In addition, each registered investment adviser is required to file an annual update to its registration statement within 90 days of the close of the adviser's fiscal year. [217]

Footnotes

204 Applications for registration as an adviser must be submitted electronically through the Investment Adviser Registration Depository ("IARD"). SEC Release No. IA-1897 (Sept. 12, 2000). Investment advisers may satisfy filing obligations under both state and federal law with a single electronic filing made through the IARD.

FINRA (the operator of the IARD) typically charges an initial set-up fee and annual fees that vary depending on the amount of assets under management. Rule 204-1(d) under the Advisers Act. Under the current fee structure, the amount of filing fees paid by an adviser depends on its R-AUM. SEC Release No. IA-3126 (Dec. 22, 2010). All states (and the District of Columbia), with the exception of Wyoming, which does not regulate investment advisers, permit registration under local securities laws using Form ADV. Most states now mandate electronic filing. For a discussion of local securities regulation applicable to investment advisers, *see* § 16.14.

205 § 203(c)(2) of the Advisers Act.

206 The SEC staff has taken the position on at least one occasion, presumably on the basis of general antifraud principles, that a person holding himself out as an investment adviser "represents that he has adequate qualifications by virtue of his educational background or experience to engage in that activity." *Edgardo H. Segura* (avail. Apr. 14, 1978). In addition, many state securities authorities require that employees of investment advisers registered in the state that provide clients with investment advice or who supervise such employees pass a standardized examination. *See*, *e.g.*, GA. CODE ANN. § 10-5-41; R.I. GEN. LAWS § 7-11-203. Certain states also require the posting of a bond or the maintenance of professional liability insurance or minimum capital requirements as a condition to registration as an investment adviser in the state. *See*, *e.g.*, GA. CODE ANN. § 10-5-40; ARK. CODE ANN § 23-42-303; 64 PA. CODE § 303.042.

207 § 203(e)(1) of the Advisers Act.

208 § 203(e)(2) of the Advisers Act.

209 § 203(e)(3) of the Advisers Act.

210 §§ 203(e)(2) and 203(e)(3) of the Advisers Act.

211 Rule 0-2 under the Advisers Act. The Advisers Act prescribes the precise form of the required consent to

service of process. The breadth of inquiry to which the consent exposes a foreign adviser may pose special issues in the case of foreign banks and bank holding companies conducting securities-related activities in the United States in reliance on Rule 15a-6 under the Exchange Act, which provides such entities (and other foreign brokers and dealers) an exemption from broker-dealer registration in limited circumstances. *See* § 14.03[3]. A foreign broker or dealer also registered under the Advisers Act is subject to examination with respect to all of its activities, including securities activities conducted in reliance on Rule 15a-6.

212 There is no published authority to the effect that an entity exempt from reporting requirements pursuant to Rule 12g3-2(b) under the Exchange Act would not be required to disclose its beneficial owners, and it would appear that this disclosure would be required to be made by such an entity. For a further discussion of Rule 12g3-2(b), *see* § 4.02[3].

213 SEC Release No. IA-3221 (June 22, 2011).

214 Form ADV, Part 2, Item 18.

215 The SEC adopted significant amendments to Part 2 of Form ADV that, among other things, (i) expanded the scope of information required on the form, (ii) changed the manner in which the Part 2 information is presented from the prior "check-the-box" form to a narrative discussion, and (iii) required that Part 2 of Form ADV, and any amendments thereto, be filed with the SEC through the IARD. SEC Release No. IA-3060 (July 28, 2010).

216 See Rule 204-1(a) under the Advisers Act.

217 Rule 204-1(a) under the Advisers Act. An annual fee typically must be paid to FINRA, as the operator of the IARD, upon filing of the annual report. *See supra* Note 204.

U.S. Regulation of the International Securities and Derivatives Markets, § 16.05, "BROCHURE RULE" AND RELATED DISCLOSURE

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 § 16.05 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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Pursuant to the so-called "Brochure Rule," Part 2 of Form ADV, or a comparable document providing at least the information called for by the form, must be provided to advisory and prospective advisory clients before or at the time they enter into an investment advisory contract, unless the client has the right to terminate the contract without penalty for a period of five business days after concluding the contract, in which case the required information must be delivered at the time the contract is entered into. [218]

An adviser to a fund that is also the general partner (or an entity serving in a similar capacity) to the fund typically delivers a copy of its "brochure" to each investor in or beneficial owner of the fund, in addition to delivering a copy of the "brochure" to the fund itself. [219] In addition, it is market practice for advisers who are not also the general partners of the funds to deliver their "brochures" and make certain other disclosures to the investors in or beneficial owners of the funds but these disclosures can be made in the offering materials or in other disclosure documents that investors receive.

The SEC staff has also taken the position that foreign advisers need not deliver a "brochure" to their non-U.S. clients, subject to satisfaction of certain

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conditions. [220] The staff has conditioned the ability of a foreign adviser not to comply with the Advisers Act in the case of non-U.S. advisory clients on the adviser's agreement that it will not hold itself out to such clients as being registered with the SEC. [221]

A brochure need not be delivered in connection with a contract with an investment company registered under the Investment Company Act that has been approved by a majority of its directors who are not interested parties with respect to the contract. [222] The Brochure Rule, as well as the other regulatory provisions of the Advisers Act, only apply to activities concerning advisory clients. A broker-dealer that is also an investment adviser has to comply with the Advisers Act provisions only with respect to its advisory clients. The adviser must offer to deliver its brochure annually to its clients. [223]

Registered investment advisers that are "sponsors" of "wrap fee programs" [224] must provide prospective clients in these programs with a separate narrative brochure, which must also be filed with the SEC as part of Form ADV. [225]

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The brochure must disclose information regarding the programs and related fees and services and include a statement that persons who solicit participation in the programs will be compensated and may have a financial incentive to recommend the wrap fee program over other programs or services. Where a sponsor offers several programs, the sponsor has the option to prepare either a single brochure describing all of its wrap fee programs or separate brochures for each program. The wrap fee brochure is required to be updated promptly after any information in the brochure becomes materially inaccurate. The requirement to deliver a wrap fee brochure does not apply to "managed account programs," defined as programs in which clients are provided with advice about portfolio managers, continuous monitoring of portfolio managers and brokerage services, but are charged advisory fees and transaction-based commissions, or to "mutual fund asset allocation programs," defined as programs that provide recommendations of mutual funds, rather than portfolio managers, and do not involve the provision of advisory and brokerage services for a single wrap fee. [226]

Under Regulation S-P, investment advisers (as well as broker-dealers and investment companies) must provide notice to "customers"—that is, clients who are natural persons about the advisers' privacy policies and practices. [227] The notice must be provided to a client when the relationship is established and on an annual basis during the term of the relationship. Regulation S-P also requires an investment adviser not to disclose nonpublic personal information about a client to unaffiliated third parties unless the adviser provides certain information to the client and the client has not elected to opt out of the disclosure. [228] While a fund client is not a "customer" under Regulation S-P, the Consumer Financial Protection Bureau's ("CFPB's") Regulation P applies to private funds, whose "customers" are natural persons who are investors in those funds. [229] In addition, The Federal Trade Commission had similar authority related to privacy notices over financial institutions including private funds before Dodd-Frank, [230] which transferred privacy notice rulemaking authority from a number of agencies over a number of types of institutions to the CFPB. In each case, regardless of the agency imposing the rule, the requirements are generally as described above with regard to Regulation S-P. [231]

Footnotes

218 Rule 204-3 under the Advisers Act; *see also Money-Matters! Limited Partnership* (avail. Oct. 1, 1991) (no-action relief denied to "900 number" telephone call-in advisory service seeking to respond to telephone inquiries without previously providing brochure). Advisers may satisfy their delivery obligations under the Advisers Act by using electronic media as an alternative to paper-based media. In particular, advisers may use electronic media to fulfill their obligations under §§ 205(a)(2), 205(a)(3) and 206(3) of the Advisers Act, and Rules 204-3, 205-3(d), 206(3)-2, 206(4)-2 and 206(4)-3 under the Advisers Act. *See* SEC Release No. IA-1562 (May 9, 1996). Clients also may consent to having their primary adviser receive brochures on their behalf from any subadvisers hired to advise their accounts. *Goldman, Sachs & Co.* (avail. June 20, 2013).

219 However, the SEC has made clear that an adviser is not *required* to deliver its brochure to investors in funds managed by the adviser. *See* SEC, Division of Investment Management, Frequently Asked Questions: Staff Responses to Questions About Part 2 of Form ADV, Question III.2 (Mar. 18, 2011) (responding that brochures need only be delivered to "clients" under Rule 204-3, not to investors in a private fund that is itself the client).

220 Hedge Fund Release. *See also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *The National Mutual Group* (avail. Mar. 8, 1993) (substantive provisions of Advisers Act do not apply to foreign registered advisers with respect to non-U.S. clients).

221 *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993). *But see* Hedge Fund Release, 69 Fed. Reg. 72,054, 72,072 n. 215 (Dec. 10, 2004) ("We are not, at this time, prohibiting offshore advisers from representing themselves as SEC-registered advisers, but we remind them that they remain subject to the Act's antifraud provisions and that substantial clarification and disclosure may be necessary to make the representation not misleading.").

222 Rule 204-3(c)(1) under the Advisers Act. A "brochure" is also not required in connection with a "contract for impersonal services" for a fee of less than $500, whereby the adviser provides advice solely through written statistical or other information that is not designed to meet the specific investment objectives of the client and does not make any recommendation as to the investment merits of a particular security. Rule 204-3(h)(1) under the Advisers Act.

223 Rule 204-3(b)(2) under the Advisers Act. The SEC has indicated that an adviser has a fiduciary obligation to inform its clients every time a material change occurs, and that this duty could be fulfilled through a revised brochure. SEC Release No. IA-3060 (Oct. 12, 2010); SEC Release No. IA-664 (Jan. 30, 1979).

224 *See* § 16.06 for a discussion of wrap fee arrangements.

225 SEC Release No. IA-1411 (Apr. 19, 1994). A "wrap fee program" is defined in Rule 204-3(h)(5) under the Advisers Act as "an advisory program under which a specified fee or fees not based directly upon transactions in a client's account is charged for investment advisory services (which may include portfolio

management or advice concerning the selection of other investment advisers) and the execution of client transactions." The Glossary of Form ADV defines a "sponsor" as an adviser "that sponsors, organizes, or administers the program, or selects, or provides advice to clients regarding the selection of, other investment advisers in the program." Accordingly, the definition would include only persons who "promote or solicit" clients for programs that have "some degree of uniformity among clients and that are entered into more than occasionally." SEC Release No. IA-1411 (Apr. 19, 1994), 59 Fed. Reg. 21,657, 21,658 n.8 (Apr. 26, 1994). In promulgating these requirements, the SEC stated its expectation that prospective wrap fee clients will generally not be interested in or eligible for other investment programs, so that sponsors will not need to deliver both their general brochure and their wrap fee brochure to a significant number of prospective clients.

226 SEC Release No. IA-1411 (Apr. 19, 1994).

227 SEC Release No. IA-1883 (June 22, 2000).

228 SEC Release No. IA-1883 (June 22, 2000). *See* §§ 248.13, 248.14 and 248.15 of Regulation, 79 Fed. Reg. 64,057.

229 *See* Bureau of Consumer Financial Protection, Amendment to the Annual Privacy Notice Requirement Under the Gramm-Leach-Bliley Act (Regulation P), 79 Fed. Reg. 64,057 (Oct. 28, 2014) (codified at 12 C.F.R. Part 1016 (the "Regulation P Adopting Release").

230 The FTC's Privacy of Consumer Financial Information, 16 C.F.R. Part 313, governed private funds until the CFPB inherited the authority under which it promulgated Regulation P.

231 § 1093 of the Dodd-Frank Act. *See* Regulation P Adopting Release, 79 Fed. Reg. 64,057, 64,058 (Oct. 28, 2014).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.06, PERFORMANCE FEES AND COMPENSATION ARRANGEMENTS

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 § 16.06 (11th and 12th Editions 2014-2017)
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Among the more significant provisions of the Advisers Act is its prohibition on receipt by an adviser subject to regulation thereunder of certain performance fees that are based on a share of the capital gains or appreciation in a client's account. [232] The prohibition applies to new contracts, as well as to renewals and extensions of existing contracts, thus excluding the possibility for "grandfathering" an adviser's existing client relationships for contracts, which would require renewal or extension. [233]

There are a number of exemptions to the prohibition against performance fees that have significantly reduced the impact of the restriction. First, as a result of the National Securities Markets Improvement Act of 1996 ("NSMIA"), [234] the prohibition does not apply to an investment advisory contract with a person who is not a resident of the United States.

Second, the prohibition does not apply to compensation that is based on a fixed percentage of the value of assets under management as of a particular date or dates or averaged over a definite period of time. [235] The SEC's general antifraud rules would, however, operate to prohibit any advisory fee that is "greater than that normally charged in the industry for investment advisory services" unless appropriate disclosure is made to clients, generally in the adviser's "brochure." [236] The SEC staff has taken the position that an adviser would be required to disclose that an annual advisory fee in excess of 2% of assets under management is greater than that normally charged in the industry.” [237]

Third, the prohibition does not apply to a contract with any registered investment company or certain other persons, if the contract relates to at least $1 million of assets, provides for compensation based on the value of assets under management averaged over a specified period and increases and decreases

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proportionately with the investment performance [238] of the assets in relation to the investment record [239] of an index of securities prices or any other measure approved by the SEC. [240] Increases and decreases in the adviser's compensation are measured from the fee, known as the "fulcrum fee," that the adviser would earn if the performance of the company or fund were equivalent to the applicable index. [241]

Fourth, an exemption exists in the case of contracts that investment advisers have with "qualified clients." For these purposes, a qualified client means: (i) a natural person or a company that has at least $1,000,000 [242] under management, (ii) a natural person or company that is reasonably believed by the adviser to have a net worth of more than $2,100,000 [243] or is a "qualified purchaser" as defined in the Investment Company Act or (iii) a natural person who is an executive officer, director, trustee, general partner or person performing a similar function with the adviser or an employee of the adviser who has been performing investment activities for at least 12 months. [244]

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Fifth, compensation including up to 20% of the realized capital gains, calculated as provided in the Advisers Act, may be paid in connection with advice to a limited class of U.S.-domiciled investment companies—known as "business development companies" [245]—that are subject to the reporting requirements of the Exchange Act, have assets invested in specified types of securities and have their principal operations in the United States. [246]

Finally, also pursuant to amendments introduced by NSMIA, the prohibition does not apply to an investment advisory contract with a company excepted from the definition of an investment company under § 3(c)(7) of the Investment Company Act. [247]

Under the Private Fund Advisers Act, the SEC is required to adjust any dollar amounts used in connection with the compensation-related tests discussed above not later than July 21, 2011, and every five years thereafter, for the effects of inflation on such test. [248]

The SEC also has the power to:

> by rule or regulation, upon its own motion or by order upon application, … conditionally or unconditionally exempt any person or transaction, or any class or classes of persons or transactions, from [the prohibition], if and to the extent that the exemption relates to an investment advisory contract with any person that the [SEC] determines does not need the protections of [the prohibition], on the basis of such factors as financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the [SEC] determines are consistent with [the prohibition]. [249]

It is also worth noting that a registered investment adviser that provides both securities advice and commodities advice may charge its clients fees based on the capital appreciation in the value of the commodities in the clients' account without complying with the Advisers Act provisions relating to performance fees. [250]

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The Advisers Act proscriptions may also extend to other compensation practices that may not be prohibited or, in fact, may be expressly permitted under an adviser's home country practices. For example, the antifraud provisions of the Advisers Act [251] have been interpreted by the staff, in cases addressing acceptable practices in U.S. financial markets, as requiring *pro rata* refunds for pre-paid advisory fees in the event an advisory contract is terminated by a client (particularly in the case of advisers providing advice tailored to the needs of particular clients), [252] and as prohibiting the imposition of an additional charge on a client for choosing to change his investment [253] or terminate his contract. [254] Such practices are commonly accepted in many other jurisdictions, and SEC staff positions suggest that these prohibitions may (subject to satisfaction of certain conditions) not be applicable in the case of the non-U.S. clients of a registered adviser located outside the United States, except to the extent that the practices in question involve conduct or have effects in the United States or on the adviser's U.S. clients. [255]

An advisory service that has experienced explosive growth over the past two decades is the so-called "wrap fee" arrangement, which can take a variety of forms. Under a common arrangement, a client retains a brokerage firm that assists the client in selecting an adviser from the firm's "approved" list of money managers that may include affiliates of the broker. The broker charges the client a single "wrap fee" that includes fees payable to the adviser for the client's account, as well as custodial and brokerage and other transactional charges. The SEC has provided a "nonexclusive safe harbor from the definition of investment company" for certain wrap accounts, [256] but has not taken any official position regarding the propriety under the Advisers Act of wrap accounts. [257] The SEC

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staff has indicated, however, that the arrangements raise numerous issues under the Advisers Act, as well as other federal and state securities laws. [258] Among the issues raised by wrap programs under the Advisers Act is whether the arrangement constitutes an abusive compensation practice in that the fee charged exceeds the sum of the fees that would otherwise be payable for each of the services provided in the program. [259] It is also uncertain whether a wrap program that contemplates the use of a single broker for execution services will satisfy the adviser's obligation to obtain the "best execution" for clients in the program. [260] The payment of a portion of the "wrap fee" to the sponsoring broker may also require compliance with Rule 206(4)-3 under the Advisers Act relating to the payment of fees by advisers to others in exchange for client referrals. [261] Finally, the applicability to wrap programs of the restrictions on principal and agency cross transactions in § 206(3) of the Advisers Act is uncertain. [262]

Footnotes

232 The SEC staff has held that the Advisers Act also prohibits an investment adviser from entering into contingent advisory fee arrangements, such as agreements under which fees are waived or refunded if a client's account does not meet a certain specified level of performance. *See* SEC Release No. IA-721 (May 16, 1980). The staff has also stated that the Advisers Act does not prohibit the voluntary, noncontractual refund of advisory fees by an investment adviser so long as the client had no original understanding with the adviser regarding a fee refund or waiver related to investment performance. *Investment Advisors, Interpretive Matters* (avail. July 18, 1995).

233 § 205(a) of the Advisers Act. The prohibition appears not to apply to an existing contract that does not require renewal or extension.

234 Pub. L. No. 104-290, 110 Stat. 3416 (1996).

235 § 205(b) of the Advisers Act.

236 *See*, *e.g.*, *Commodity Management Service Corp.* (avail. May 19, 1974).

237 *See*, *e.g.*, *Equitable Communications* (avail. Feb. 26, 1975); *Consultant Publications, Inc.* (avail. Jan. 29, 1975).

238 "Investment performance" of an investment company for any period is defined in Rule 205-1(a) under the Advisers Act as "the sum of: (1) The change in its net asset value per share during such period; (2) The value of its cash distributions per share accumulated to the end of such period; and (3) The value of capital gains taxes per share paid or payable on undistributed realized long-term capital gains accumulated to the end of such period; expressed as a percentage of its net asset value per share at the beginning of such period." For these purposes, the amount of certain distributions, dividends and provisions for taxes are deemed to be reinvested in the investment company as described in the rule.

239 Rule 205-1(b) under the Advisers Act defines "investment record" of such an index for any period as "the sum of: (1) The change in the level of the index during such period; and (2) The value, computed consistently with the index, of cash distributions made by companies whose securities comprise the index accumulated to the end of such period; expressed as a percentage of the index level at the beginning of such period." Cash distributions on the indexed securities are considered reinvested in the index as provided in the rule.

240 § 205(c) of the Advisers Act provides that an index of securities will be deemed appropriate unless the SEC by order determines otherwise. *See* SEC Release No. IC-7113 (Apr. 6, 1972) (stating the SEC staff's view on factors to be considered in determining the appropriateness of an index); *see also James R. Waters, CFP* (avail. June 1, 1995).

241 § 205(c) of the Advisers Act. Rule 205-2 under the Advisers Act provides that the specified period during which the asset value of the company or fund is averaged for purposes of determining the fulcrum fee may vary from that during which asset value is averaged for purposes of determining the performance component of the adviser's fee only if certain conditions are met.

242 SEC Release No. IA-4421 (June 14, 2016).

243 SEC Release No. IA-4421 (June 14, 2016).

244 Rule 205-3(d)(1) under the Advisers Act. For purposes of this exemption, each investor in a registered investment company, a private investment company (*i.e.*, a fund operating pursuant to the exception from investment company registration provided under § 3(c)(1) of the Investment Company Act) or a business development company must be counted as a client of the adviser seeking to charge a performance fee.

245 § 202(a)(22) of the Advisers Act.

246 § 205(b)(3) of the Advisers Act.

247 § 205(b)(4) of the Advisers Act.

248 § 418 of the Dodd-Frank Act; SEC Release No. IA-3372 (Feb. 15, 2012).

249 § 205(e) of the Advisers Act.

250 *John W. Henry & Co., Inc.* (avail. Sept. 20, 1996); *see also EQK Partners* (avail. July 13, 1988) (registered investment adviser may charge fees based on capital appreciation in the value of real estate without complying with § 205 of the Advisers Act and Rule 205-3 thereunder).

251 *See* § 206 of the Advisers Act; §§ 16.07 and 16.08.

252 *See*, *e.g.*, *Churchill Management Corp.* (avail. May 30, 1974); *cf. Wellington Financial Corp.* (avail. Jan. 7, 1983) (no-action relief permitting an investment adviser to enter into an agreement with an affiliated limited partnership to publish a uniform publication without giving existing subscribers an opportunity to terminate their subscription agreements); *Daily Graphs* (avail. Dec. 13, 1978) (failure to provide *pro rata* refund on cancellation or termination would not violate § 206 of the Advisers Act where advisory services were only provided through uniform publications distributed to subscribers pursuant to contracts for "reasonable periods" and adequate disclosure of "no refund" policy was made in advance of execution of subscription agreement); *Anametrics, Inc.* (avail. Oct. 21, 1976). *But see Stephenson and Co.* (avail. Dec. 29, 1980) (termination fee reasonably related to actual services performed would, subject to disclosure and certain other limitations, not necessarily violate § 206 of the Advisers Act).

253 *National Deferred Compensation* (avail. Aug. 31, 1987).

254 *National Deferred Compensation* (avail. Aug. 31, 1987).

255 *The National Mutual Group* (avail. Mar. 8, 1993). *See* Hedge Fund Release.

256 *See* Rule 3a-4 under the Investment Company Act.

257 SEC Release No. IA-1623 (Mar. 24, 1997). The SEC staff has taken the position that a mutual fund wrap fee program may defer, and eventually excuse, the payment of certain broker's fees for those clients that participate in the program for a specified period (and charge the deferred fees to those clients who terminate early), as long as proper disclosure is provided. *Constellation Financial Management L.L.C.* (avail. Jan. 9, 2003); *BISYS Fund Services, Inc.* (avail. Sept. 2, 1999).

258 SEC Release No. IA-1510 (July 27, 1995).

259 To improve disclosure about wrap fee programs, the SEC has adopted rules that require an adviser that sponsors a program (other than managed account programs and mutual fund asset allocation programs) to deliver a separate narrative brochure to prospective clients describing the programs, fees and services. SEC Release No. IA-1411 (Apr. 19, 1994); *see* § 16.05.

260 *See* § 16.09.

261 *See* § 16.08[3]. Another issue raised by wrap accounts is whether clients are in fact accorded individualized investment advisory services or are instead "investors" in an unregistered investment company. *See* § 18.02. Wrap programs can also raise special issues for regulated entities, such as pension plans subject to ERISA. *See, e.g.*, Department of Labor, Opinion 82-26 A (June 9, 1982).

262 SEC Release No. IA-1623 (Mar. 24, 1997). The SEC staff has indicated, however, that they would not recommend enforcement action under § 206(3) of the Advisers Act where an entity registered as both an adviser and a broker-dealer received fees pursuant to a wrap program for executing trades directed to it by another investment adviser, provided that the dual registrant did not recommend, select or participate in the selection of particular securities to be purchased for, or sold on behalf of, clients of the program. *See*

Morgan, Lewis & Bockius LLP (avail. Apr. 16, 1997).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.07, PROHIBITED RELATIONSHIPS WITH AFFILIATES

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 § 16.07 (11th and 12th Editions 2014-2017)
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The Advisers Act prohibits an investment adviser, whether or not subject to registration requirements, from engaging in any principal [263] or agency

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cross [264] transaction with an advisory client unless at or before the completion [265] of the transaction the adviser provides written disclosure to the client of the capacity in which the adviser is acting and obtains the consent of the client to the transaction. [266] This provision, contained in § 206(3) of the Advisers Act, is also interpreted as applying to transactions involving an affiliate of an investment adviser. The SEC staff has taken the position that the prohibition would also bar an adviser from acting as broker in connection with a sale to its advisory clients of interests in an entity controlled by the adviser (in a situation where a controlled entity is also the seller), [267] and has expressed doubt that a "riskless principal" transaction would not be prohibited by § 206(3) of the Advisers Act. [268] The client's consent to a principal or agency cross transaction need not be in writing, although prudence dictates to the contrary; [269] consent must be made on a transaction-by-transaction basis in the context of a principal transaction, whereas a blanket consent is acceptable in the context of an agency cross transaction. [270] The requirement would appear to apply to advisers (whether

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subject to registration or not) to hedge funds or other investment vehicles that are not registered under the Investment Company Act in respect of transactions with an adviser's dealer affiliate. The way in which a fund would give the transaction consent in those circumstances is a matter of some uncertainty, but could depend on the structure and manner of governance of the vehicle.

In addition to disclosure of the capacity in which the adviser is acting in relation to the transaction, the adviser may be required to make additional disclosures to the client, depending on the facts and circumstances. In the first pronouncement on the practical application of § 206(3) of the Advisers Act, the director of the former SEC Division of Trading and Exchange stated that the purpose of § 206(3) was to ensure that the client has all information in his possession to determine whether to enter into a transaction. [271] In the director's opinion, the minimum information that must be disclosed (although not necessarily in writing) would include, in addition to the adviser's capacity:

- the cost to the adviser of any security to be sold to the client;
- in the case of securities to be purchased by the adviser from the client, the price at which the securities will be resold by the adviser, if known by the adviser;
- in the case of an agency cross transaction, the total commission to the broker; [272] and
- the best price at which the transaction could be effected by or for the client elsewhere if that price would be more advantageous for the client. [273]

The staff has taken the position that other information necessary to the client's appreciation of the merits of the investment in question may also be required to be disclosed, including for example the tax consequences to the client of owning a security to be purchased from the adviser. [274] Moreover, the staff

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has suggested that § 206 is intended not only to ensure appropriate disclosure but also to prevent an adviser from "dumping" undesirable securities in client accounts. [275] In any event, the SEC has provided a nonexclusive safe harbor for compliance with § 206(3) in the case of agency cross transactions. [276]

The prohibition of § 206(3) of the Advisers Act is not applicable to a transaction with a broker-dealer that is not acting as an investment adviser in relation to the transaction. [277] Moreover, Rule 206(3)-1 under the Advisers Act provides that a broker-dealer will not be required to obtain a client's consent if it is acting as an investment adviser in relation to the transaction solely by reason of:

- having publicly distributed or made written or oral statements; [278]

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- having issued written materials or made oral statements that do not purport to meet the investment objectives of any individual client; or
- having issued statistical information that contains no opinion as to the merits of any particular security (or any combination of the foregoing activities).

Like the safe harbor provided in Rule 206(3)-2 under the Advisers Act, the availability of the exemption does not affect the applicability of the other antifraud provisions contained in § 206 of the Advisers Act.

As in the case of many of the substantive provisions of the Advisers Act and related regulations, no-action positions taken by the SEC staff suggest that, subject to satisfaction of certain conditions, a registered adviser located outside the United States need not comply with the limitations of § 206(3) with respect to its non-U.S. clients. [279]

Footnotes

263 While a principal transaction includes any sale of a security to, or purchase of a security from, a client by the adviser or its affiliates, the SEC staff has indicated that an investment adviser would not be engaging in a sale of a security to, or a purchase of a security from, an advisory client if the client grants a security interest to the adviser for purposes of maintaining a margin account, the adviser liquidates securities in the margin account or the adviser transfers or loans securities on behalf of a client to facilitate a short sale. *Goldman, Sachs & Co.* (avail. Feb. 22, 1999).

264 An "agency cross" transaction is one in which an adviser or its affiliate acts as broker on behalf of the other party in a transaction involving an adviser's advisory client. Rule 206(3)-2(b) under the Advisers Act.

265 The SEC has stated that "completion" means settlement of the transaction. SEC Release No. IA-1732 (July 17, 1998).

266 Depending on the nature of the client, other prohibitions or restrictions on transactions with affiliates may apply. Investment companies subject to the Investment Company Act and employee benefit plans subject to ERISA are, for example, subject to numerous restrictions on their ability to deal with their advisers and the affiliated persons of such advisers. Transactions in security futures products may be subject to additional restrictions under the CEA. *See* U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS, TWELFTH EDITION, DERIVATIVES MARKETS, §§ 2.16 and 4.07.

267 *Haven Investments, Ltd.* (avail. June 1, 1981); *see also Interplan Securities Corp.* (avail. Feb. 23, 1978) (interrelationships between broker-dealer and adviser required that they be collapsed and treated as a single dually registered entity for purposes of § 206(3)).

The SEC has, however, granted no-action relief under § 206(3) of the Advisers Act to permit a registered investment adviser to invest client funds in mutual funds sponsored, advised and distributed by affiliates of the investment adviser. *Merrill Lynch Trust Co., FSB* (avail. July 6, 2000).

268 *See Municipal Investment Group* (avail. Jan. 5, 1989) (agreeing that an adviser may establish a broker-dealer to transmit orders in municipal securities for execution in "riskless principal" transactions with a

clearing broker through an omnibus customer account in the name of the adviser, provided adequate disclosure of commissions and other compensation is made, but declining to agree that riskless principal transactions were not principal transactions within the meaning of § 206(3) of the Advisers Act).

269 SEC Release No. IA-40 (Jan. 5, 1945); *see also Dillon Read & Co., Inc.* (avail. Aug. 6, 1975).

270 SEC Release No. IA-40 (Jan. 5, 1945); *see also Dillon Read & Co., Inc.* (avail. Aug. 6, 1975); *Alan R. Gordon* (avail. July 6, 1982). Rule 206(3)-2 under the Advisers Act allows for the blanket consent of certain agency cross transactions effected in accordance with specified restrictions under the Rule. *See infra* Note 276.

In connection with a court decision regarding the treatment of certain fee-based accounts of broker-dealers under the Advisers Act, the SEC has also adopted a temporary rule, Rule 206(3)-3T under the Advisers Act, that provides an "alternative basis" for complying with the consent requirement for certain principal transactions. *See* SEC Release No. IA-2653 (Sept. 24, 2007); § 16.03[2][b]. However, the rule, which was originally effective through December 31, 2009 but has been extended through December 31, 2016, does not provide relief from any transaction-by-transaction consent requirements (although the rule explicitly allows such consent to be provided orally). *See* SEC Release No. IA-3522 (Dec. 20, 2012); SEC Release No. IA-3984 (Dec. 17, 2014).

271 SEC Release No. IA-40 (Jan. 5, 1945).

272 An adviser would not be acting as a broker under § 206(3) of the Advisers Act if it receives no compensation other than its advisory fee for effecting an agency transaction between advisory clients. SEC Release No. IA-1732 (July 17, 1998).

273 SEC Release No. IA-40 (Jan. 5, 1945). The basis for the additional disclosure would be the general antifraud provisions contained in subsections (1) and (2) of § 206, rather than § 206(3) itself. *See*, *e.g.*, *Grover J. Rees* (avail. June 19, 1976).

274 *Edward D. Jones & Co.* (avail. Oct. 29, 1975); *see also Yankee Management of Boston* (avail. June 5, 1974) (registered investment adviser who is also an employee of a registered broker-dealer must disclose all conflicts of interest arising from the dual registration and association). An obligation to disclose material information regarding a security recommended by an adviser may also arise under the general antifraud prohibition of § 206 of the Advisers Act. *See*, *e.g.*, *Dennis M. Hardaker* (avail. Sept. 17, 1977) (adviser may have obligation to disclose risks of investment in foreign securities recommended by the adviser).

275 *Salomon Brothers Asset Management Inc.* (avail. Oct. 10, 1990) (citing Investment Trusts and Investment Companies: Hearing On S. 3580 Before A Subcomm. Of The Senate Comm. On Banking And Currency, 76th Cong., 3d Sess., 322 (1940)).

276 Rule 206(3)-2 under the Advisers Act. In adopting the safe harbor, the SEC expressly rejected requests that similar relief be extended in the case of principal transactions. Rule 206(3)-2 permits an adviser, subject to satisfaction of certain conditions, to comply with the consent requirement of § 206(3) by obtaining a client's prospective blanket consent to such transactions. The safe harbor is not available for any agency cross transaction in which the adviser, or any person controlling, controlled by or under common control with the adviser, has advised both the buyer and seller, and for these purposes, an investment adviser that exercises investment discretion with respect to a client account will be deemed to have "advised" such client. The rule also requires that the adviser provide specified disclosures to its client, including information concerning the potential for conflicts of interest and price, compensation and other details of agency cross transactions effected in reliance on the rule. Each written disclosure required to be made under the rule must also contain a conspicuous statement that the client's consent may be revoked at any time by written notice to the investment adviser or to any other person relying on the rule. The rule does not derogate from the adviser's general obligations as a fiduciary to act in the best interests of its clients and to obtain the best price and execution for its clients, nor does it otherwise relieve the adviser from the applicability of the other antifraud provisions of § 206 of the Advisers Act.

277 § 206(3) of the Advisers Act. The SEC staff has taken the position that a dual registrant, *i.e.*, a firm registered as both a broker-dealer and an investment adviser, would not be deemed to be acting as an

investment adviser for purposes of § 206(3) if a trade had been directed to the dual registrant by another registered investment adviser. *Morgan, Lewis & Bockius LLP* (avail. Apr. 16, 1997).

278 Rule 206(3)-1(b) under the Advisers Act defines such "publicly" distributed items as those distributed or made to 35 or more persons who pay for access thereto. To avail itself of this exemption, the broker-dealer must include in the written or oral statements in question a statement that if the recipient uses the facilities of the broker-dealer to execute any transaction in a security that was discussed by the broker-dealer, the broker-dealer may be acting as principal or as agent for another person.

279 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992); *see* Hedge Fund Release.

U.S. Regulation of the International Securities and Derivatives Markets, § 16.08, GENERAL ANTIFRAUD PROVISIONS

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 § 16.08 (11th and 12th Editions 2014-2017)
11th and 12th Editions

In addition to the specific prohibition of § 206(3) of the Advisers Act against dealing with an advisory client, § 206 contains the general antifraud provisions of the Advisers Act. [280] Although originally directed solely at registered investment advisers, § 206 is now applicable to all persons within the statutory definition of "investment adviser," whether or not registered or required to be registered. In the case of advisers located outside the United States, no-action positions taken by the SEC staff suggest that the specific prohibitions under § 206(3) are not applicable with respect to a foreign adviser's non-U.S. clients, subject to conditions substantially similar to those set out in *Unibanco*, except to the extent that any otherwise prohibited practice involves conduct or has effects in the United States or has effects on the adviser's U.S. clients; however, the general antifraud provisions apply to a foreign adviser's interactions

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with all its clients. [281] In response to the court decision vacating the SEC's adoption of a rule that treated investors in hedge funds and other pooled investment vehicles as "clients" for purposes of § 206, the SEC adopted Rule 206(4)-8 under the Advisers Act, which prohibits advisers to such vehicles from defrauding investors and prospective investors in such vehicles. [282]

Although similar in wording to other antifraud provisions of the federal securities laws, the antifraud prohibitions of the Advisers Act have a somewhat different application. For example, unlike § 10(b) of the Exchange Act and Rule 10b-5 thereunder, [283] § 206 of the Advisers Act extends beyond the purchase or sale of a security to encompass the entire relationship of an adviser with its client. In addition, *scienter* [284] is not an element necessary to prove a violation of § 206. [285] However, § 206 has been interpreted as not providing a private right of action for damages, except for rescission and restitution of fees under an advisory agreement, against an adviser for violating its obligations under the Advisers Act. [286]

The prohibitions of § 206 have been applied in a variety of circumstances. The U.S. Supreme Court has found that the provision is violated if an adviser engages in "scalping," that is, recommending purchases of a security that the adviser purchased for its own account shortly before making the recommendation. [287] The SEC staff has also taken the position that § 206 may be violated if an adviser receives both an advisory fee and a fee for advising an investment company in which its clients invest, unless the fees are netted or the adviser's services fully justify the additional cost. [288] Similarly, the staff has stated that

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"hedge" clause provisions included in advisory agreements to limit the liability of the adviser to cases of negligence or intentional misconduct may constitute a breach of the adviser's fiduciary obligations to its clients by suggesting that a client may have waived a nonwaivable cause of action. [289] Many investment advisers, however, continue to include such clauses in their advisory contracts.

The staff has used § 206 to regulate the method by which investment advisers can aggregate client orders for the purchase and sale of securities. [290] The staff has also used § 206 to hold investment advisers accountable for failing to disclose a number of practices and issues, including market timing and late trading arrangements, conflicts of interest, violations of codes of ethics, principal transactions, fees and allocations of expenses. [291]

The staff has even addressed the matter of time limitations on the ability of an advisory client to terminate its contract. In *Robert D. Brown Investment Counsel, Inc.*, the staff stated that a provision in an advisory contract permitting clients to terminate only on the contract anniversary date was not consistent with the adviser's fiduciary duty, since the provision would require a client to accept and pay for services even when the services were unsatisfactory. [292]

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At least one court has refused to terminate an advisory contract on the basis of fraud and violation of fiduciary duty in the context of a complex transaction that was carefully negotiated for the protection of many interested parties. [293] While the court agreed that the adviser owed a fiduciary duty to the plaintiffs and as an equitable principle a party to whom a fiduciary duty is owed may terminate its relationship with that fiduciary as of right, notwithstanding contractual provisions that provide otherwise, it held that "carefully negotiated, highly specific rights should not be overridden by a court armed only with general equitable principles, particularly at the behest of entities who may not be the only ones to whom the fiduciary is obligated and who may not have the greatest economic stake in the matter." [294]

In addition to the practices addressed in responses to requests for no-action relief and enforcement actions, the SEC is also authorized to address specific acts or practices that violate § 206 through rulemaking. [295] The SEC has exercised this authority by adopting rules, applicable to registered investment advisers only, that govern compliance programs, advertising practices, custody of client funds and securities, client solicitations and disclosure of an adviser's disciplinary history. [296] Again, the SEC staff has taken the position that a foreign adviser need not, subject to satisfaction of certain conditions, comply with these rules with respect to its non-U.S. clients. [297]

[1] Advertisements

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Rule 206(4)-1 under the Advisers Act prescribes limits on the ability of registered investment advisers to advertise. [298] In addition to including a general prohibition against the use of any advertisement "which contains any untrue statement of a material fact, or which is otherwise misleading," [299] the rule contains a number of specific proscriptions. The principal matter covered by the rule is an adviser's advertisement of its investment results. The rule prohibits a registered adviser from referring, directly or indirectly, to past "specific recommendations" [300] of the adviser that were or would have been profitable for any person, unless the adviser satisfies the conditions of the rule. Those conditions require that the adviser set out or offer to furnish a list of all recommendations made by the adviser for the most recent 12-month period that contains a cautionary legend and specifies: (i) the name of the security, (ii) the recommendation and related details, such as the market price of the security when recommended, (iii) the price at which the recommendation was to be followed and (iv) the current market price of the security. [301]

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In addition to satisfying these conditions, performance data must also not be so misleading as to violate the general antifraud prohibition of the rule. [302] The SEC staff has repeatedly stated that information concerning performance would be misleading:

> if it implies something about, or is likely to cause an inference to be drawn concerning, the experience of advisory clients, the possibilities of a prospective client's having an investment experience similar to that which the performance data suggest was enjoyed by the adviser's clients, or the adviser's competence, when there are additional facts which the adviser knew or ought to have known, which if also disclosed would prevent the implication from arising or the

inference from being drawn. [303]

An advertisement thus may not, for example, include performance figures for a "nonrepresentative" sample of accounts or provide comparisons of an adviser's performance with any other index, unless the differences between the adviser's performance as presented and the index are explained in the presentation. [304] The staff has also questioned the use of advertisements showing percentage gains over time as presenting a misleading view of actual gains realized

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(particularly in the case of low-priced securities), the use of a hypothetical portfolio [305] and the use of performance data that does not reflect deductions for all charges for advisory fees and brokerage and other commissions. [306] The staff has, however, taken a no-action position with respect to disclosure of gross performance results to be presented to certain sophisticated clients (including high net worth individuals, pension funds and institutional clients) in "one-on-one" client presentations, if the adviser makes certain disclosures to the client concerning its fees. [307] The staff has also taken a narrow no-action position with respect to disclosure of gross performance results if the adviser also presents net performance results with equal prominence in a format designed to facilitate ease of comparison and the advertisement is not otherwise misleading. [308]

The staff has likewise taken no-action positions with respect to newly registered investment advisers that present performance information for accounts managed by another advisory entity so long as the persons responsible for investment management of those accounts at the other advisory entity are the same persons who will be responsible for investment management at the new firm. Such positions are typically based upon representations that:

- the person or persons who manage accounts at the current adviser were also those primarily responsible for achieving the prior performance at the other adviser;
- the accounts managed at the predecessor advisory entity are similar to the accounts currently under management;

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- all similarly managed accounts are included in the performance information; and
- the advertisement discloses that the performance results were from accounts managed at another entity. [309]

Rule 206(4)-1 also prohibits the use of any advertisement that refers, directly or indirectly, to any testimonial concerning the adviser or any of its services [310] or that states that any service will be provided free of charge unless the service will in fact be furnished free of charge and without any condition or obligation. [311] Finally, under the rule an adviser may not in any advertisement state that any graph, chart, formula or other device can, in and of itself, be used to determine which securities to buy or sell or when to buy or sell them or can assist any person in making those determinations, unless the limitations of the device in question are also set out. [312]

[2] Custody of Client Funds and Securities

A registered investment adviser that has custody of client funds or securities is subject to special limitations prescribed in Rule 206(4)-2 under the Advisers Act, which prohibits the adviser from taking any action with respect to

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a client's property unless the conditions of the rule are satisfied. [313] The SEC staff has taken the position that the rule's requirements are not applicable to the non-U.S. clients of a foreign adviser, subject to the adviser's compliance with certain conditions. [314]

"Custody" for purposes of Rule 206(4)-2 means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them." [315] Rule 206(4)-2 also includes the following examples of activities that constitute custody:

- possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them; [316]
- any arrangement (including a general power of attorney) under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the adviser's instruction to the custodian; [317] and

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- any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the adviser or its supervised person legal ownership of or access to client funds or securities. [318]

The SEC amended the custody rules in 2009 to increase the obligations of advisers holding client assets. [319] An adviser is deemed to have custody of any client assets held directly or indirectly by a "related person" in connection with advisory services provided by the adviser to the client. [320] A "related person" for purposes of Rule 206(4)-2 means any person, directly or indirectly, "controlling or controlled by" or that is "under common control with" the adviser. [321]

To comply with Rule 206(4)-2, a registered adviser who has custody of client funds and securities must maintain them with a "qualified custodian." "Qualified custodians" under Rule 206(4)-2 include the types of financial institutions that clients and advisers ordinarily use for custodial services, such as banks and savings associations and registered broker-dealers. [322] The term also includes registered futures commission merchants in the case of security futures or other securities incidental to transactions in commodity futures and options thereon, and foreign financial institutions that customarily hold customer assets, so long as the customer assets are held in segregated customer accounts. [323]

The adviser must have a reasonable belief that the qualified custodian provides account statements at least quarterly to the adviser's clients whose funds and securities the custodian holds. [324] If a client does not wish to receive

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custodial reports directly, it may choose to have an "independent representative" receive account statements on its behalf. [325]

The rules require that advisers with custody of client assets undergo a surprise examination at least once during each calendar year by an independent public accountant to verify client assets. [326] However, an adviser will not be subject to the surprise examination requirement if it is deemed to have custody of client assets either (i) solely as a result of its authority to deduct advisory fees from client accounts, [327] or (ii) solely because of custody by a related person from whom it is "operationally independent." [328] The accountant must notify the SEC within one business day of the finding of any material discrepancies during the course of the examination. [329]

An adviser or a related person that maintains client funds as a qualified custodian is subject to additional restrictions, including a requirement to obtain within six months of becoming the qualified custodian and each year thereafter an internal control report by independent public accountants. [330]

Advisers need not comply with the custody rules with respect to clients that are registered investment companies. [331] Advisers also need not comply with the notice to clients and account statement requirements of the rule and are deemed to have complied with the surprise independent verification of the client assets for which the adviser has custody with respect to any pooled investment vehicle that (i) is audited at least annually and (ii) distributes its audited GAAP financial statements to all limited partners (or other beneficial owners) within 120 days of the end of its fiscal year. [332]

[3] Client Solicitation

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For many years, the SEC staff took the position that paid client solicitation was a practice so fraught with conflicts of interest that it was *per se* fraudulent and not susceptible of cure through disclosure. [333] Such arrangements were approved by the staff in no-action letters only in cases where the solicitor was an employee or otherwise under the control of a registered adviser. [334] With the adoption of Rule 206(4)-3 under the Advisers Act, the SEC clarified its approach to payment of referral fees, which the rule prohibits except in limited circumstances upon compliance with various disclosure and supervisory obligations set out in the rule. Rule 206(4)-3 is available only to registered investment advisers and, accordingly, would be unavailable to an adviser not otherwise subject to registration. [335] The SEC staff has taken the position that the rule's requirements are not applicable to the non-U.S. clients of an adviser located outside the United States, subject to the adviser's compliance with certain conditions. [336] The rule also does not apply to payments made to a broker or other person paid to solicit investors in a fund. SEC guidance made clear that Rule 206(4)-3 applies to an adviser's solicitation of *clients*, not investors. [337] The rule would also not apply to a referral program where the individuals who access the program are provided with a list of randomly selected advisers and the annual charge is a flat fee unrelated to the number of referrals to, or clients obtained by, the adviser. [338]

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Rule 206(4)-3 applies only to payment of cash referral fees and would not extend, for example, to compensation paid in the form of directed brokerage. [339] Such compensation would continue, in the absence of relief to the contrary, to be governed by the earlier positions of the staff finding such arrangements to be severely restricted, if not altogether prohibited, under the antifraud provisions of the Advisers Act.

[4] Disclosure of Disciplinary History

Although the Advisers Act imposes no special requirements concerning competence or financial responsibility of investment advisers, Part 2 of Form ADV does require a registered adviser to disclose to its clients any material financial, legal or disciplinary events. [340] Such disciplinary disclosure is subject to the "Brochure Rule" discussed in § 16.05. Any subsequent reportable events must be communicated promptly to all existing clients. If an adviser has custody of client funds and securities, it must also inform the client of any matter that could impair its ability to meet contractual commitments.

[5] Proxy Voting

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Rule 206(4)-6 under the Advisers Act addresses an adviser's fiduciary obligation to its clients when the adviser has authority to vote their proxies. [341] The rule provides that it is a "fraudulent, deceptive or manipulative act, practice or course of business" within the meaning of § 206(4) of the Advisers Act for a registered investment adviser to exercise voting authority with respect to client securities unless:

- the adviser has adopted and implemented written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of its clients and that describe how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting; [342]

- the adviser describes its voting procedures to its clients and provides copies on request; and
- the adviser discloses to its clients how they may obtain information on the adviser's vote.

[6] "Pay to Play" Regulations

Following a number of scandals in which investment advisers allegedly made campaign contributions to elected officials or others with the intention of influencing their selection of public pension fund asset managers, the SEC adopted new rules effectively banning the influence of so-called "pay to play" practices by investment advisers, significantly curtailing an adviser's ability to make political contributions to elected officials who have a decision making role over public pension fund assets. [343]

Rule 206(4)-5 under the Advisers Act directly prohibits an investment adviser from receiving any compensation for advisory services provided to a government entity, including any public pension plan, for two years after the

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advisory firm or certain of its executives or employees makes a contribution to certain elected officials, candidates or political action committees. [344] The rule encompasses donations made to any "official" (*e.g.*, an incumbent, candidate, or successful candidate for elective office in a U.S. state or political subdivision of a state) with a responsibility for or influence over the selection of an investment adviser. [345] There is, however, a *de minimis* exception for contributions up to $350 per candidate per election, if the donor is eligible to vote for the candidate, or up to $150, if the donor is ineligible. [346] Furthermore, investment advisers are prohibited from "bundling" political contributions, which means soliciting or coordinating contributions from others on behalf of an elected official or political action committee. [347]

Lastly, Rule 206(4)-5 prohibits an investment adviser from hiring a third-party placement agent, such as a consultant, solicitor or other intermediary, to attempt to obtain government business on its behalf, unless the third party is itself an SEC-registered investment adviser or broker-dealer subject to similar "pay to play" regulations. [348]

The SEC has adopted a few amendments to the recently enacted pay to play rules in response to the Dodd-Frank Act:

- The scope of the pay to play rules has been expanded to cover Exempt Reporting Advisers and foreign private advisers; and
- The rule adds municipal advisers to the categories of "regulated persons" who are permitted to solicit advisory business from government entities on their own behalf and on behalf of other advisers (*i.e.*, third-party solicitation). [349]

[7] Compliance Programs

Rule 206(4)-7 under the Advisers Act requires all registered investment advisers to create and maintain compliance programs. [350] In particular, the rule requires advisers to:

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- adopt and implement policies and procedures designed to prevent violations of the federal securities laws;
- review the policies and procedures at least annually for adequacy and effectiveness of implementation and maintain records of the reviews in accordance with the recordkeeping rules under the Advisers Act; and
- designate a chief compliance officer responsible for administering the policies and procedures.

While the rule does not require compliance programs to contain any specific elements, the following issues, at a minimum, should be addressed to the extent that they are applicable to the adviser:

- portfolio management processes (*e.g.*, processes for allocating investment opportunities and maintaining consistency of portfolios with clients' investment objectives);
- trading practices (*e.g.*, procedures for best execution, soft dollar arrangements and allocating aggregated trades among clients);
- proprietary trading by the adviser and personal trading by supervised persons;
- accuracy of disclosures to investors, clients and regulators (including account statements and advertisements);
- safeguarding client assets;
- accurate creation and protective storage of records;
- marketing advisory services (including the use of solicitors);
- processes used to value client holdings and assess client fees based on those valuations;
- safeguarding client privacy; and
- business continuity plans. [351]

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Compliance policies and procedures of advisers need not be contained in one document. In addition, entities that are registered as both investment advisers and broker-dealers are not required under Rule 206(4)-7 to have separate compliance policies and procedures for their advisory and broker-dealer businesses.

[8] Code of Ethics

Rule 204A-1 under the Advisers Act requires all registered investment advisers to adopt and enforce a code of ethics detailing standards of conduct for advisory personnel. [352] An adviser's code of ethics must include the following minimum provisions:

- standards of business conduct that reflect the fiduciary obligations of the adviser and its supervised employees;
- requirements to comply with federal securities laws;
- reporting of personal securities transactions conducted by "access persons" and review of such transactions; [353]

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- safeguards for material nonpublic information about client transactions;
- pre-approval of certain transactions;
- reporting of code violations; and
- review and enforcement of the code by the adviser's chief compliance officer, to whom personal securities transaction reports will be submitted. [354]

Footnotes

280 Section 206 of the Advisers Act provides that it is unlawful for any investment adviser using U.S. jurisdictional means:

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
>
> (3) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

281 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992). *See also* Hedge Fund Release, 69 Fed. Reg. 72,054, 72,073 n. 221 (Dec. 10, 2004). ("… [T]he adviser does have a fiduciary duty to provide those [offshore] clients with full and fair disclosure of conflicts of interest.…We would not apply section 206(3)'s restrictions to an offshore adviser's principal transactions with offshore clients.").

282 SEC Release No. IA-2653 (Sept. 24, 2007).

283 *See* § 11.04[2].

284 *See* § 11.04[2].

285 *See*, *e.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). *But see SEC v. Steadman*, 967 F.2d 636 (D.C. Cir. 1992) (holding that *scienter* is required under § 206(1) of the Advisers Act).

286 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979); *see also* § 16.12.

287 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

288 *See*, *e.g.*, *Neuberger & Berman* (avail. Mar. 30, 1987); Letter from Alan Rosenblat to Morton Klevan (June 22, 1989); *see also National Association of Investors Corp.* (avail. Oct. 16, 1992). An exception to the general rule against dual fees also exists for investments of uninvested cash balances in affiliated money market funds, provided the client consents thereto. *Neuberger & Berman* (avail. May 29, 1984); *E.F. Hutton & Co., Inc.* (avail. Nov. 17, 1983); *see also WestAmerica Investment Co.* (avail. Nov. 26, 1991) (dual fees permitted in connection with "wrap fee" program, where client would pay advisory fee directly to adviser and indirectly through investments in mutual funds that were selected by adviser but managed by other, unaffiliated advisers).

289 *See, e.g., First National Bank of Akron* (avail. Feb. 27, 1976); SEC Release No. IA-58 (Apr. 18, 1951).

290 The staff has agreed to permit aggregation if (i) the practice of aggregating orders will be fully disclosed in the adviser's Form ADV and separately to each of the adviser's existing clients and (ii) no advisory client, including those clients in which the adviser or person associated with the adviser has a direct or indirect beneficial interest, will be favored by the adviser over any other client, and each client who participates in an aggregated order will participate at the average share price, with all transaction costs shared on a *pro rata* basis. *SMC Capital, Inc.* (avail. Sept. 5, 1995); *see also SEC v. Moran*, 922 F. Supp. 867, 885–86 (S.D.N.Y. 1996) (concluding that the defendant violated § 206 of the Advisers Act by allocating stock to his personal and family accounts at a lower price than that paid by his clients).

291 *See, e.g., In re JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC*, SEC Release No. IA-4295 (Dec. 18, 2015) (failure to disclose conflict in investing client funds in firm's proprietary products); *In re JH Partners, LLC*, SEC Release No. IA-4276 (Nov. 23, 2015) (failure to disclose adviser's loans that were senior interests to fund clients' portfolio companies); *In re Fenway Partners, LLC, et al.*, SEC Release No. IA-4253 (Nov. 3, 2015) (failure to disclose change in fee arrangements that ended an offsetting arrangement, thereby increasing fees); *In re Guggenheim Partners Investment Management, LLC*, SEC Release No. IA-4163 (Aug. 10, 2015) (failure to disclose a loan from a client to an executive of the adviser in violation of code of ethics); *In re Parallax Investments, LLC, et al.*, SEC Release No. IA-4159 (Aug. 6, 2015) (failure to disclose or receive consent for principal transactions); *In re Banc of America Capital*

Management, LLC, SEC Release No. IA-2355 (Feb. 9, 2005) (market timing and late trading); *In re Columbia Management Advisors, Inc.*, SEC Release No. IA-2531 (Feb. 9, 2005) (market timing and late trading).

292 *Robert D. Brown Investment Counsel, Inc.* (avail. July 19, 1984). The *Brown* letter is by its terms limited to restrictions on termination of advisory contracts for the provision of advice and services tailored to the investment objectives of particular clients, and the staff has not addressed whether the same conclusion would be reached, as a result of an adviser's fiduciary obligations or otherwise, in the case of an advisory contract for the provision of impersonal services. *See also BISYS Mutual Fund Asset Allocation Program* (avail. Sept. 2, 1999) (expressing the view that, although the imposition of fees upon termination of an advisory relationship may be inconsistent with the adviser's fiduciary duty, a contingent fee paid to an adviser by a client for services previously rendered to the client would not violate § 206 solely because such fee was payable upon the termination of a client's investment in the program, if at all); *Constellation Financial Management LLC* (avail. Jan. 9, 2003) (reaching the same conclusion as in BISYS Mutual Fund letter in a substantively similar contingent fee scenario); *supra* Notes 252–254 and accompanying text.

293 *Beacon Hill CBO II, Ltd. v. Beacon Hill Asset Management Limited Liability Company*, 249 F. Supp. 2d 268 (S.D.N.Y. 2003).

294 *Beacon Hill CBO II, Ltd. v. Beacon Hill Asset Management Limited Liability Company*, 249 F. Supp. 2d 268, 275 (S.D.N.Y. 2003).

295 § 206(4) of the Advisers Act.

296 *See* SEC Release No. IA-2204 (Dec. 17, 2003); SEC Release No. IA-1633 (May 15, 1997); *see also* SEC Release No. IA-1406 (Mar. 16, 1994) (proposing rules regarding suitability of investment advice). Although no further action has been taken with respect to this proposed rulemaking regarding suitability, the SEC has considered recommendations of unsuitable investments to constitute a breach of an adviser's fiduciary duty in certain circumstances. *See In the Matter of Grey Financial Group, Inc.*, SEC Release No. IA-4094 (May 21, 2015).

297 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992); Hedge Fund Release.

298 Rule 206(4)-1(b) defines "advertisement" as including:

> any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (1) any analysis, report, or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (2) any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or (3) any other investment advisory service with regard to securities.

Rule 204-2 under the Advisers Act requires advisers to maintain all advertisements, as well as supporting materials (*e.g.*, with respect to performance data included in any advertisement), for a period of five years from the end of the fiscal year in which the advertisement was published or otherwise disseminated.

299 Rule 206(4)-1(a)(5) under the Advisers Act.

300 In this regard, in 1977 the SEC staff stated its position that the recommendations referred to in the rule are recommendations made by the adviser as an adviser during a period of not less than one year in which the adviser was either registered as an investment adviser or, if the adviser was not registered because of an

applicable exemption from registration, a period during which the adviser made his recommendations for compensation. *John Warner Seder* (avail. June 10, 1977). Thus, the rule would not be complied with by the furnishing of information about the adviser's personal transactions and those of his family trust. *John Warner Seder* (avail. June 10, 1977); *see also Conway Asset Management, Inc.* (avail. Jan. 27, 1989).

301 Rule 206(4)-1(a)(2) under the Advisers Act. The SEC staff has stated that it would not recommend enforcement action under the rule where an adviser discussed specific securities bought and sold in periodic reports if: (i) the selection criteria were objective and nonperformance based, (ii) the same selection criteria would be used for each quarter for each particular investment category, (iii) reports would not discuss the amount of profit or loss of any particular security recommended by the adviser and (iv) the adviser maintained certain records relating to the selected securities. *Franklin Management, Inc.* (avail. Dec. 10, 1998).

302 In addition to the SEC's requirements under the Advisers Act, FINRA-member broker-dealers distributing marketing material on behalf of hedge funds must comply with NASD Rule 2210, which governs members' communications with the public, even if a nonmember, such as a hedge fund adviser, prepared the marketing material. *See also* Interpretive Letter from Gary L. Goldsholle, NASD, to Michael D. Udoff, Securities Industry Association (Oct. 2, 2003) (interpretive guidance concerning the sale of hedge funds and NASD Rule 2210).

303 *See*, *e.g.*, *Dow Theory Forecasts, Inc.* (avail. Aug. 26, 1983) and letters cited therein; *see also Clover Capital Management, Inc.* (avail. Oct. 28, 1986) (recognizing that whether an advertisement is misleading may also depend on the sophistication of the prospective client).

304 *See*, *e.g.*, *In re Harvest Financial Group, Inc.*, SEC Release No. IA-1155 (Feb. 21, 1989); *Covato/Lipsitz, Inc.* (avail. Oct. 23, 1981). In *Clover Capital Management, Inc.*, the SEC staff enumerated a nonexclusive list of 11 specific practices relating to advertisements of model or actual results that in its view would be deemed to be inappropriate under Rule 206(4)-1(a)(5), including failure to disclose: (i) the effect of material market or economic conditions on the results presented, (ii) the extent to which results reflected reinvestment of earnings, (iii) limitations inherent in model results or (iv) that the adviser's clients experienced investment performance materially different from that portrayed in the model. *Clover Capital Management, Inc.* (avail. Oct. 28, 1986); *see also Investment Company Institute* (avail. Aug. 24, 1987). Whether a successor to an adviser may use the adviser's performance data may also raise an issue under Rule 206(4)-1(a)(5). *Great Lakes Advisors, Inc.* (avail. Apr. 3, 1992).

305 *Donaldson, Lufkin & Jenrette Securities Corp.* (avail. Mar. 2, 1977); *S.H. Dike & Co., Inc.* (avail. Apr. 20, 1975); *see also Morrill-Stanfill & Co.* (avail. Apr. 13, 1978).

306 *See*, *e.g.*, *Investment Company Institute* (avail. Aug. 24, 1987) (confirming that although advisory fees must be reflected, custodian fees for safe-keeping client funds and securities need not be reflected); *In the Matter of Bond Timing Services, Inc.*, SEC Release No. IA-920 (July 23, 1984) (administrative proceeding for failure of investment adviser to include in advertisements of annualized returns information regarding advisory fees, sales loads and transfer fees); *Morrill-Stanfill & Co.* (avail. Apr. 13, 1978) (stating that account performance figures not reflecting commissions, advisory fees and other expenses and charges may convey an impression or give rise to an inference concerning the experience of existing accounts that is misleading); *see also Securities Industry Association* (avail. Nov. 27, 1989) (providing temporary no-action relief permitting deduction of a model fee from advertisements of historical net performance data).

307 *Investment Company Institute* (avail. Sept. 23, 1988); *see also Anametrics Investment Management* (avail. May 5, 1977) (among the factors relevant in determining whether an advertisement is false or misleading is the sophistication of the prospective client).

308 *Association for Investment Management and Research* (avail. Dec. 18, 1996); *see also J.P. Morgan Investment Management Inc.* (avail. May 7, 1996) (adviser may advertise the composite performance of accounts for which it employs a particular investment strategy by deducting a model fee equal to the highest fee charged to any account employing that strategy during the performance period).

309 *See Horizon Asset Management, LLC* (avail. Sept. 13, 1996); *Bramwell Growth Fund* (avail. Aug. 7, 1996).

The SEC staff has also taken the position that § 206 of the Advisers Act would not prohibit mutual funds from including in their prospectuses, advertisements or sales literature information about the performance of private accounts or other registered investment companies with the same adviser that have similar investment objectives, policies and strategies, as long as the information was not presented in a misleading manner or as a substitute for the funds' own performance. *See Nicholas-Applegate Mutual Funds* (avail. Feb. 7, 1997); *ITT Hartford Mutual Funds* (avail. Feb. 7, 1997); *GE Funds* (avail. Feb. 7, 1997). The SEC staff has stated that it would not recommend enforcement action under § 206 if a newly registered open-end investment company used performance results from an existing class of shares of a separate investment company in its prospectus, advertisements or sales literature, where such shares were spun off to the newly registered entity pursuant to a reorganization. *Janus Adviser Series* (avail. Aug. 28, 2000).

310 Rule 206(4)-1 under the Advisers Act; *see also Multi-Financial Securities Corp.* (avail. Nov. 9, 1995); *Gallagher and Associates, Ltd.* (July 10, 1995); *Amherst Financial Services* (avail. May 23, 1995). The SEC staff has held that a partial client list that merely identifies certain clients of an investment adviser is not a testimonial. *Cambiar Investors, Inc.* (avail. Aug. 28, 1997). In addition, the staff has indicated that an investment adviser rating system would not be subject to enforcement under Rule 206(4)-1(a)(1), where the system does not emphasize favorable or ignore unfavorable responses, the rating represents the responses in a fair manner, the questionnaire is unbiased in presentation and the rating system operator does not perform any subjective analysis of the results. *See DALBAR, Inc.* (avail. Mar. 24, 1998).

311 Rule 206(4)-1(a)(4) under the Advisers Act.

312 *See*, *e.g.*, *S.H. Dike & Co., Inc.* (avail. Apr. 20, 1975).

313 Voluntary registration under the Advisers Act will subject the adviser to all of the requirements of Rule 206(4)-2 under the Advisers Act. *Brighton Pacific Realty Asset Management* (avail. Feb. 10, 1992).

314 *The National Mutual Group* (avail. Mar. 8, 1993); Hedge Fund Release.

315 Rule 206(4)-2(d)(2) under the Advisers Act.

316 In amending Rule 206(4)-2, the SEC made clear that an adviser has custody when it has possession of client funds or securities, even briefly. *See* SEC Release No. IA-2176 (Sept. 25, 2003); *see also New England Asset Management Corp.* (avail. May 1, 1976) (custody exists where an adviser received client funds and securities on opening an advisory account, even though the funds were immediately turned over to a custodian); *Piedmont Financial Company, Inc.* (avail. May 30, 1990); *Denver Investment Advisers* (avail. Jan. 10, 1986). The staff has also found custody to exist where an adviser did not generally retain physical possession of client property but received nominal amounts of client funds as a result of interest rate changes on commercial paper. *Omni Management Corp.* (avail. May 10, 1979).

317 An adviser authorized to deduct advisory fees or other expenses directly from a client's account has access to, and therefore has custody of, the client funds and securities in that account. SEC Release No. IA-2176 (Sept. 25, 2003). Note, however, that for purposes of Form ADV, an adviser that has custody solely because it deducts advisory fees or other expenses may answer "no" to Item 9 of the Form, which asks whether the adviser has custody of client funds or securities. SEC Release No. IA-2176 (Sept. 25, 2003).

An adviser's authority to issue instructions to a broker-dealer or a custodian to effect or to settle trades does not constitute custody. SEC Release No. IA-2176 (Sept. 25, 2003); *see also Piette and Associates, Ltd.* (avail. Sept. 17, 1981) (custody will not result if an adviser is authorized to effect client transactions only on a "delivery versus payment" basis). The SEC staff has determined that an adviser does not have custody solely by reason of its use of a registered clearing agency, such as The Depository Trust Company, where client securities are transferred into nominee name in denominations reflecting their respective ownership interests in a security. *Gardner and Preston Moss, Inc.* (avail. Feb. 18, 1983); *see also Newton Growth Fund* (avail. June 13, 1984).

318 Rule 206(4)-2(d)(2) under the Advisers Act.

319 SEC Release No. IA-2968 (Dec. 30, 2009).

320 Rule 206(4)-2(d)(2) under the Advisers Act.

321 Rule 206(4)-2(d)(7) under the Advisers Act.

322 Rule 206(4)-2(d)(6) under the Advisers Act. The adviser must notify the client in writing of the qualified custodian's name, address and the manner in which the client's funds or securities are maintained, as well as changes to this information. Rule 206(4)-2(a)(2) under the Advisers Act.

323 Rule 206(4)-2(d)(6) under the Advisers Act. The rule contains special provisions for custody of mutual fund shares and privately offered uncertificated securities. *See* Rule 206(4)-2(b)(1) and (2). In the case of the former, an adviser may use a mutual fund transfer agent in lieu of a qualified custodian. In the case of the latter, an adviser is excepted from the rule if ownership of the securities is recorded only on the books of the issuer (or a transfer agent) in the name of the client and transfers are subject to prior consent of the issuer or the holders of the issuer's outstanding securities. This exception applies for privately offered uncertificated securities held for the account of a limited partnership only if the limited partnership is audited annually and its audited financial statements are distributed to its investors as described in the rule. *See* SEC Release No. IA-2176 (Sept. 25, 2003).

324 Rule 206(4)-2(a)(3) under the Advisers Act.

325 Rule 206(4)-2(a)(7) under the Advisers Act. An "*independent representative*" means a person that acts for the advisory client, is not in a control relationship with the adviser and does not have, and has not had within the past two years, a material business relationship with the adviser. Rule 206(4)-2(d)(4) under the Advisers Act. With respect to pooled investment vehicles for which the adviser acts as general partner (or in a similar capacity), the rule requires that account statements be sent directly to the investors in the vehicle.

326 Rule 206(4)-2(a)(4) under the Advisers Act.

327 Rule 206(4)-2(b)(3) under the Advisers Act.

328 Rule 206(4)-2(b)(6) under the Advisers Act. An adviser is presumed not to be "operationally independent" from a related person unless certain conditions are met: (i) client assets in custody of the related person may not be subject to claims of the adviser's creditors, (ii) adviser personnel may not have authority over the client assets of which the related person has custody, (iii) advisory personnel and personnel of the related person who have access to client advisory assets may not be under common supervision, and (iv) advisory personnel may not hold any position with the related person or share premises with the related person. Rule 206(4)-2(d)(5) under the Advisers Act.

329 Rule 206(4)-2(a)(4)(ii) under the Advisers Act.

330 Rule 206(4)-2(b)(6) under the Advisers Act.

331 Rule 206(4)-2(b)(5) under the Advisers Act.

332 Rule 206(4)-2(b)(4) under the Advisers Act.

333 *See*, *e.g.*, *Argus Securities Management Corp.* (avail. July 1, 1971).

334 *See*, *e.g.*, *Rhodes, King, Ruman & Farber* (avail. Nov. 2, 1972); *Mericka & Co., Inc.* (avail. July 28, 1972).

335 Rule 206(4)-3 under the Advisers Act generally provides that a registered investment adviser may pay a cash referral fee to a person who is not subject to a statutory disqualification specified in § 203 of the Advisers Act (or exempted from application of the disqualification) pursuant to a written agreement that, in the case of an unaffiliated solicitor or an adviser providing other than impersonal advisory services: (i) describes the solicitor's activities and related compensation, (ii) contains an undertaking by the solicitor to perform its activities in accordance with the adviser's instructions and the requirements of the Advisers Act, and (iii) requires the solicitor to deliver to any prospective client a copy of the adviser's "brochure" (*see* § 16.05) and a separate disclosure document describing the solicitor's relationship with the adviser. An adviser relying on the rule is also required to keep certain records relating to such arrangements and to disclose such arrangements in its "brochure." Upon application to the SEC, the requirement that the solicitor not be subject to certain statutory disqualifications may in appropriate circumstances be waived. *See, e.g., Oppenheimer & Co.* (avail. June 5, 1992); *see also Merchants Capital Management* (avail. Oct. 4, 1991) (no-action relief denied where required written contract would not be executed by each soliciting employee).

336 *The National Mutual Group* (avail. Mar. 8, 1993); Hedge Fund Release.

337 *See Mayer Brown LLP* (avail. July 28, 2008).

338 *International Association for Financial Planning* (avail. June 1, 1998); *see also National Football League Players Association* (avail. Jan. 25, 2002) (Rule 206(4)-3 would not apply to the party arranging and operating a program whereby individuals were provided with a list of pre-screened investment advisers that were charged only a flat fee for participation in the program).

339 *See supra* Note 116; § 16.09. *But see Lincoln National Investment Management* (avail. Mar. 26, 1992) (in granting no-action relief under Rule 206(4)-3 with respect to solicitors not receiving cash compensation, SEC staff relied in part on representation that no noncash compensation would be paid to solicitors).

340 When the SEC released its new Form ADV requirements, it withdrew Rule 206(4)-4 under the Advisers Act, which required an adviser to disclose its disciplinary history, because it was duplicative of the new Form ADV requirements. SEC Release No. IA-3060 (July, 28, 2010). Rule 206(4)-4 created a rebuttable presumption that various events were "material" within the meaning of the rule. Included among those events were: (i) regulatory proceedings before any federal or state agency if the adviser or a management official of the adviser was found to have been involved in a violation of securities, commodities, banking, insurance or real estate laws and was the subject of an agency order denying, suspending or revoking authority to act or associate with an investment-related business or significantly limiting investment-related business activities or to have caused another entity to lose its license or to have been involved in such a violation, (ii) certain proceedings before self-regulatory organizations, and (iii) certain criminal and civil actions determined adversely to the defendant, including actions relating to fraud, wrongful taking of property, bribery, forgery, counterfeiting and extortion. Other events not specifically identified in Rule 206(4)-4 could have also subjected the adviser to a reporting obligation, although the staff generally declined to provide any guidance in this area. *See*, *e.g.*, *Whitaker Capital Management* (avail. June 7, 1990); *Douglas Capital Management, Inc.* (avail. Jan. 11, 1988). The staff has also required persons receiving cash payments for soliciting clients on behalf of a registered investment adviser to disclose remedial sanctions to which they are subject. *See*, *e.g.*, *Dougherty & Company LLC* (avail. Mar. 21, 2003).

341 SEC Release No. IA-2106 (Jan. 31, 2003); *see also In re Deutsche Asset Management, Inc.*, SEC Release No. IA-2160 (Aug. 19, 2003) (Order finding that an investment adviser had violated § 206(2) of the Advisers Act by failing to disclose to its clients a material conflict of interest before it voted the clients' proxies in favor of the merger of Hewlett-Packard Company and Compaq Computer Corporation).

342 The SEC did not adopt any specific policies or procedures, nor did it provide a list of approved procedures. Rather, recognizing that investment advisory activities are "varied," Rule 206(4)-6 permits advisers the flexibility to develop procedures suitable to their businesses and the conflicts they face. SEC Release No. IA-2106 (Jan. 31, 2003).

343 SEC Release No. IA-3043 (July 1, 2010).

344 Rule 206(4)-5(a)(1) under the Advisers Act. Note that the prohibition under this rule can apply in certain cases to a newly hired employee and contributions made up to six months prior to the employee being hired.

345 Rule 206(4)-5(f)(5) and (6) under the Advisers Act.

346 Rule 206(4)-5(b)(1) under the Advisers Act.

347 Rule 206(4)-5(a)(2)(ii) under the Advisers Act.

348 Rule 206(4)-5(a)(2)(i) under the Advisers Act.

349 SEC Release No. IA-3221 (June 22, 2011).

350 SEC Release No. IA-2204 (Dec. 17, 2003). A separate rule adopted in the same release imposes a similar requirement on registered investment companies.

351 SEC Release No. IA-2204 (Dec. 17, 2003). Currently, as noted above, the SEC has stated in guidance that investment advisers should address business continuity planning as part of their compliance programs to the extent that it is applicable to the adviser. In June 2016, the SEC issued a notice of proposed rulemaking

that would impose business continuity plan and transition plan requirements on investment advisers. *See* SEC Release No. IA-4439 (June 28, 2016). If enacted, the proposed new Rule 206(4)-4 would require registered investment advisers to adopt business continuity plans with certain prescribed components. The plans would be required to address critical internal and third-party operations and systems, data protection, alternate physical locations, and communications procedures. Transition plans would be required to include policies and procedures to safeguard client assets and information, information on the corporate governance and material financial resources of the adviser, and an assessment of legal issues implicated by a transition.

In addition, although the SEC has not amended the compliance program rule to explicitly require that an adviser adopt policies regarding cybersecurity, the SEC has been increasingly focused on the importance of cybersecurity as a compliance matter for investment advisers issuing guidance recommending that funds and advisers consider conducting periodic assessments of cybersecurity threats, developing a strategy to prevent, detect, and respond to such threats, and preparing written policies and procedures including training and guidance to officers and employees to implement the strategy. *See* SEC, Division of Investment Management, Cybersecurity Guidance, IM Guidance Update 2015-02 (Apr. 2015).

352 SEC Release No. IA-2256 (July 2, 2004).

The SEC adopted in the same release corresponding amendments to the recordkeeping requirements of Rule 204-2 under the Advisers Act, Form ADV and the code of ethics requirements of Rule 17j-1 under the Investment Company Act. *See* Rule 204-2(a)(12)–(13) under the Advisers Act and Form ADV, Part 2. Recordkeeping requirements under the Advisers Act are discussed in § 16.11.

353 An "access person" is defined under Rule 204A-1(e)(1) as a supervised person who has access to non-public information regarding any client's purchase or sale of securities, is involved in making securities recommendations to clients or who has access to such recommendations that are nonpublic. The definition also includes a presumption that all directors, officers and partners of a firm will be presumed to be access persons if the firm's primary business is providing investment advice. Rule 204A-1(e)(1) under the Advisers Act.

The access persons of an adviser that is required to have a code of ethics pursuant to both Rule 204A-1 under the Advisers Act and Rule 17j-1 under the Investment Company Act (*i.e.*, an adviser or sub-adviser to a registered investment company) will not be required to report under Rule 17j-1 regarding their personal securities holdings to the extent that any such report will duplicate information required by Rule 204-2. Rule 17j-1(d)(2)(iv) under the Investment Company Act.

354 Rule 204A-1 under the Advisers Act. Supervised employees of an adviser must acknowledge in writing that they have received a copy of the adviser's code of ethics. Rule 204A-1 under the Advisers Act.

U.S. Regulation of the International Securities and Derivatives Markets, § 16.09, “SOFT DOLLAR” ARRANGEMENTS

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 § 16.09 (11th and 12th Editions 2014-2017)
11th and 12th Editions

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As a fiduciary, an investment adviser must obtain the "best execution" for a transaction effected on behalf of an advisory client. In connection with the abolition of fixed brokerage commissions for exchange transactions pursuant to amendments to the Exchange Act adopted in 1975, [355] concern arose about fiduciaries paying more than the lowest available brokerage commissions. Under general fiduciary principles prohibiting a fiduciary from using trust assets to benefit himself, it is questionable whether an investment adviser would be permitted to pay commissions in excess of the lowest available unless it could demonstrate that any services it received were of corresponding value to the account in question. In addition, there was concern that even where, for example, research services purchased with commission dollars were for the benefit of the account that paid the commissions, the transaction could be viewed as for the benefit of the fiduciary since the use of commissions to pay for such services relieved the fiduciary of the need to develop or pay for such services itself. [356] To alleviate these concerns, in 1975 Congress also adopted § 28(e) of the Exchange Act, which provides a limited safe harbor for fiduciaries that "pay up" in order to obtain brokerage or research services. [357] In addition to permitting in certain circumstances

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the practice of "paying up," and permitting a fiduciary to pay amounts for brokerage and research that (if determined in good faith) are "reasonable" (rather than the lowest available), the safe harbor obviates the need for an adviser to demonstrate that a particular client's commission dollars were used to obtain services directly benefiting that client. [358]

Registered investment advisers are required to disclose on Form ADV their brokerage selection practices, including the circumstances surrounding any "soft dollar" arrangements in which they engage, even if the arrangements would fall within the scope of § 28(e). [359] While a detailed discussion of the impact of

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§ 28(e) on activities of advisers and other fiduciaries and of broker-dealers is beyond the scope of this book, some of the basic principles of the safe harbor as interpreted by the SEC are worth enunciating. [360]

First, the safe harbor is applicable only if the services provided constitute brokerage or research services. The SEC describes "brokerage services" as products and services that relate to the execution of a trade, from the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution through the point at which funds or securities are delivered or credited to the advised account. [361] "Research services" consist solely of advice, analysis and reports that have substantive intellectual or informational content. [362] The 2006 release confirms that research services related to the market for securities, trade analytics, advice on market color and execution are eligible for the safe harbor. The release also explains that market, financial, economic and similar data could also be eligible for the safe harbor, provided that the data relate to the subject matters set forth in the safe harbor (*e.g.*, data concerning the value of securities or concerning issuers or industries). Physical items (*e.g.*, computer hardware) and mass-marketed publications will not be eligible for the safe harbor.

Second, this safe harbor has been interpreted by the SEC to require that the service provide lawful and appropriate assistance to the adviser in the discharge of its responsibilities. The SEC has also stated that whether the test is satisfied requires a fact-intensive inquiry and has generally refused to provide specific

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guidance in this area. [363] An adviser may rely on the safe harbor only if it exercises discretion with respect to the accounts whose commission dollars are being used to obtain the brokerage or research services. As a result, in the case of a pension fund or trust the trustees of which have delegated investment discretion to an adviser, the safe harbor would be available to the adviser, although not to the trustees of the underlying account if they attempted to direct to which brokers the adviser should send business. [364]

Third, the adviser must make a "good faith determination" that the commission to be paid is "reasonable" in relation to the value of the brokerage or research services to be obtained. If the soft dollar arrangement has been negotiated on an arm's-length basis, this standard ordinarily does not present any issues. If, on the other hand, an adviser intends to pay a higher rate of commission to an affiliated broker-dealer, the adviser may be subject to a heightened burden of proof to demonstrate the *bona fides* of its determination. [365]

Finally, § 28(e) requires that the broker-dealer or exchange member provide the research to the adviser. The SEC has stated that research prepared by third parties but provided to the fiduciary by the broker in the transaction falls within the purview of the section if the broker itself has a direct obligation to pay for the research and does not merely reimburse the adviser for the adviser's own expenses and the broker controls and is familiar with the types of research provided to the adviser. However, the SEC commenced a private investigation of, and obtained consents to remedial action (albeit without admissions of wrongdoing) from, investment advisers acting as fiduciaries and participating broker-dealers in a situation where the broker-dealers paid a portion of their commissions received from the fiduciaries to a third party. The third-party administered accounts for fiduciaries and provided services selected by the fiduciaries directly to them. Fees owing to the third party could be paid by the fiduciary either by way of directed commission dollars to the executing broker (who in turn would pay the third party) or in cash paid directly to the third party by the fiduciary. The broker executing the trade was not involved in and indeed did not know which services were selected. The SEC viewed this arrangement as involving impermissible "give-ups" by broker-dealers in return for the direction of brokerage by fiduciaries rather than the permissible providing of brokerage

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and research services. [366] The SEC has also stated that § 28(e) is available to an adviser that obtains research from an introducing broker that clears its transactions through an executing broker only if there is a legitimate correspondent relationship between the two brokers. An introducing broker that does no more than provide research and direct brokerage to an executing broker would not satisfy this test. [367]

In its 1990 correspondence with the Department of Labor, [368] the SEC determined that the § 28(e) safe harbor is applicable only in the case of "commissions" paid—that is, where the broker, dealer or exchange member acts as agent—and not in the case of "mark-ups" or "mark-downs" payable in connection with principal transactions. As a result of the SEC's interpretation, transactions conducted in the over-the-counter market, which are typically executed on a principal basis, including most transactions in debt securities, are not within the scope of § 28(e). Moreover, the SEC clarified that transactions in exchange-listed equity securities are covered by the safe harbor only to the extent that the broker acts as agent and would not be covered if the broker filled the customer order using securities from its inventory. The correspondence also confirmed that § 28(e) is applicable only to transactions in "securities" within the meaning of the Exchange Act, thus excluding transactions in futures and commodity options from safe harbor coverage. [369] In a subsequent no-action letter, the SEC confirmed that safe harbor coverage is available to transactions in fixed-income securities conducted on an agency basis. [370]

Footnotes

355 § 6(e) of the Exchange Act.

356 SEC Release No. 34-23170 (Apr. 23, 1986).

357 Section 28(e) of the Exchange Act provides in pertinent part that:

> No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

The CFMA amended § 28(e) to provide that the provisions of § 28(e) do not apply to transactions in security futures products. § 28(e)(4) of the Exchange Act.

358 Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess., 71 (1975). Notwithstanding the availability of § 28(e), special issues may be raised in the case of investment companies registered under the Investment Company Act, *see* SEC Release No. 34-23170 (Apr. 23, 1986), and if the account is a pension plan, additional limitations may be imposed under ERISA.

359 *See* Form ADV, Part 2, Item 12; *see also Kingsley, Jennison, McNulty & Morse*, SEC Admin. Proc. File No. 3-7446 (Nov. 14, 1991). When the SEC overhauled Part 2 of Form ADV, it did not change the substance of the disclosure related to "soft dollar" arrangements. The SEC's rules in response to the Dodd-Frank Act require disclosure of conflicts related to "soft dollar" arrangements in Part 1 of Form ADV in addition to Part 2. SEC Release No. IA-3221 (June 22, 2011). In addition, an adviser that is also a broker-dealer is required to make certain disclosures in its customer confirmations about its soft dollar and payment for order flow practices. See Rule 10b-10 under the Exchange Act. In 1998, the SEC undertook an investigation of soft dollar practices and published its findings in a report entitled INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (Sept. 22, 1998).

In 1995, the SEC proposed a rule and form under the Advisers Act that would require each registered adviser that has the discretion to direct client brokerage transactions and receives services other than execution in exchange for that brokerage to provide its clients with an annual report that would contain information about its use of client brokerage. The report would disclose for the adviser's most recently completed fiscal year: (i) the 20 brokers to which the adviser directed the largest amounts of commissions, (ii) the three largest execution-only brokers utilized by the adviser, (iii) the aggregate amount of commissions directed by the adviser to each broker listed and the percentage of the adviser's total discretionary brokerage this amount represents, (iv) the average commission rate paid to each broker listed, and (v) for each broker other than an execution-only broker, information concerning products or services obtained from the broker. The report would also disclose the percentages of the adviser's total commissions that are directed to execution-only brokers, to other brokers and at the request of clients. The report would require information only about the adviser's use of client brokerage on an aggregate basis. *See* SEC Release No. IA-1469 (Feb. 14, 1995). No further action has been taken with respect to this proposed rulemaking.

In 2004, the NASD Mutual Fund Task Force submitted recommendations to the SEC regarding improvements in the transparency of mutual fund costs and distribution arrangements, including with respect to mutual fund portfolio transaction costs and soft dollar arrangements. The Mutual Fund Task Force recommended that the SEC narrow the types of research services that may be obtained with soft dollars to brokerage services described in § 28(e)(3) of the Exchange Act and the "intellectual content" of research (*i.e.*, not the means by which such content is provided). *See* NASD Mutual Fund Task Force, *Report of the Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs* (Nov. 11, 2004).

360 In 2006, the SEC issued an interpretive release to address developments in industry practices and technology since its last major interpretive release in 1986. SEC Release No. 34-54165 (July 18, 2006). The 1986 interpretive release regarding § 28(e) of the Exchange Act set out the SEC's views regarding the nature of brokerage and research services within the safe harbor, the purchase by fiduciaries from brokers of research prepared by third parties (so-called "*third-party research*"), the disclosure obligations of investment advisers regarding soft dollar arrangements, special requirements applicable to soft dollar arrangements where the account for which the fiduciary is acting is an investment company registered under the Investment Company Act and a number of other matters. SEC Release No. 34-23170 (Apr. 23, 1986). That release replaced an earlier release that covered some of the same subjects, but had a more restrictive standard for brokerage and research services falling within the safe harbor. SEC Release No. 34-12251 (Mar. 24, 1976). In 2008, the SEC issued additional proposed guidance to boards of directors of registered investment companies to assist them in fulfilling their fiduciary responsibilities with respect to overseeing fund advisers' satisfaction of "best execution" obligations, including the use of brokerage commissions. SEC Release No. 34-58264 (July 30, 2008). In addition, the SEC has issued a large number of no-action letters providing guidance regarding various issues raised under § 28(e) of the Exchange Act.

361 SEC Release No. 34-54165 (July 18, 2006).

362 SEC Release No. 34-54165 (July 18, 2006).

363 Securities Acts Amendments of 1975, Report of the Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess., 71 (1975); *see also* SEC Release No. 34-54165 (July 18, 2006); SEC Release No. 34-23170 (Apr. 23, 1986).

364 *See Foley & Lardner* (avail. Dec. 3, 1976). Similarly, "directed brokerage" arrangements, whereby a person other than the investment adviser routes trades to a particular broker, are outside the safe harbor. *See* SEC Release No. 34-23170 (Apr. 23, 1986).

365 SEC Release No. 34-23170 (Apr. 23, 1986); *see also* SEC Release No. 34-54165 (July 18, 2006).

366 SEC Release No. 34-16679 (Mar. 19, 1980).

367 *See*, *e.g.*, *Data Exchange Securities* (avail. May 20, 1981).

368 *See* Letter from Richard Ketchum, Director, SEC Division of Market Regulation, to Charles Lerner, Director of Enforcement, Pension and Welfare Benefit Administration (July 25, 1990).

369 Section 28(e) does not apply to transactions in security futures products. *See supra* Note 360.

370 *See Carolina Capital Markets, Inc*. (avail. July 30, 2013).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.10, ASSIGNMENT OF ADVISORY CONTRACTS

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 § 16.10 (11th and 12th Editions 2014-2017)
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The Advisers Act prohibits an adviser from entering, extending or renewing any advisory contract that fails to prohibit assignment without the consent of the client. [371] This requirement can be of considerable importance in planning overall corporate strategy for a group of affiliated companies, since the most routine of corporate reorganizations theoretically constitutes an assignment. The

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SEC staff has taken the position, however, that an adviser located outside the United States is not subject to the requirement in the case of its non-U.S. clients, subject to the satisfaction of certain conditions. [372]

"Assignment" is defined under the Advisers Act to include "any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities." [373] Change in the ownership of an adviser can thus constitute an assignment that triggers a client consent requirement. [374] Where partnerships are concerned, the death, withdrawal or admission to partnership of persons representing a minority of the partners having only a minority interest in an adviser will not constitute an assignment. [375]

Recognizing that the purpose of the prohibition is to prevent "trafficking" in advisory contracts in order to protect clients from having new or different

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investment advisers imposed upon them without their knowledge, [376] the SEC adopted Rule 202(a)(1)-1 under the Advisers Act. The rule provides that "a transaction which does not result in a change of actual control or management" of an adviser will not constitute an assignment under § 202(a)(2) of the Advisers Act. The rule essentially codifies prior staff no-action advice in a variety of corporate reorganization transactions, in which the staff has taken the position that no assignment will result if: (i) subsequent to the transfer, the new advisory entity will have the same directors, officers, advisory and other professional support staff, (ii) the business of the adviser will continue to be conducted in the same manner, and (iii) persons having ultimate control of the new adviser are the same as those controlling the transferor, which would include, in the case of publicly held companies, a shifting base of public owners. [377] With the adoption of Rule 202(a)(1)-1, the SEC indicated that it will no longer respond to inquiries as to whether a specific transaction is within the rule. [378]

When consent to an assignment is required, it is the general position of the staff that mere failure of the client to object to the assignment is not sufficient to constitute consent and, moreover, can constitute a fraudulent and deceptive practice in violation of the Advisers Act antifraud provisions. [379] Indeed, the staff has

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stated that an adviser's failure to describe to the client the arrangements that will be made if the client fails to consent to the assignment also constitutes a fraudulent and deceptive practice. [380]

In *Funds Inc. Investment Advisory Co.*, the staff refused to grant no-action relief where, in connection with a proposed spin-off of the shares of a registered adviser, the adviser proposed to notify its clients that (i) the spin-off could constitute an assignment requiring client consent, (ii) advisory services would continue for a period of 30 days after such notice, and (iii) in the absence of written notice to the contrary after such period, the advisory client "will be considered to wish to continue the relationship." [381] The staff explained that it had insufficient facts to conclude that the 30-day period was reasonable in those circumstances. [382] Although relief was refused, and the staff reaffirmed its position that silence is generally insufficient to constitute consent, the staff also explained that it generally raises no question if the customer is informed that the prospective assignee would continue the advisory services of the assignor for a specified reasonable period of time and that if the customer continues to accept such services without objection during the specified period, the assignee could, on that basis, assume the customer's consent to the assignment. [383]

The staff did not specify any guidelines as to the length of period that it might consider "reasonable," but suggested that the determination of the reasonableness of a given period would depend on the circumstances.

Footnotes

371 § 205(a)(2) of the Advisers Act. The Advisers Act also prohibits an adviser organized as a partnership from entering into, extending or renewing any advisory contract that fails to provide that the adviser will notify the client of any change in the membership of the partnership. § 205(a)(3) of the Advisers Act. The staff has held, however, that an adviser organized as a limited partnership does not need to include in its advisory contracts a provision obligating it to notify its clients whenever there is a change in the identity of the adviser's limited partners. *The Ayco Company, L.P.* (avail. Dec. 14, 1995).

It is important to note that while § 205(a)(2) prohibits an adviser from entering into an advisory contract that fails to prohibit assignment without the client's consent, it does not prohibit an adviser's assignment of an advisory contract without client consent. Thus, the assignment of an advisory contract without client consent could constitute a breach of the advisory contract or, in egregious circumstances, a breach of the adviser's fiduciary duty, but would not be a violation of § 205(a)(2). *American Century Cos., Inc.* (avail. Dec. 23, 1997); *see also JPMorgan Chase; Bear Stearns Asset Management I* (avail. Mar. 16, 2008) (revised July 14, 2008).

372 *The National Mutual Group* (avail. Mar. 8, 1993); *see also Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992); Hedge Fund Release. Nevertheless, where a non-U.S. adviser's contracts with its non-U.S. clients provide for client consent to assignments—even if the provision was included solely for purposes of compliance with § 205(a)(2) of the Advisers Act—the adviser should comply with the contractual provision.

373 § 202(a)(1) of the Advisers Act. The permissibility of sub-advisory contracts is subject to § 15(a) of the Investment Company Act, which provides that no person may serve as an investment adviser to a registered fund except pursuant to a written contract approved by a majority vote of the fund's shareholders. The SEC staff has agreed not to recommend enforcement action, however, where a new advisory contract was created from a pre-existing contract or fees were reallocated between the primary adviser and a sub-adviser, provided that the new contract or arrangement did not constitute a material change. *See*, *e.g.*, *Wells Fargo Bank, N.A.* (avail. Mar. 31, 1998).

374 The SEC has stated, however, that "the transfer or issuance of a block of stock in connection with a merger involving two issuers generally would not by itself cause an assignment of the advisory contracts of their advisory subsidiaries, for purposes of the Investment Company Act or the Advisers Act, unless (1) a person who had control of either issuer prior to the transaction does not have control of the surviving entity after the transaction, (2) a person who did not have control of either issuer prior to the transaction gains control of the surviving entity, or (3) the transaction results in an advisory subsidiary being merged out of existence." *Dean Witter, Discover & Co; Morgan Stanley Group Inc.* (avail. Apr. 18, 1997). But the SEC has informally cast doubt on the application of this no action letter beyond its facts, suggesting a narrow view of the change of control provisions. *See JPMorgan Chase; Bear Stearns Asset Management I* (avail. Mar. 16, 2008); Adviser and Broker-Dealer Study.

375 § 202(a)(1) of the Advisers Act.

376 SEC Release No. IA-1034 (Sept. 9, 1986); *see also* SEC Release No. IC-10809 (Aug. 6, 1979).

377 In *Investors Research Corp.*, for example, the staff granted no-action relief in the context of a proposed share exchange by affiliated companies, one of which was a registered adviser, such that the ownership interests of shareholders in each company would be the same. *Investors Research Corp.* (avail. Sept. 10, 1984). In addition, the adviser planned to continue to manage the portfolios of its clients using the same management and professional staff. The purpose of the reorganization was to "arrange the corporate structure in a manner which will assure the continuity and stability of the management of the enterprise both during the lifetime of [the principal stockholder] and at his death." *Investors Research Corp.* (avail. Sept. 10, 1984); *see also Nikko International Capital Management Co., Ltd.* (avail. June 1, 1987) (assumption by majority-owned subsidiary of parent's sub-advisory agreement was within Rule 202(a)(1)-1); *Equitable Life Assurance Society of the United States* (avail. Jan. 11, 1984) (incorporation of unincorporated advisory division did not result in assignment). *But see United Asset Management Corp.* (avail. Nov. 2, 1981) (refusing to agree that transfers, each of less than a controlling block of voting securities of an adviser's parent, did not constitute an "assignment" since such transfers, if coordinated, could result in transfer of a controlling interest).

378 SEC Release No. IA-1034 (Sept. 9, 1986); *Zurich Insurance Company, Scudder Kemper Investments, Inc.* (avail. Aug. 31, 1998) (whether change in control or management occurred as a result of a merger between two financial services providers, where no material change in services, fees, board of directors or executive committee would result, could be determined under Rule 202(a)(1)-1, but staff took no position as to whether the merger itself might involve a change in control or management).

379 *See*, *e.g.*, *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972); *In the Matter of Bridwell & Co., Inc.*, SEC Release No. IA-180 (Dec. 18, 1964). *But see Equitable Life Assurance Society of the United States* (avail. Jan. 11, 1984) (although counsel opined that no assignment would result from incorporation of unincorporated division of company, notice to certain accounts was provided and, if client did not notify company of intent to terminate contract, company would assume consent to transfer to newly incorporated division).

380 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

381 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

382 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

383 *Funds Inc. Investment Advisory Co.* (avail. Mar. 3, 1972).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.11, MAINTENANCE OF BOOKS AND RECORDS

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 § 16.11 (11th and 12th Editions 2014-2017)
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The Advisers Act and the SEC's related regulations impose detailed recordkeeping requirements on registered investment advisers. [384] Included among the records that the adviser must maintain are:

- financial ledgers (including trial balances and internal audit papers), checkbooks, bank statements, cancelled checks and the like;

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- detailed trade orders, client instructions regarding transactions, trade confirmations and all other written communications relating to the placing or execution of any order;
- paid and unpaid bills;
- records of discretionary accounts managed by the adviser and all related powers of attorney granted to the adviser by its clients;
- copies of all advisory and related contracts;
- copies of all notices, advertisements and the like recommending the purchase or sale of a specific security;
- copies of the adviser's statements satisfying the "Brochure Rule";
- any records or documents necessary to demonstrate the calculation of performance in any advertisement circulated to ten or more persons; [385]
- a copy of the adviser's code of ethics, records of code of ethics violations and any actions taken as a result of those violations, and supervised employees' written acknowledgements of having received the adviser's code of ethics; [386]
- securities holding reports and securities transaction reports of the adviser's access persons and related records; [387] and
- records pertaining to the adviser's compliance with restrictions on political contributions pursuant to Rule 206(4)-5 under the Advisers Act, including documentation of direct or indirect political contributions made by the adviser or any of its "covered associates." [388]

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Under the Private Fund Advisers Act and the related SEC rules, Exempt Reporting Advisers are required to maintain records of certain information with respect to the funds they manage. [389]

An adviser that renders "investment supervisory" or "investment management" services is also required to keep records showing separately for each client the securities purchased and sold, the date, amount and price of each purchase and sale and the current positions held in the client's account. [390] An adviser that has custody of client funds and securities is subject to additional requirements, including a requirement to maintain a separate ledger account for each client showing all purchases, sales, receipts and deliveries of securities, as well as details concerning the prices of transactions. [391]

Subject to satisfaction of certain conditions, a foreign adviser need not comply with all of the recordkeeping requirements of the Advisers Act in the case of its non-U.S. clients. [392] A foreign adviser must, in any event, maintain at a designated place within the United States correct, complete and current copies of the books and records maintained under the Advisers Act, unless the adviser files a written undertaking to furnish the SEC upon demand with copies of any required books and records and in fact provides such material at its own expense within 14 days subsequent to a written demand of the SEC. [393] In addition, where a foreign adviser's parent or affiliates provide the adviser with research, staff or other

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advisory services, or services relating to transactions effected by the adviser on behalf of its clients, the SEC staff has taken the position that the parent or affiliates must comply with certain of the recordkeeping requirements under the Advisers Act in order to avoid registration under the Advisers Act. [394]

Footnotes

384 § 204 of the Advisers Act and Rule 204-2 thereunder. In 2001, the SEC amended Rule 204-2 to permit electronic retention of required books and records. *See* SEC Release No. IA-1945 (May 24, 2001). The SEC staff has suggested that it may soon consider how to modernize the books and records rule requirements in light of, among other things, developments in recordkeeping technology. *See* Andrew J. Donohue, Director, SEC Division of Investment Management, Remarks at the Tenth Annual Investment Adviser Compliance Best Practices Summit (Mar. 21, 2008).

385 Rule 204-2(a) under the Advisers Act. The SEC has indicated in no-action relief that advisers can facilitate examinations of performance claims if they maintain (i) custodial or brokerage statements that confirm the accuracy of the account statements and other internally generated documents and (ii) reports prepared by an independent auditor that verify performance claims. *See Jennison Associates LLC* (avail. July 6, 2000).

Investment advisers, whether or not registered, may also have reporting requirements to the SEC under provisions of the U.S. securities laws not tied to the Advisers Act. For example, advisers having investment discretion for institutional investors that in the aggregate, together with the adviser's proprietary holdings, hold more than $100 million of publicly traded equity securities designated by the SEC pursuant to § 13(f) of the Exchange Act are required to file quarterly reports on Form 13F. Rule 13f-1 under the Exchange Act. In addition, advisers with investment discretion over accounts holding more than 5% of a class of voting equity securities of an issuer that is registered under the Exchange Act are required to make filings on Schedule 13D or 13G. *See* § 6.02[2].

386 Rule 204-2(a)(12) under the Advisers Act.

387 Rule 204-2(a)(13) under the Advisers Act.

388 Rule 204-2(a)(18) under the Advisers Act.

389 *See* §§ 404, 407 and 408 of the Private Fund Advisers Act; SEC Release No. IA-3221 (June 22, 2011); § 16.03[3][d].

390 Rule 204-2(c) under the Advisers Act. "Investment supervisory services" is defined in § 202(a)(13) of the Advisers Act as the "giving of continuous advice as to the investment of funds on the basis of the individual needs of each client," and the SEC has described "investment management services" as the "management of accounts where either the individual needs of the client are not considered or where the management services are not continuous." SEC Release No. IA-1000 (Dec. 3, 1985), 50 Fed. Reg. 49,835, 49,838 (Dec. 5, 1985). All of the records required to be maintained under the Advisers Act must be preserved in an easily accessible place for at least five years from the end of the fiscal year during which the last entry was made, and during the first two of these years they must be maintained in an office of the investment adviser. Even subsequent to the termination of an adviser's business, the Advisers Act requires retention of the corporate records (including such documents as the minute books, share certificate books and bylaws of an adviser organized in corporate form) for a period of at least three years. Records may, however, be maintained on microfilm or by computer. *See* Rule 204-2(g) under the Advisers Act. In certain circumstances, principally

investment adviser subscriptions to electronic document provider services, records may even be maintained solely on the computer system of a third-party document provider. *See Disclosure Incorporated* (avail. Aug. 22, 1996); *First Call Corporation* (avail. Sept. 6, 1995); *Oppenheimer Management Corporation* (avail. Aug. 28, 1995).

391 Rule 204-2(b) under the Advisers Act.

392 *The National Mutual Group* (avail. Mar. 8, 1993); Hedge Fund Release.

393 Rule 204-2(j)(3)(i) under the Advisers Act specifies that such undertaking be in the following form:

> The undersigned hereby undertakes to furnish at its own expense to the [SEC] at its principal office in Washington, DC, or at any Regional Office of [the SEC] specified in a demand for copies of books and records made by or on behalf of [the SEC], true, correct, complete and current copies of any or all, or any part, of the books and records which the undersigned is required to make, keep current or preserve pursuant to any provision of any rule or regulation of the [SEC] under the Investment Advisers Act of 1940. This undertaking shall be suspended during any period when the undersigned is making, keeping current, and preserving copies of all said books and records at a place within the United States in compliance with Rule 204-2(j) under the Investment Advisers Act of 1940. This undertaking shall be binding upon the undersigned and the heirs, successors and assigns of the undersigned, and the written irrevocable consents and powers of attorney of the undersigned, its general partners and managing agents filed with the [SEC] shall extend to and cover any action to enforce same.

394 *Murray Johnstone Holdings Ltd.* (avail. Oct. 7, 1994); *Kleinwort Benson Investment Management Ltd.* (avail. Dec. 15, 1993); *Mercury Asset Management* (avail. Apr. 16, 1993); *Unibanco* (avail. July 28, 1992).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.12, ENFORCEMENT

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 § 16.12 (11th and 12th Editions 2014-2017)
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[1] SEC Enforcement

The Advisers Act, as amended by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, [395] provides for broad SEC enforcement powers. These include:

- authority to bring suit to enjoin any actual or threatened violation of the Advisers Act by any person, including persons aiding and abetting any such violation and certain supervisory personnel;
- subpoena power to compel the production of witnesses and documents;
- authority to order a party to cease and desist from further violations;
- power to require an accounting and disgorgement of profits; and

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- authority to bar an investment adviser convicted of securities fraud from associating with other investment advisers. [396]

Both administrative and civil fines can be imposed by the SEC in amounts ranging up to $178,156 in the case of a natural person or $890,780 in the case of any entity. [397] In addition, violators are subject to criminal prosecution by the Department of Justice upon referral by the SEC, with potential penalties in the case of willful violations of up to five years in prison and/or a fine of up to $10,000. [398]

[2] Private Right of Action

The Advisers Act does not expressly provide for a private right of action by advisory clients to sue for damages resulting from an adviser's violations of the Advisers Act. [399] For many years a legal controversy existed as to whether such a private right could properly be implied under certain provisions of the Advisers Act—particularly under the antifraud provisions of § 206 of the Advisers Act. [400] The controversy was settled in 1979 with the U.S. Supreme Court's decision in *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*. [401] In that case, the Court found an implied private right of action for rescission and restitution of fees under an advisory agreement under § 215 of the Advisers

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Act, [402] but declined to recognize an implied private right of action for additional damages under § 206. The Court reasoned that in declaring in § 215 that contracts made in violation of the Advisers Act were void, Congress "intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission or for an injunction against continued operation of the contract, and for restitution." [403] Section 206, on the other hand, "simply proscribes certain conduct, and does not in terms create or alter any civil liabilities," [404] and thus provides no basis for inferring a damages remedy. [405]

[3] SEC Oversight

Registered investment advisers are also subject to SEC oversight. Under § 204 of the Advisers Act, the SEC has the authority to make such "reasonable, special, or other examinations by representatives of the SEC as it deems necessary or appropriate in the public interest or for the protection of investors." The SEC staff uses risk-based methodologies to identify activity that may warrant examination and thus to determine which registered investment advisers will be subject to routine examinations in a given year. [406] In particular, the staff divides all registered investment advisers into two groups—high-risk and low-risk—based on certain criteria. [407] In 2008 the SEC staff indicated that it would "zero in" on (i) firms that are of such size that, if anything went wrong, a significant number of investors would be affected, (ii) firms and areas within firms where compliance controls or supervision appears to be weak, and (iii) firms that are involved in activities that may present increased compliance risk, if not controlled adequately, such as dealing in structured products and illiquid securities. [408] Since 2015, SEC staff has aggregated and analyzed data concerning all registrants to identify activity that may warrant examination, identifying operational red flags, such as firms with aberrant swings in reported assets under management, changes in key individuals, business activities, and affiliates, and other possible indicia of heightened risk. [409]

In response to market turmoil and the effect of a significant number of Ponzi schemes and other fraudulent activities detected during the 2008 financial crisis, the SEC has implemented significant improvements to its surveillance efforts. As a result of the SEC's efforts to improve its risk-based methodologies, there was a significant increase in the number of firms identified by the SEC as "high-risk" by 2009. [410] The SEC missed its goal of examining "high-risk" advisers at least once every three years for the three-year period ending in 2013. [411] However, it exceeded its goals for the percentage of all advisers examined in both 2014 and 2015. [412]

In 2012, the SEC completed the restructuring of its enforcement division and launched a reorganization of its inspection unit with the intention of more aggressively and effectively spotting violations and pursuing fraud. As a result of the enforcement division restructuring, the SEC created specialized units to concentrate on high-priority areas of enforcement, one of which focuses on asset management (hedge funds and investment advisers). [413] In 2010, the SEC Office

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of Inspector General conducted an investigation into the SEC's response to Robert Allen Stanford's alleged Ponzi scheme and delivered a report recommending certain changes. [414] In light of the report's recommendations, the SEC implemented changes regarding the agency's leadership, its internal procedures and its culture of collaboration and continues to consider additional reforms as necessary for effective investor protection. [415]

In 2010, the staff generally sought to examine each registered investment adviser in the high-risk group once every three years. Registered investment advisers that were rated in the low-risk category did not receive routine examinations on a regularly scheduled basis. Instead, the firms within the low-risk group were subject to cause examinations resulting from tips, complaints and referrals and special purpose reviews such as risk-targeted examination sweeps and risk assessment reviews. [416] In 2013, the SEC conducted routine inspections of advisers with high-risk profiles (the examined "high-risk" advisers have assets under management that represent approximately 25% of the overall assets under management for currently registered advisers). The SEC examined 9% of the entire population of registered advisers in 2013. The percentage of advisers examined each year generally decreased over the period 2004–2013. While 18% of advisers were examined in 2004, only 8–9% of advisers were examined in each of 2011, 2012 and 2013. [417] However, the trends reversed in 2014 and 2015, when the SEC increased its percentage of advisers examined and exceeded its planned percentage. [418] In March 2016 the SEC's Office of Inspector General reviewed the Office of Compliance Inspections and Examinations ("OCIE")’s goals for investment adviser examination coverage, concluding that OCIE's risk-based examination prioritization was key to meeting the SEC's examination

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goals, and that OCIE has worked to increase its exam coverage. [419] The report recommended that OCIE improve by considering metrics other than the percentage of investment advisers examined each year. [420]

Footnotes

395 Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

396 § 203(f) of the Advisers Act. The D.C. Circuit has held that this authority allows the SEC to bar an investment adviser from associating with both registered and unregistered investment advisers. *Teicher v. SEC*, 177 F.3d 1016 (D.C. Cir. 1999), *cert. denied*, 529 U.S. 1003 (2000).

The SEC is also empowered to adopt rules, regulations and orders concerning payments to investors, rates of interest, periods of accrual and other matters appropriate to the implementation of an order for an accounting and disgorgement of profits. § 203(j) of the Advisers Act.

397 §§ 203(i)(2) and 209 of the Advisers Act; SEC Release No. IA-1596 (Nov. 1, 1996); *see*, *e.g.*, *SEC v. Moran*, 944 F. Supp. 286 (S.D.N.Y. 1996). The maximum amount of the civil monetary penalties that may be assessed under the Advisers Act is periodically adjusted for inflation. *See* SEC Release No. IA-4437 (June 27, 2016) (interim final rule effective Aug. 1, 2016), to be codified at 17 C.F.R. § 201.1001. Settlements for Advisers Act violations involving multiple violations can exceed the statutory maximum civil monetary penalty limits. *In the Matter of Banco Espirito Santo S.A.*, SEC Release No. IA-3304 (Oct. 24, 2011), for example, a Portuguese bank agreed to pay approximately $5,000,000 to settle claims that the bank provided investment advice to U.S. persons without registering with the SEC as an investment adviser.

398 § 217 of the Advisers Act.

399 Nor, according to at least one case, is there any private right of action for aiding and abetting a violation of the Advisers Act. *Mekhjian v. Wollin*, 782 F. Supp. 881 (S.D.N.Y. 1992).

400 *See*, *e.g.*, *Wilson v. First Houston Investment Corp.*, 566 F.2d 1235 (5th Cir. 1978), *cert. vacated and rem'd*, 444 U.S. 959 (1979); *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978).

401 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11 (1979).

402 Section 215 of the Advisers Act provides:

> (a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of [the Advisers Act] or with any rule, regulation, or order thereunder shall be void.
>
> (b) Every contract made in violation of any provision of [the Advisers Act] and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of [the Advisers Act], or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision.

403 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 19 (1979); *see also Payne v. Wood*, No. 94-1230, 1995 U.S. App. LEXIS 22551, at *17–18 (6th Cir. 1995).

404 *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 19 (1979); *see also Goldstein v.*

Malcolm G. Fries & Assoc., Inc., 72 F. Supp. 2d 620, 625 (E.D. Va. 1999) (holding that no private right of action exists for violations of § 206 of the Advisers Act).

405 The U.S. District Court for the District of Massachusetts has held that a 1990 amendment to the Advisers Act, made pursuant to the Securities Law Enforcement Remedies Act, did not create a private right of action under § 206. *Filson v. Langman*, No. 99-30021-FHF, 2002 U.S. Dist. LEXIS 22036 (D. Mass. Nov. 13, 2002).

406 *See* SEC, 2007–2015 Annual Reports.

407 SEC, 2013 Annual Report.

408 *See* Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Remarks at the Private Fund Compliance Forum (May 6, 2014); Lori A. Richards, Director, SEC Office of Compliance Inspections and Examinations, Remarks at the Tenth Annual Investment Adviser Best Practices Summit (Mar. 20, 2008).

409 *See* Andrew J. Donohue, Chief of Staff, Remarks at NRS 30th Annual Fall Investment Adviser and Broker-Dealer Compliance Conference (Oct. 14, 2015).

410 SEC, 2009 Annual Report.

411 SEC, 2013 Annual Report.

412 SEC, 2015 Annual Report.

413 SEC, 2010 Annual Report. For 2016 the SEC identified the following examination priorities: (i) protecting retail investors and investors saving for retirement, including focus on exchange traded funds, branch offices, fee selection and reverse churning, variable annuities, and public pension advisers; (ii) assessing market-wide risks, including cybersecurity; and (iii) using data analytics to identify signals of potential illegal activity, including to find recidivist representatives, to examine AML programs, and to identify breaches of fiduciary obligations with respect to promotion of new products. Other initiatives not among the enumerated priorities but referred to in OCIE's document included examinations of municipal advisors, never-before-examined entities, and private fund advisers. *See* SEC, Office of Compliance Inspections and Examinations, Examination Priorities for 2016 (Jan. 11, 2016).

414 *See* SEC Office of Inspector General, Report of Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme (Mar. 31, 2010).

415 Press Release, SEC, Statement from Chairman Shapiro on OIG Report 526: "Investigation of the SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme" (Apr. 16, 2010); *see also* SEC, 2013 Annual Report.

416 Adviser and Broker-Dealer Study, SEC, 2010 Annual Report. The SEC's risk-based examination approach reflects an effort to make the most efficient use of its limited resources. *See* U.S. Government Accountability Office, GAO-02-302, SEC Operation—Increased Workload Creates Challenges 11 (2002) ("SEC's resource constraints contributed to bottlenecks in the examination and inspection area as workload grew."). From 2004 to 2010, the number of SEC registered investment advisers has increased significantly while SEC resources committed to examination of advisors has declined, increasing reliance on the risk-based approach. Adviser and Broker-Dealer Study.

417 Advisers and Broker-Dealer Study. In 2010, the SEC conducted approximately 1,083 examinations overall. In each year from 2004 to 2008, the SEC conducted over 1,300 examinations. After decreasing in 2010 and 2011, the number of overall examinations increased to just over 1,400 in 2013. *See* SEC, 2013 Annual Report.

418 SEC, 2014 Annual Report; SEC, 2015 Annual Report (SEC planned to examine 9% of advisers but examined 10% each year).

419 SEC, Office of Inspector General, OCIE's Management of Investment Adviser Examination Coverage Goals, Draft Report No. 533 (Mar. 10, 2016).

420 SEC, Office of Inspector General, OCIE's Management of Investment Adviser Examination Coverage Goals, Draft Report No. 533 (Mar. 10, 2016).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.13, INSIDER TRADING ACT AND PERSONAL TRADING

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 § 16.13 (11th and 12th Editions 2014-2017)
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Investment advisers (other than investment advisers specifically exempted from registration under § 203(b) of the Advisers Act) are subject to Section 204A of the Advisers Act, [421] which imposes liability on firms and individuals who supervise [422] or employ persons who are found to have violated the insider trading prohibitions contained in the Advisers Act or the Exchange Act. [423] Pursuant to amendments made to the Exchange Act, liability under the Insider Trading Act can take the form of civil penalties of $1.425 million or more or SEC disciplinary action. [424] In addition, the Insider Trading Act also creates an express private right of action for damages against supervisory personnel, as well as against violators of the act's provisions. [425]

The Advisers Act requires an adviser to implement written policies and procedures to prevent the misappropriation and misuse of material nonpublic information by the adviser or its associated persons. [426] Neither the Advisers Act nor its legislative history provides specific guidance as to the appropriate scope

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of such procedures, [427] which will of course depend on the nature of the adviser's business and its affiliations (if any) with a registered broker-dealer. At a minimum, however, such procedures should include identification of specific personnel to monitor dissemination of information and ongoing monitoring of the procedures and establishment of reporting and other mechanisms to aid in detection of insider trading violations. These mechanisms may include, for example, employee education, certifications from employees that they have reviewed and understood the policies and procedures, the use of restricted lists, watch lists and information barriers to isolate certain of the entity's operations, other proprietary and employee trading restrictions to limit transactions in securities concerning which the entity is in possession of material nonpublic information, blackout periods to prevent "trading ahead" of clients based on the adviser's research recommendations and limitations on the dissemination of sensitive information. [428]

In addition to policies and procedures required to prevent insider trading, the Advisers Act also imposes recordkeeping requirements on registered advisers with respect to trading by "access persons." [429] Records under these provisions must be maintained for prescribed periods and are subject to inspection by the SEC at any time that the SEC deems necessary or appropriate in the public interest or for the protection of investors. [430] In particular, registered advisers are required to keep a record of the names of their access persons, the securities holdings and transaction reports made by access persons and records of

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decisions approving access persons' acquisition of securities in initial public offerings and limited offerings (*i.e.*, offerings exempt from registration under § 4(a)(2) or § 4(a)(6) of the Securities Act or Regulation D under the Securities Act). [431] Advisers to investment companies registered under the Investment Company Act are subject to special rules governing the conduct of their employees. Trading practices of such advisers and their personnel have been the subject of public and industry scrutiny favoring increased limitations on the ability of such persons to engage in securities transactions that may result in conflicts of interest with their investment company clients. [432]

Footnotes

421 *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); *see also* § 15(g) of the Exchange Act (analogous provision applicable to broker-dealers).

422 *See* § 203(e)(6) of the Advisers Act, which provides that a failure to supervise will not be deemed to have occurred if:

> (A) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (B) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

423 *See* §§ 14.07[1][b] and 14.08.

424 § 21A of the Exchange Act; 17 C.F.R. § 201.1004 and Table IV to Subpart E of Part 201.

425 § 20A of the Exchange Act. Whether an individual constitutes a "supervisor" for these purposes "depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue." *In the Matter of George J. Kolar*, SEC Release No. 34-46127 (June 26, 2002) (citing *In the Matter of John H. Gutfreund*, SEC Release No. 34-31554 (Dec. 3, 1992)).

426 Section 204A of the Advisers Act provides in pertinent part that every investment adviser, other than those specifically exempted from registration under § 203(b) of the Advisers Act,

> [S]hall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of [the Advisers Act or the Exchange Act], or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser.

427 As reported in the U.S. House of Representatives,

> [T]he Committee expects that institutions subject to the requirements of this provision will adopt policies and procedures appropriate to restrict communication of nonpublic information and to monitor its dissemination, such as restraining access to files likely to contain such information; providing continuing education programs concerning insider trading; restricting or monitoring trading in securities relating to which the firm's employees possess nonpublic information; and vigorously monitoring and reviewing trading for the account of the firm or individuals.

H.R. Rep. 910, 100th Cong., 2d Sess., 21, 22 (1988).

428 For a more complete discussion of these procedures and mechanisms and of responses to the requirements of the Insider Trading Act applicable to both broker-dealers and advisers, see §§ 14.07[1][b] and 14.08.

429 *See supra* Note 353.

430 § 204 of the Advisers Act.

431 Rule 204-2(a)(13) under the Advisers Act. Section 4(a)(2) of the Securities Act and Regulation D thereunder are discussed in Chapter 7.

432 *See, e.g.*, Investment Company Institute, REPORT TO THE DIVISION OF INVESTMENT MANAGEMENT, U.S. SECURITIES AND EXCHANGE COMMISSION, IMPLEMENTATION OF THE INSTITUTE'S RECOMMENDATIONS ON PERSONAL INVESTING (Apr. 21, 1995).

U.S. Regulation of the International Securities and Derivatives Markets, § 16.14, STATE REGULATION

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 § 16.14 (11th and 12th Editions 2014-2017)
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As described in § 16.02[1][a], the Coordination Act, together with the Private Fund Advisers Act, provides for a division in supervisory responsibility with respect to investment adviser regulation between the SEC and the state securities regulatory authorities—with small advisory firms under state supervision and large advisory firms under SEC supervision. The Private Fund Advisers Act created a new category of "mid-sized" advisers with assets under management [433] of between $25 million and $100 million that generally may not register with the SEC unless the adviser would be required to register with 15 or more states or is an adviser to a registered investment company or a business development company. [434] The Advisers Act gives the SEC primary responsibility for the regulation of advisers that remain registered with the SEC by preempting certain state laws with respect to those advisers. The states may not impose their own registration requirements on such SEC-registered advisers or "supervised persons" of such advisers, although states may license, register or otherwise qualify any investment adviser representative that has a place of business located within that state. [435] Those advisers with less than $25 million in assets under management and mid-sized advisers will be subject to state regulation and must continue to register with their home state and any other state where they may conduct business.

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Each state of the United States, as well as the District of Columbia and Puerto Rico, has the authority to require that persons who provide investment advisory services, whether from or to persons within that state or jurisdiction, register with the appropriate state or local authorities. [436]

Generally, all states and other jurisdictions that regulate investment advisory operations require that an adviser consent to service of process within the state or jurisdiction for state securities law violations. In addition, certain states impose minimum capital requirements, which may not be satisfied through the posting of a bond or the maintenance of insurance. These requirements are usually applicable only to advisers with custody of client funds or securities. [437] The majority of states require that the adviser post a surety bond or otherwise maintain professional liability insurance with respect to its operations. However, the Advisers Act provides that the states may not impose recordkeeping, minimum net capital and bonding requirements on an adviser that differ from those imposed by the state where it maintains its principal office and place of business. [438] Many states also require that persons employed by registered investment advisers be separately registered as agents or representatives. [439] The Advisers Act further provides that the states may require those investment adviser representatives who are employed by SEC-registered investment advisers but have a place of business in the state to register under the state's securities laws. [440] In addition, the Advisers Act sets forth a *de minimis* standard whereby states may not require registration of any adviser that does not have a place of business in the state and has fewer than six clients in the state during the previous 12-month period. [441]

The Coordination Act preserved the authority of the states to require SEC-registered advisers to file with the state (for notice purposes) any documents filed with the SEC, together with a consent to service of process and filing fee, [442] and the Private Fund Advisers Act and related SEC rules do not alter this authority of the states. The states retain their authority to investigate and bring enforcement actions with respect to fraud claims against advisers and their associated persons. [443]

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Most state Regulation D erives from the Uniform Securities Act (1956), adopted at one time or another, in whole or in part, by 37 jurisdictions, and its successor, the Revised Uniform Securities Act. As both of these acts were preempted in part by NSMIA, the Uniform Securities Act (2002) was drafted and approved by the National Conference of Commissioners on Uniform State Laws as a "new" Uniform Securities Act. [444] The North American Securities Administrators Association (the "NASAA") has also provided a model form of regulation for investment advisers consisting of a set of administrative rules incorporating many of the federal securities law requirements. Although most states have adopted some version of the foregoing models, many state legislatures and securities authorities have adjusted the model provisions in light of their own regulatory schemes, as state regulation can vary substantially from jurisdiction to jurisdiction. SEC rulemaking has, however, created a central registration procedure through the Investment Advisers Registration Depositary ("IARD") for filings of state-registered advisers. [445] The SEC has re-programmed the IARD system to function under the Private Fund Advisers Act regime, but the IARD will still serve as a database for SEC-registered and state-registered advisers. [446]

Notwithstanding the substantial variations that can exist among state investment adviser regulations, most state initiatives closely follow the federal scheme. Form ADV has been, for example, the uniform form of application used for registration under the laws of most states, although a number have required supplementary information. [447] In addition, most state securities statutes provide for exclusions and exemptions from registration requirements, which in some cases are broader than those provided under the Advisers Act. For example, the definition of "investment adviser" under the Uniform Securities Act (1956)

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excludes "savings institutions" and "trust companies" in addition to those entities covered by the similar provision contained in § 202(a)(11)(A) of the Advisers Act. Another example is the elimination by a number of states of the requirement, in connection with the exclusion for broker-dealers, [448] that the advisory activities be "solely incidental" to the broker-dealer's securities trading business. [449] Moreover, the definition of "investment adviser" in many state statutes provides for an "institutional" exclusion for advisers that do not have any place of business within the state and only advise "financial institutions," which would generally include banks, thrifts, investment companies and insurance companies. [450] Nevertheless, states that have adopted the Revised Uniform Securities Act or the Uniform Securities Act (2002) have eliminated the "institutional adviser" and the *de minimis* exclusions from the definition of investment adviser and treated such advisers as being exempt from registration. As in the case of the federal liability provisions, the effect of the change is to bring such advisers within the ambit of state antifraud provisions applicable to all advisers, regardless of registration status. [451]

State substantive regulation of investment advisers generally incorporates all of the requirements applicable to advisers under the Advisers Act. Currently, the most significant difference between federal and state regulation of advisers relates to compensation: most states have not updated applicable regulations to permit the limited performance-based compensation arrangements permitted under Rules 205-1, 205-2 and 205-3 under the Advisers Act. [452] In addition, those states that have used the NASAA-proposed regulations as a basis for their regulatory scheme impose certain additional restrictions, including prohibitions against an adviser's engaging in trading that is excessive in size or frequency in view of the financial resources and character of a client's account. [453] Such states may also require that an adviser have reasonable grounds to believe that a recommendation is suitable for a client, on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs. Finally, as in the case of current federal regulation, many states do not provide for any express private right of action for damages against investment advisers, although the Uniform Securities Act (2002) creates such a right.

Footnotes

433 R-AUM is used for purposes of determining whether an adviser is a "mid-sized" adviser. *See* § 16.03[3][a][i] for discussion of R-AUM.

434 The addition of the mid-sized adviser category was the principal change the Private Fund Advisers Act made to the regime imposed by the Coordination Act. The Private Fund Advisers Act also changed references in the related sections from "principal place of business" to "principal office and place of business," but otherwise left the Coordination Act regime intact.

435 § 203A(b)(1) of the Advisers Act.

436 Currently, the only state that does not regulate investment advisory activities is Wyoming.

437 *See*, *e.g.*, CAL. CORP. CODE § 25237, CAL. CODE REGS. tit. 10, § 260.237.2; CONN. GEN. STAT. § 36b-5(c), CONN. AGENCIES REGS. § 36b-31-9c; FLA. STAT. § 517.12, FLA. ADMIN. CODE ANN. r.69W-600.016; KY. REV. STAT. ANN. § 292.330, 808 KY. ADMIN. REGS. 10:200; WASH. REV. CODE ANN. § 21.20.060, WASH. ADMIN. CODE § 460-24A-170; WIS. STAT. § 551.406, WIS. ADMIN. CODE DFI-SEC 5.02.

438 §§ 222(b) and 222(c) of the Advisers Act.

439 *See*, *e.g.*, GA. CODE ANN. § 10-5-33; R.I. GEN. LAWS § 7-11-203.

440 § 203A(b)(1) of the Advisers Act.

441 § 222(d) of the Advisers Act.

442 §§ 307(a) and 307(b) of the Coordination Act.

443 § 203A(b)(2) of the Advisers Act.

444 The Uniform Securities Act (2002) has been adopted by Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Minnesota, Missouri, Oklahoma, South Carolina, South Dakota, Vermont, Wisconsin and the U.S. Virgin Islands.

445 SEC Release No. IA-1897 (Sept. 12, 2000). All states are required to accept filing of Forms ADV and ADV-W (the form used to withdraw an adviser registration) through the IARD. Most states have adopted legislation and/or regulations that require state-registered advisers to use the IARD. *See also* § 16.04.

446 SEC Release No. IA-3221 (June 22, 2011). The SEC envisions the IARD as a tool to identify whether particular advisers meet the requirements to register with the SEC under the Private Fund Advisers Act and related SEC rules.

447 The SEC has adopted rules overhauling Form ADV. The new Form ADV requires additional information, in particular with respect to advisers to private funds, and a reorganization of information provided in order to standardize presentation of information across all advisers. *See* §§ 16.04, 16.05. States that adopted the SEC's Form ADV prior to the Private Fund Advisers Act have generally adopted the amended Form ADV. The NASAA has also adopted amendments to its model rules to reflect SEC changes to the brochure rule and Form ADV.

448 § 202(a)(11)(C) of the Advisers Act.

449 *See, e.g.*, N.J. STAT. ANN. § 49:3-49(g); 70 PA. STAT. ANN. § 1-102.

450 *See* N.J. STAT. ANN. § 49:3-49(g); 70 PA. STAT. ANN. § 1-102.

451 *See* § 16.03[2].

452 The Revised Uniform Securities Act contains no prohibition on performance-based compensation, and the NASAA's regulations permit performance-based fees that are calculated essentially as provided in Rule 205-3 under the Advisers Act.

453 *See*, *e.g.*, IOWA ADMIN. CODE r. 191-50.38(502); MONT. ADMIN. R. 6.10.402; OR. ADMIN. R. 441-205-0145.

U.S. Regulation of the International Securities and Derivatives Markets, § 16.15, ANTI-MONEY LAUNDERING COMPLIANCE

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 § 16.15 (11th and 12th Editions 2014-2017)
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Investment advisers have not traditionally been regulated as "financial institutions" under the Bank Secrecy Act of 1970 (the "BSA") [454] and therefore have not been subject to anti-money laundering compliance regulations issued by the Financial Crimes Enforcement Network ("FinCEN"). [455] In May 2003, FinCEN issued a proposal to require certain investment advisers that offer asset management services to adopt an anti-money laundering program under the USA Patriot Act. [456] While the 2003 proposal was withdrawn in October 2008, in August 2015, FinCEN again issued a notice of proposed rulemaking that would impose anti-money laundering ("AML") compliance obligations on investment advisers under the BSA. The proposed AML regulations would require registered investment advisers to establish an AML program consistent with the requirements of the BSA, including risk-based policies, procedures and controls; independent testing; designation of an AML compliance officer or committee, and appropriate employee training. It would also require advisers to file suspicious activity reports and currency transactions reports. [457] The proposed AML regulations would not subject investment advisers to the customer due diligence rules applicable to broker-dealers and others summarized in § 14.07[4][e]. However, subsequent rulemaking is expected to extend these requirements to investment advisers.

Footnotes

454 Bank Secrecy Act of 1970, Pub. L. No. 91-508, 84 Stat. 1118 (1970).

455 However, investment advisers have been and continue to be subject to criminal anti-money laundering laws.

456 *See* FinCEN, Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg. 23,646 (May 5, 2003); FinCEN, Withdrawal of the Notice of Proposed Rulemaking; Anti-Money Laundering Programs for Investment Advisers, 73 Fed. Reg. 65,568 (Nov. 4, 2008).

457 FinCEN, Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, 80 Fed. Reg. 52,680 (Sept. 1, 2015).

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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 -A- (11th and 12th Editions 2014-2017)
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Chieftain International Funding Corporation

(avail. Nov. 3, 1992)
.... 15.05[1]

China Light & Power Company Limited

(avail. Jan. 2, 1998)
.... 4.02[3][a][iii]

China National Chemical Corporation and CNAC Saturn (NL) B.V.

(avail. Mar. 21, 2016) .... 9.05[1]

Churchill Management Corp.

(avail. May 30, 1974) 16.06

Citicorp

(avail. Sept. 14, 1986) .... 14.04[3][a]

Citicorp Homeowner, Inc.

(avail. Oct. 7, 1987) .... 14.03[1][b]

Citicorp Securities, Inc.

(avail. Aug. 4, 1995) .... 15.05[3][b]

Citigroup Inc.

(avail. May 27, 2004) .... 6.04[1][b]

Citizen VC, Inc.

(avail. Aug. 6, 2015) .... 10.05[3][c]

Citytrust

(avail. Dec. 19, 1990) .... 15.05[3][a]

Cleary, Gottlieb, Steen & Hamilton

(avail. Dec. 23, 1985) .... 15.05[1]

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Cleary, Gottlieb, Steen & Hamilton

(avail. July 24, 1990) .... 8.02[1][a]

Cleary, Gottlieb, Steen & Hamilton

(avail. Nov. 22, 1995, revised Jan. 30, 1996) .... 14.03[3][b][ii][C]

Cleary, Gottlieb, Steen & Hamilton

(avail. Apr. 9, 1997) .... 14.03[3][b][iii][A]

Cleary Gottlieb Steen & Hamilton LLP

(avail. Sept. 12, 2006) .... 14.07[6][c]

Cleary Gottlieb Steen & Hamilton LLP

(avail. Apr. 4, 2007) .... 9.05[2][a]

Clover Capital Management, Inc.

(avail. Oct. 28, 1986) .... 16.08[1]

CNET Networks, Inc.

(avail. Feb. 28, 2007) .... 9.03[2]

CNO Financial Group, Inc.

(avail. Feb. 11, 2013) .... 9.03[2]

CNSX Markets Inc.

(avail. Feb. 24, 2010) .... 8.02[2]

Coach, Inc. & J.P. Morgan Chase Bank N.A.

(avail. Nov. 28, 2011) .... 8.02[1][c][iii]

Coca-Cola Co.

(avail. Dec. 12, 1991) .... 6.04[1][b], 6.04[1][e]

College Ret. Equities Fund

(avail. Feb. 18, 1987) .... 7.01, 8.02[2]

Comcast Corp.

(avail. Oct. 7, 2004) .... 9.03[2]

CommandTRADE, LP

(avail. Dec. 28, 2005) .... 14.03[1][a]

Commodity Management Service Corp.

(avail. May 19, 1974) 16.06

CommScan, LLC

(avail. Feb. 3, 1999) .... 7.02[3][a]

Communicator Inc.

(avail. Sept. 20, 2002) .... 7.02[3][a]

Compass Group plc

(avail. May 13, 1999) 10.08

....

Computer Language Research, Inc.

(avail. Dec. 26, 1985)
.... 16.03[1][b]

Constellation Brands, Inc.

(avail. Jan. 29, 2003)
.... 9.05[4][a]

Constellation Financial Management L.L.C.

(avail. Jan. 9, 2003)
.... 16.06, 16.08

Consultant Publications, Inc.

(avail. Jan. 29, 1975)
.... 16.06

Continental Grain Company

(avail. Nov. 6, 1987)
.... 14.03[1][b]

Conway Asset Management, Inc.

(avail. Jan. 27, 1989)
.... 16.08[1]

Corimon C.A. S.A.C.A.

(avail. Mar. 22, 1993)
.... 7.05[2]

Country Business, Inc.

(avail. Nov. 8, 2006)
.... 14.03[1][a]

Coutts Global Fund

(avail. Apr. 11, 1994)
.... 15.06[3][c]

Covato/Lipsitz, Inc.

(avail. Oct. 23, 1981)
.... 16.08[1]

Credit Suisse First Boston Corporation

(avail. Sept. 9, 1998)
.... 15.02

Crosby Investment Consultants, Inc.

(avail. Oct. 28, 1977)
.... 16.03[3][e]

Crown Cork & Seal Company, Inc.

(avail. Mar. 10, 1997)
.... 4.05[5][c]

CSR Limited, CSR America, Inc. and CSR Finance Limited, Inc. 3.02[1][b]

(avail. Oct. 25, 1995)
....

Custody of B Shares Trading on the Shenzhen and Shanghai Securities Exchanges

(avail. Apr. 26, 1993)
.... 15.09[2]

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Daily Graphs

(avail. Dec. 13, 1978)
.... 16.06

DALBAR, Inc.

(avail. Mar. 24, 1998)
.... 16.08[1]

Darco Asso. Calny Food Services, Inc.

(avail. May 6, 1979)
.... 6.04[1][d]

Data Exchange Securities

(avail. May 20, 1981)
.... 16.09

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Datastream International, Inc.

(avail. Mar. 15, 1993)
.... 16.03[1][b]

David Parkinson, Ph.D.

(avail. Oct. 19, 1995)
.... 16.03[1][a]

David Streetman

(avail. Aug. 17, 1979)
.... 16.03[3][b][ii]

Dean Witter & Co., Inc.

(avail. Dec. 23, 1974)
.... 9.04[5][b][iii]

Dean Witter, Discover & Co; Morgan Stanley Group Inc.

(avail. Apr. 18, 1997)
.... 16.10

Dean Witter Reynolds (Canada)

(avail. Mar. 1, 1990)
.... 14.03[3][b][iii][A]

Debevoise & Plimpton

(avail. July 23, 1990)
.... 7.02[3][b]

Dennis M. Hardaker

(avail. Sept. 17, 1977) 16.07

Denver Investment Advisers

(avail. Jan. 10, 1986) .... 16.08[2]

Depositary Receipts

(avail. Apr. 14, 1993) 7.06

Derivative Products Committee of the Securities Industry Association

(avail. Nov. 21, 2005) .... 14.07[6][c]

Deutsche Bank AG

(avail. Apr. 9, 1996) .... 6.04[1][b]

Deutsche Bank Aktiengesellschaft

(avail. Sept. 16, 2010) .... 3.02[9][a][ii]

Deutsche Telekom AG

(avail. June 13, 1995) .... 3.02[4][c]

Development Bank of Singapore Ltd.

(avail. Aug. 12, 1999) .... 9.05[4][a]

Development Finance Corporation of New Zealand

(avail. Jan. 27, 1979) .... 15.05[2]

Devonshire Capital Corp.

(avail. Feb. 15, 1976) .... 15.06[3][b]

Dexia Municipal Agency

(avail. Dec. 26, 2007) .... 15.05[2], 15.05[3][a]

Dillon Read & Co., Inc.

(avail. Aug. 6, 1975) 16.07

Disclosure Incorporated

(avail. Aug. 22, 1996) 16.11

Distributions of Certain United Kingdom Securities and of Certain Securities Traded on SEAQ International 3.02[9][a][i] (avail. Jan. 10, 1995) ....

DnB NOR ASA

(avail. Jan. 9, 2008) .... 6.04[1][b]

Donaldson, Lufkin & Jenrette Securities Corp.

(avail. Mar. 2, 1977) .... 16.08[1]

Don Chamberlin

(avail. Aug. 10, 1979) .... 14.03[2][a]

Double D Management, Ltd.

(avail. Jan. 31, 1983) .... 16.02[1], 16.02[2]

Dougherty & Company LLC

(avail. Mar. 21, 2003) .... 16.08[4]

Douglas Capital Management, Inc.

(avail. Jan. 11, 1988) .... 16.08[4]

Dow Chemical Company

(avail. Sept. 2, 2015) .... 9.03[2]

Dow Theory Forecasts, Inc.

(avail. Aug. 26, 1983) .... 16.08[1]

Drico Industrial Corp.

(avail. June 25, 1976) .... 6.04[1][b]

Durban Roodepoort Deep, Ltd.

(avail. June 22, 1999) .... 9.05[13]

-E-

E. F. Hutton & Co.

(avail. Dec. 3, 1985) .... 7.02[2][b]

E.F. Hutton & Co., Inc.

(avail. Nov. 17, 1983) 16.08

E.ON Aktiengesellschaft

(avail. Dec. 6, 2006) 9.05[9][b]

Echo Pharma Acquisition Limited

(avail. May 1, 2013) .... 9.05[1]

Econo Lodges of America

(avail. Dec. 22, 1989) .... 15.05[3][a]

Edgardo H. Segura

(avail. Apr. 14, 1978) 16.04

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Edward D. Jones & Co.

(avail. Oct. 29, 1975) 16.07

EDX London Limited

(avail. Oct. 29, 2003) .... 14.03[3][b][i]

EGS Acquisition Co. LLC

(avail. Nov. 5, 2008) .... 9.02[2]

Electrocomponents PLC

(avail. Sept. 23, 1982) .... 9.05[13]

Elliott R. Curzon

(avail. Aug. 23, 2012) .... 14.07[6][c]

EMI Ltd.

(avail. Apr. 21, 1980) .... 9.05[7][d]

Employer Sponsors of Defined Contribution Plans

(avail. Dec. 5, 1995) .... 16.03[1][b]

Employer Sponsors of Defined Contribution Plans

(avail. Feb. 22, 1996) .... 16.03[1][b]

Empresa Brasileira de Telecommunicacoes

(avail. Oct. 15, 2010) .... 9.05[1]

Enersis Americas S.A. and Endesa Americas S.A.

(avail. Aug. 24, 2016) .... 9.05[2][a]

Epicor Software Corp.

(avail. May 13, 2004) .... 9.03[2]

EQK Partners

(avail. July 13, 1988) 16.06

Equitable Communications

(avail. Feb. 26, 1975) 16.06

Equitable Life Assurance Society of the United States

(avail. Jan. 11, 1984) 16.10

Ernst & Young Corporate Finance (Canada) Inc.

(avail. July 12, 2012) .... 14.03[3][c]

Erste Abwicklungsanstalt

(avail. Oct. 10, 2012) .... 15.05[2]

Eurex Deutschland

(avail. July 27, 2005) .... 14.03[3][b][i]

Eurolist and the Alternext Market

(avail. Mar. 16, 2007) .... 8.02[2]

Euronext Amsterdam

(avail. Apr. 7, 2006) .... 8.02[2]

Euronext Brussels

(avail. Nov. 10, 2004) .... 8.02[2]

European Association of Securities Dealers Automated Quotation N.V./S.A.

(avail. July 27, 1999) .... 8.02[1][c][iii]

European Economic Community

(avail. June 21, 1976) .... 3.05[1]

Europrospectus.com Ltd.

(avail. Apr. 28, 2004) .... 8.02[1][b]

Executive Group

(avail. July 9, 1984) 16.03[3][b][ii]

....

Exxon Capital Holdings Corp.

(avail. May 13, 1988)
.... 7.05[2]

Exxon Corporation

(avail. Dec. 13, 1989)
.... 6.04[1][b], 6.04[1][e]

Exxon Mobil Corp.

(avail. June 28, 2002)
.... 9.04[5][b][iii]

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Fairfield Trading Corp.

(avail. Jan. 10, 1988)
.... 14.03[1][b]

Federated Investors, Inc.

(avail. July 8, 1997)
.... 15.05[3][b]

Fidelity Management & Research Company, et al.

(avail. June 20, 2016)
.... 5.03[1][a]

Financial Research Center

(avail. Sept. 27, 1996)
.... 14.03[1][a]

FINRA

(avail. May 4, 2012)
.... 14.07[6][a][iv]

First Atlantic Investment Advisory Corp.

(avail. Mar. 22, 1974)
.... 16.03[1][c]

First Boston Corp.

(avail. June 14, 1990)
.... 8.02[2]

First Boston Corp.

(avail. Sept. 3, 1985)
.... 3.02[5][b]

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First CallCorporation

(avail. Sept. 6, 1995)
.... 16.11

First Federal Savings & Loan Association of Dallas, Texas and F.F. Corp. 16.03[3][e] (avail. Oct. 2, 1976) ....

First National Bank of Akron

(avail. Feb. 27, 1976) 16.08

First North and NASDAW OMX Stockholm AB, NASDAQ OMX Copenhagen A/S and NASDAQ OMX Helsinki Ltd.

(avail. Apr. 24, 2014) .... 8.02[2]

Flamel Technologies S.A.

(avail. July 14, 2016) .... 9.05[4][a]

Foley & Lardner

(avail. Dec. 3, 1976) 16.09

France Growth Fund, Inc.

(avail. July 15, 2003) .... 15.09[1]

Franklin Management, Inc.

(avail. Dec. 10, 1998) .... 16.08[1]

French Privatization Program

(avail. Apr. 17, 1987) 7.01

Fundamental Advisors, Inc.

(avail. Dec. 4, 1971) .... 16.03[1][c]

FundersClub Inc. and FundersClub Management LLC

(avail. Mar. 26, 2013) .... 14.03[1][a]

Funds Inc. Investment Advisory Co.

(avail. Mar. 3, 1972) 16.10

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Galen Holdings PLC

(avail. Aug. 7, 2000) .... 9.05[4][a]

Gardner and Preston Moss, Inc.

(avail. Feb. 18, 1983) .... 16.08[2]

Gartmore Investment, Limited Investors Diversified Services, Inc. 16.02[2]

(avail. Oct. 29, 1981)
....

Gas Natural SDG, S.A.

(avail. Mar. 2, 2006)
.... 9.05[9][b]

GE Funds

(avail. Feb. 7, 1997)
.... 16.08[1]

Gemalto S.A., Wavecom S.A.

(avail. Nov. 7, 2008)
.... 9.05[9][b]

GenCorp Inc.

(avail. Dec. 19, 2014)
.... 9.03[2]

Genentech Clinic Partners III

(avail. Apr. 28, 1989)
.... 10.10[4]

General Electric Capital Corporation; General Electric Company; General Electric Capital Services, Inc.

(avail. July 13, 1994)
.... 3.05[3]

General Electric Overseas Capital Corp.

(avail. July 7, 1983)
.... 15.05[1]

Gilat Satellite Networks Ltd.

(avail. Dec. 19, 2002)
.... 9.05[4][a]

Gim-Seong Seow

(avail. Nov. 30, 1987)
.... 16.02[1], 16.02[1][c]

Global Exempt Certificates of Ownership in NHA MBS Securities Inc.

(avail. Dec. 30, 1994)
.... 15.05[3][b]

GlobalTec Solutions, LLP

(avail. Dec. 28, 2005)
.... 14.03[1][a]

Goldman, Sachs & Co.

(avail. Mar. 26, 1986)
.... 9.04[4]

Goldman, Sachs & Co.

(avail. Apr. 27, 1995) 15.05[1]

....

Goldman, Sachs & Co.

(avail. Feb. 22, 1999)
.... 16.07

Goldman Sachs Group, Inc.

(avail. Mar. 30, 2001)
.... 6.04[1][c]

Goldman Sachs Group, Inc.

(avail. Mar. 8, 2005)
.... 15.06[3][a]

Goldman, Sachs & Co.

(avail. Dec. 30, 2008)
.... 6.04[1][b]

Goldman, Sachs & Co.

(avail. June 20, 2013)
.... 16.05

Goodwin, Procter & Hoar

(avail. Feb. 28, 1997)
.... 15.06[1], 15.05[3][b], 15.06[3][c]

Goodwin, Procter & Hoar

(avail. Oct. 5, 1998)
.... 15.06[2]

Gordian Cos., Inc.

(avail. Aug. 20, 1987)
.... 16.03[3][b][ii]

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Grace B. Vogel

(avail. Nov. 28, 2012)
.... 14.07[2][b][i], 14.07[6][a][ii]

Grand Chip Investment GmbH

(avail. Aug. 17, 2016)
.... 9.05[9][b]

Grand Metropolitan Public Limited Company

(avail. Dec. 16, 1997)
.... 4.02[3][a][iii]

Great Lakes Advisors, Inc.

(avail. Apr. 3, 1992)
.... 16.08[1]

Greencore Group plc

(avail. July 3, 1996)
.... 9.05[4][b], 10.07

Group 1 Automotive

(avail. May 16, 2014) .... 9.03[2]

Grover J. Rees

(avail. June 19, 1976) 16.07

Grupo Financiero InverMexico, S.A.

(avail. Apr. 4, 1995) .... 7.05[2]

GTIS Partners LP and GP Capital Partners IV, L.P.

(avail. Mar. 27, 2015) .... 9.05[1]

Guardian Investment Services, Inc.

(avail. Sept. 18, 1986) .... 16.03[3][e]

Guinness plc

(avail. Apr. 9, 1993) 10.08

-H-

H.P. Hambrick Co., Inc.

(avail. Oct. 14, 1988) .... 16.02[2]

Hallmark Capital Corp.

(avail. June 11, 2007) .... 14.03[1][a]

Harmony Gold Mining Company Limited

(avail. Nov. 19, 2004) .... 9.05[9][b]

Hashemite Kingdom of Jordan

(avail. Nov. 21, 1988) .... 15.05[3][a]

Haven Investments, Ltd.

(avail. June 1, 1981) 16.07

Hayes Martin

(avail. Feb. 15, 1980)., ... 16.03[1][a]

Hellenic Exchanges & Athens Stock Exchange, SA

(avail. July 15, 2016) .... 8.02[2]

Hellenic Republic 15.05[3][a]

(avail. Jan. 10, 1991) ....

Her Majesty's Government

(avail. Dec. 10, 2008) .... 6.04[1][b]

Hewlett-Packard Finance Company

(avail. Oct. 7, 1992) .... 15.05[1]

Hewlett-Packard Finance Company

(avail. July 17, 1996) .... 15.05[1]

Homestake Mining Company

(avail. Aug. 28, 1998) .... 7.02[3][c]

Hong Kong Futures Exchange Limited

(avail. Sept. 26, 1995) .... 14.03[3][b][i]

Horizon Asset Management, LLC

(avail. Sept. 13, 1996) .... 16.08[1]

Horsley Keogh Venture Fund

(avail. Apr. 27, 1988) .... 15.06[3][b]

Hudson Bay Mining and Smelting Co., Ltd.

(avail. June 19, 1985) .... 9.05[13]

Hungarian Telephone and Cable Corp.

(avail. Feb. 27, 2009) .... 4.11[2][b][i]

-I-

ICICI Bank Limited

(avail. Dec. 13, 2001) .... 9.05[4][a]

Ideal Mortgage and Realty Service Corp.

(avail. Jan. 4, 1978) .... 15.06[2]

In Bear Stearns & Co., Inc.

(avail. July 20, 2000) .... 3.02[1][c]

Independent Drug Wholesalers Group, Inc.

(avail. Apr. 16, 1992) 16.03[1][c]

Indosuez Asset Management Asia Ltd (avail. Feb. 14, 1997) .... 15.06[2]

ING Bank N.V. (avail. May 24, 1999) .... 15.09[2]

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ING Group N.V. (avail. June 10, 1997) .... 3.02[9][b]

ING Senior Income Fund (avail. Oct. 17, 2002) .... 3.02[9][a][ii]

Innosearch Corp. (avail. Sept. 12, 1985) .... 16.03[1][b]

Instinet Corp. (avail. Sept. 8, 1986) 14.10

Institute of International Bankers (avail. Sept. 25, 1992) .... 14.08[3][b]

International Association for Financial Planning (avail. June 1, 1998) .... 16.08[3]

International Business Exchange Corp. (avail. Dec. 12, 1986) .... 14.03[1][a]

International Investment Group, Inc. (avail. July 23, 1987) .... 14.03[1][b]

Internet Capital Corp. (avail. Jan. 13, 1998) .... 16.03[1][a]

Interplan Securities Corp. (avail. Feb. 23, 1978) 16.07

InTouch Global, LLC (avail. Nov. 14, 1995) .... 14.03[1][a]

Invesco Advisers, Inc.

(avail. Apr. 8, 2014) .... 15.06[1]

Investex Investment Exchange Inc.

(avail. Apr. 9, 1990) .... 16.03[1][a]

Investment Advisors, Interpretive Matters

(avail. July 18, 1995) 16.06

Investment Company Filing Guidance—1993

(avail. Feb. 2, 1993) .... 11.02[2][a]

Investment Company Institute

(avail. Aug. 24, 1987) .... 16.08[1]

Investment Company Institute

(avail. Sept. 23, 1988) .... 16.08[1]

Investment Funds Institute of Canada

(avail. Mar. 4, 1996) .... 15.05[3][b], 15.06[1], 15.06[2]

Investors Mortgage Group, Inc.

(avail. Feb. 9, 1976) .... 7.02[2][b]

Investors Research Corp.

(avail. Sept. 10, 1984) 16.10

Islamic Republic of Pakistan

(avail. Jan. 18, 1989) .... 15.05[3][a]

ITT Hartford Mutual Funds

(avail. Feb. 7, 1997) .... 16.08[1]

-J-

J.D. Manning, Inc.

(avail. Jan. 21, 1986) .... 16.03[1][a]

JDN Realty Corporation

(avail. Oct. 26, 1999) .... 9.05[4][b]

J.P. Morgan Investment Management Inc. 16.08[1] (avail. May 7, 1996) ....

J.Y. Barry Arbitrage Management Inc.

(avail. Oct. 18, 1989) .... 16.03[2][d]

James Capel

(avail. Dec. 6, 1989) .... 14.03[3][b][iii][B]

James R. Waters, CFP

(avail. June 1, 1995) 16.06

Janus Adviser Series

(avail. Aug. 28, 2000) .... 16.08[1]

Jardine Fleming China Region Fund, Inc.

(avail. Apr. 26, 1993) .... 15.09[2]

Jennison Associates LLC

(avail. July 6, 2000) 16.11

Jevic Transportation, Inc.

(avail. Apr. 20, 1999) .... 7.02[3][b]

John Hancock Trust, et al.

(avail. Apr. 12, 2012) .... 15.09[1]

John W. Henry & Co., Inc.

(avail. Sept. 20, 1996) .... 16.02[2], 16.06

John W. Loofbourrow Assoc., Inc.

(avail. June 29, 2006) .... 14.03[1][a]

John Warner Seder

(avail. June 10, 1977) .... 16.08[1]

John Wood Group PLC

(avail. Mar. 1, 2001) .... 9.05[4][a]

JPMorgan Chase; Bear Stearns Asset Management I

(avail. Mar. 16, 2008) 16.10

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KBS International Ltd.

(avail. Mar. 18, 1985) .... 15.06[2]

KDSM, Inc., Sinclair Capital

(avail. Mar. 17, 1997) .... 15.05[1]

Kenneth Leventhal & Co.

(avail. Feb. 7, 1983) .... 16.02[2]

K-III Communications Corp.

(avail. May 14, 1993) .... 7.05[2]

Kirr, Marbach & Co.

(avail. Feb. 6, 1977) .... 16.03[1][c]

Klabin S.A.

(avail. July 14, 2014) .... 9.04[5][b][iii]

Kleinwort Benson Investment Management Ltd.

(avail. Dec. 15, 1993) .... 16.02[1][c], 16.02[2], 16.11

Koninklijke Ahold N.V.

(avail. Sept. 10, 2002) .... 9.05[9][b]

Korea Stock Exchange

(avail. Sept. 11, 2000) .... 8.02[2]

Kraft Foods Inc.

(avail. July 1, 2008) .... 9.03[2]

Kraft Foods, Inc.

(avail. Dec. 9, 2009) .... 9.05[1], 9.05[2][a]

Kris Dailey

(avail. Feb. 26, 2014) .... 14.07[2][a][ii]

-L-

Lamp Technologies, Inc. 14.10[2], 16.03[3][b][ii] (avail. May 29, 1998) ....

Lazard Freres Asset Management

(avail. Feb. 12, 1996) .... 16.02[2]

Lazard Freres & Co.

(avail. Aug 11, 1995) .... 9.03[2]

Legacy Motors, Inc.

(avail. July 31, 1991) .... 14.03[2][a]

Lehman Brothers Inc.

(avail. Mar. 8, 1994) .... 15.05[1]

Lehman Brothers Inc.

(avail. May 26, 1995) .... 15.05[1]

Liberty Media Corp.

(avail. Feb. 7, 2001) .... 10.09[4]

Lincoln National Investment Management

(avail. Mar. 26, 1992) .... 16.08[3]

Lloyds Banking Group plc

(avail. Nov. 2, 2009) .... 9.05[6]

Lloyds Banking Group plc

(avail. May 28, 2010) .... 9.05[1]

Lockheed Martin Corporation

(avail. July 11, 2016) .... 9.03[2]

Loffa Interactive Corp., Inc.

(avail. Sept. 12, 2003) .... 14.03[1][a]

London International Financial Futures Exchange ("LIFFE")

(avail. May 1, 1992) .... 14.03[3][b][i]

London International Financial Futures and Options Exchange

(avail. Mar. 6, 1996) .... 14.03[3][b][i]

London Stock Exchange

(avail. Aug. 5, 1997) .... 3.02[9][a][i]

London Stock Exchange

(avail. Aug. 18, 1998) .... 8.02[2]

London Traded Options Market

(avail. Sept. 4, 1990) .... 14.03[3][b][iv]

Louis Dreyfus Corporation

(avail. July 23, 1987) .... 14.03[1][b]

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M&A Brokers

(avail. Jan. 31, 2014) .... 14.03[1][a]

MACRO Securities Depositor, LLC

(avail. Dec. 1, 2006) 15.02

Madison Park Investment Management

(avail. Mar. 4, 1986) .... 15.06[3][c]

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Malta Stock Exchange plc

(avail. July 9, 2013) .... 8.02[2]

Managed Fund Accounts

(avail. Feb. 6, 2014) .... 15.06[1]

Mandatorily Exchangeable Issuer Securities

(avail. Oct. 18, 1999) .... 10.02[3][b]

Mandatorily Exchangeable Issuer Securities

(avail. Oct. 25, 1999) .... 10.06[3]

Man-Glenwood Lexington TEI, LLC

(avail. Apr. 30, 2004) .... 15.08, 15.09[1]

Marakon Systems, Inc.

(avail. Sept. 6, 1982) 16.03[1][b]

....

Martha Stewart Living Omnimedia, Inc.

(avail. Nov. 7 2003)
.... 9.03[2]

Mary Lee Botsaris—900 Stock Tip Number

(avail. Mar. 25, 1993)
.... 16.03[2][c]

Maxcom Telecommunicaciones, S.A. de C.V.

(avail. Oct. 31, 2001)
.... 4.05[5][c]

Mayer Brown LLP

(avail. July 28, 2008)
.... 16.08[3]

May-Pac Management Company

(avail. Dec. 20, 1973)
.... 14.03[1][a]

McDonald's Corporation

(avail. Sept. 27, 2006)
.... 9.03[2]

Meadowbrook Real Estate Fund

(avail. Aug. 26, 1998)
.... 15.06[1]

MEC Finance USA, Inc.

(avail. Oct. 25, 1991)
.... 15.05[1]

Mecs, Ph.D., B.M.

(avail. Dec. 6, 1970)
.... 16.03[1][c]

Medeva PLC

(avail. Jan. 31, 1995)
.... 9.05[4][b], 10.07

Melco Crown Entertainment Ltd.

(avail. Oct. 18, 2010)
.... 4.05[5][c]

Mellon Financial Corp.

(avail. Nov. 16, 2006)
.... 6.04[1][b]

Mercato Italiano dei Derivati

(avail. Sept. 1, 1998)
.... 14.03[3][b][i]

Merchants Capital Management 16.08[3] (avail. Oct. 4, 1991) ....

Mercury Asset Management

(avail. Apr. 16, 1993) .... 16.02[1][c], 16.02[2], 16.05, 16.07, 16.08, 16.10, 16.11

Mericka & Co., Inc.

(avail. July 28, 1972) .... 16.08[3]

Meridian Bancorp, Inc., Meridian Funding Corp.

(avail. Sept. 21, 1984) .... 3.05[3]

Merrill Lynch & Co.

(avail. Mar. 2, 1994) .... 15.05[1]

Merrill Lynch & Co.

(avail. May 25, 1995) .... 15.05[1]

Merrill Lynch Trust Co., FSB

(avail. July 6, 2000) 16.07

Merrill Lynch, Pierce, Fenner & Smith Inc.

(avail. Sept. 3, 1999) .... 15.06[2]

Microsoft Corp.

(avail. Oct. 14, 2003) .... 9.03[2]

Microsoft Corp., Martha Stewart Living and Microtune, Inc.

(avail. Sept. 13, 2007) .... 9.03[2]

Mike Bantuveris

(avail. Oct. 23, 1975) .... 14.03[1][a]

Miller & Co., Inc.

(avail. Aug. 15, 1977) .... 14.03[1][a]

Mineral Lands Research & Marketing Corp.

(avail. Dec. 4, 1985) .... 7.02[2][b]

Minnesota Mining

(avail. Oct. 13, 1988) .... 10.10[4]

Minnesota Mining and Manufacturing Company

(avail. Oct. 13, 1988) .... 10.10[4]

Missouri Innovation Center, Inc.

(avail. Oct. 17, 1995) .... 16.03[1][a]

Mitsubishi UFJ Financial Group, Inc.

(avail. Jan. 23, 2006) .... 6.04[1][b]

Mittal Steel

(avail. June 22, 2006) .... 9.05[2][a]

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Monchik-Weber Associates, Inc.

(avail. Oct. 23, 1981) .... 16.03[1][b]

Money-Matters! Limited Partnership

(avail. Oct. 1, 1991) 16.05

Monument Capital Management, Inc.

(avail. July 12, 1990) .... 15.06[3][c]

Morgan Stanley & Co. Inc.

(avail. June 5, 1991) .... 7.05[2]

Morgan Stanley & Co., Inc.

(avail. June 24, 1996) .... 10.06[2]

Morgan Stanley India Securities Pvt. Ltd.

(avail. Dec. 20, 1996) .... 14.03[3][c][i][D]

Morgan Stanley Smith Barney LLC

(avail. May 29, 2009) .... 6.04[1][b]

Morgan Stanley Smith Barney LLC

(avail. Nov. 22, 2016) .... 3.02[1][a]

Morgan, Lewis & Bockius LLP

(avail. Apr. 16, 1997) 16.06, 16.07

Morrill-Stanfill & Co.

(avail. Apr. 13, 1978) .... 16.08[1]

Mortgage Investors of Washington

(avail. Oct. 8, 1980) .... 9.04[5][b][iii]

Motorola, Inc.

(avail. Jan. 31, 1972) .... 7.02[3][b]

Mr. R. Bate

(avail. June 28, 1988) .... 16.03[3][b][ii]

Multi-Financial Securities Corp.

(avail. Nov. 9, 1995) .... 16.08[1]

MuniAuction Inc.

(avail. Mar. 13, 2000) .... 14.03[1][a]

Municipal Investment Group

(avail. Jan. 5, 1989) 16.07

Municipality Finance Ltd.

(avail. Apr. 28, 1994) .... 15.05[2], 15.05[3][a]

Murray Johnstone Holdings Ltd.

(avail. Oct. 7, 1994) .... 16.02[1][c], 16.02[2], 16.03[3][c], 16.05, 16.07, 16.08, 16.10, 16.11

-N-

Nabi Biopharmaceuticals/Biota Holdings Limited

(avail. June 20, 2012) .... 9.05[4][a]

NASD

(avail. May 7, 1986) .... 14.03[3][b][iv]

NASD

(avail. Oct. 22, 1986) .... 14.03[3][b][iv]

NASD

(avail. June 9, 1987) .... 14.03[3][b][iv]

NASD 14.03[3][b][iv]

(avail. Mar. 18, 1988) ....

NASD

(avail. Dec. 5, 1989) .... 14.03[3][b][iv]

NASD

(avail. Oct. 11, 1991) .... 14.04[1]

Nasdaq International Service

(avail. Oct. 11, 1991, revised Jan. 11, 1993) .... 14.03[3][b][v]

National Association of Investors Corp.

(avail. Oct. 16, 1992) 16.08

National Consumer Cooperative Bank

(avail. Jan. 3, 2011) .... 6.04[1][b]

National Council of Savings Institutions

(avail. July 27, 1986) .... 14.03[1][b]

National Deferred Compensation

(avail. Aug. 31, 1987) 16.06

National Football League Players Association

(avail. Jan. 25, 2002) .... 16.08[3]

National Mutual Group

(avail. Mar. 8, 1993) .... 16.02[1][c], 16.02[2], 16.05, 16.06, 16.07, 16.08, 16.08[2], 16.08[3], 16.10, 16.11

National-Oilwell, Inc.

(avail. July 30, 1997) .... 9.05[4][a]

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National Westminster Bank PLC

(avail. July 7, 1988) .... 14.04[3][b], 14.03[3][b][ii][A]

Natixis S.A.

(avail. Oct. 9, 2007) .... 6.04[1][b]

Net Roadshow, Inc. 7.02[5][b]

(avail. Jan. 30, 1998) ....

Net Roadshow, Inc.

(avail. Sept. 8, 1997) .... 7.02[5][b]

Neuberger & Berman

(avail. Mar. 30, 1987) 16.08

Neuberger & Berman

(avail. May 29, 1984) 16.08

New England Asset Management Corp.

(avail. May 1, 1976) .... 16.08[2]

New South Wales

(avail. Sept. 15, 2009) .... 3.02[2][b]

Newton Growth Fund

(avail. June 13, 1984) .... 16.08[2]

Nicholas-Applegate Mutual Funds

(avail. Feb. 7, 1997) .... 16.08[1]

Nikko International Capital Management Co., Ltd.

(avail. June 1, 1987) 16.10

Nippon Telegraph and Telephone Corp.

(avail. Dec. 11, 1998) .... 3.02[9][b]

Nippon Telegraph and Telephone Corp.

(avail. July 28, 2000) .... 3.02[9][b]

Nippon Telegraph and Telephone Corp.

(avail. Nov. 8, 1999) .... 3.02[9][b]

NoLoad Mutual Fund Association, Inc.

(avail. Dec. 31, 1984) .... 16.03[1][a]

Nordic Telephone Company ApS

(avail. Jan. 3, 2006) .... 9.05[1]

Nordiska Investeringsbanken

(avail. Feb. 1, 1982) .... 3.05[1]

Norsk Hydro a.s.

(avail. May 6, 1988) .... 3.02[9][a][i]

Northwestern Mutual Life Insurance Co.

(avail. Mar. 3, 1983) .... 10.10[4]

Novo Nordisk A/S

(avail. June 18, 1991) .... 3.02[9][a][i]

-O-

Oak Leaf B.V., Acorn B.V and Acorn Holdings B.V.

(avail. May 21, 2013) .... 9.05[1]

Oakwood Homes

(avail. Oct. 11, 1978) .... 14.07[6][c]

Oldcastle, Inc.

(avail. July 3, 1986) .... 9.05[13]

OM Stockholm Exchange

(avail. Oct. 11, 2000) .... 8.02[1][c][iii]

Omni Management Corp.

(avail. May 10, 1979) .... 16.08[2]

ONB Securities, Inc.

(avail. Dec. 17, 1978) .... 16.03[3][b][ii]

Ontala Forest Products Inc.

(avail. Dec. 14, 1994) .... 14.07[6][c]

Ontario Teachers' Pension Plan Board

(avail. May 6, 1992) .... 6.04[1][b]

Oppenheimer & Co.

(avail. June 5, 1992) .... 16.08[3]

Oppenheimer Arbitrage Partners, L.P. 15.06[3][c]

(avail. Dec. 26, 1985)
....

Oppenheimer Management Corporation

(avail. Aug. 28, 1995)
.... 16.11

Oppenheimer Senior Floating Rate Fund

(avail. Aug. 31, 2005)
.... 3.02[9][a][ii]

Opticon Medical, Inc.

(avail. June 28, 2002)
.... 4.11[2][b][ii]

Orbis Group

(avail. July 16, 2008)
.... 6.04[1][b]

Osaka Securities Exchange

(avail. July 23, 1999)

Oslo Børs—Merkur Market

(avail. Apr. 13, 2016)
.... 8.02[2]

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Panama Stock Exchange

(avail. June 21, 2006)
.... 8.02[2]

Paragon Advisers, Inc.

(avail. Oct. 1, 1998)
.... 15.06[1]

ParisBourse SA

(avail. Dec. 6, 1999)
.... 14.03[3][b][i]

Pasadena Investment Trust

(avail. Jan. 22, 1993)
.... 15.06[3][c]

Paul Anka

(avail. July 24, 1991)
.... 14.03[1][a]

Pauline Wang

(avail. Mar. 21, 1980)
.... 16.03[1][a]

PBT Covered Option Fund 15.06[3][c] (avail. Feb. 17, 1979) ....

Pepsi-Cola (Bermuda) Ltd.

(avail. Mar. 18, 2011) .... 9.05[9][b]

Pepsi-Gemex, S.A. de C.V.

(avail. June 1, 2001) .... 9.04[5][b][iii]

Perfect Data Corp.

(avail. Aug. 5, 1996) .... 16.03[1][a]

Perfect Information

(avail. Dec. 22, 2000) .... 8.02[1][b]

Petroleum Geo-Services

(avail. June 8, 1999) .... 9.04[5][b][iii]

Petro-Search, Inc.

(avail. July 28, 1975) .... 7.02[3][b]

PHH Corporation

(avail. June 12, 2015) .... 9.03[2]

Piedmont Financial Company, Inc.

(avail. May 30, 1990) .... 16.08[2]

Pierce, Lewis & Dolan

(avail. Mar. 17, 1972) .... 15.06[3][b]

Piette and Associates, Ltd.

(avail. Sept. 17, 1981) .... 16.08[2]

Popular High Grade Fixed-Income Fund

(avail. Sept. 10, 2002) .... 3.02[9][a][ii]

Prague Stock Exchange

(avail. May 28, 2004) .... 8.02[2]

Prescient Markets, Inc.

(avail. Apr. 2, 2001) .... 14.03[2][b][i]

Price Waterhouse

(avail. Oct. 1, 1987) .... 16.02[2]

Privatization of the United States Enrichment Corp.

(avail. May 13, 1998) .... 7.02[6]

Procter & Gamble Company Exchange Offer

(avail. Sept. 1, 2016) .... 9.03[2]

Prospect Group

(avail. Nov. 29, 1988) .... 16.03[2][d]

Prudential Corp. Ltd.

(avail. Nov. 6, 1981) .... 16.02[2]

PSEG Capital Corp.

(avail. July 13, 1988) .... 15.05[1]

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Quad City Holdings, Inc.

(avail. Apr. 8, 1993) .... 7.02[6]

Quebecor Printing Inc., Quebecor Printing Capital Corporation and Quebecor Printing Capital GP

(avail. Mar. 12, 2000) .... 3.02[1][b]

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Rank Group plc

(avail. Feb. 2, 1998) .... 3.02[1][b]

Refreshment Machinery, Inc.

(avail. June 16, 1975) .... 6.04[1][b], 6.04[1][e]

Republic of Chile

(avail. April 27, 2015) .... 3.05[1]

Republic of Turkey

(avail. Nov. 3, 1988) .... 15.05[3][a]

Resolution Trust Corp.

(avail. July 18, 1991) 15.06[3][c]

Resource Bank & Trust

(avail. Mar. 29, 1991) .... 16.03[3][b][ii]

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Reuters Holding PLC

(avail. Mar. 6, 1990) .... 9.05[7][b]

Reuters Information Services, Inc.—TV 2000

(avail. Jan. 17, 1991) .... 16.03[2][c]

Rhodes, King, Ruman & Farber

(avail. Nov. 2, 1972) .... 16.03[1][a], 16.08[3]

Rhone-Poulenc S.A.

(avail. Jan. 25, 1993) .... 3.02[9][a][i]

Richard Daniels

(avail. Dec. 12, 1984) .... 16.03[1][a]

Richard Ellis, Inc.

(avail. Sept. 17, 1981) .... 16.02[2]

Richard K. May

(avail. Dec. 11, 1979) .... 16.03[1][a]

RingsEnd Partners, LLC/EBIC Program

(avail. Mar. 4, 2013) .... 5.05[1]

Robert C. DeFazio

(avail. Dec. 17, 1981) .... 14.03[1][b]

Robert D. Brown Investment Counsel, Inc.

(avail. July 19, 1984) 16.08

Robert R. Jones

(avail. Nov. 14, 1984) .... 16.03[1][c]

Robert T. Willis, Jr., P.C.

(avail. Jan. 18, 1988) .... 7.02[2][b]

Rogers, Casey & Associates, Inc.

(avail. June 16, 1989) .... 15.06[3][c]

Roland Berger Strategy Consultants

(avail. May 28, 2013) .... 14.03[3][b][iii][A], 14.03[3][h]

Ronald F. Bentley

(avail. Jan. 24, 1978) .... 16.03[3][b][ii]

Roto American Corp.

(avail. Feb. 19, 1971) .... 7.04[2]

Roy Heybrock

(avail. Apr. 5, 1982) .... 16.03[3][e]

Royal Bank of Canada

(avail. Dec. 10, 1990) .... 6.04[1][b]

Royal Bank of Canada

(avail. June 3, 1998) .... 16.02[1][c], 16.02[2]

Royalty Pharma

(avail. Aug. 13, 2010) .... 15.05[3][a]

Russell H. Smith

(avail. May 2, 1996) .... 16.03[1][c]

Ruth Quigley

(avail. July 14, 1973) .... 14.03[1][a]

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S3 Matching Technologies LP

(avail. July 19, 2012) .... 14.03[1][a]

S.H. Dike & Co., Inc.

(avail. Apr. 20, 1975) .... 16.08[1]

Safra Republic Holdings, S.A.

(avail. Apr. 21, 1998) .... 15.05[2]

Saipem SpA 9.05[9][b]

(avail. July 29, 2002)
....

Sales of Convertible Securities of U.S. Reporting Companies Under **Regulation S**

(avail. Aug. 26, 1998)
.... 10.06[4]

Salomon Brothers Inc.

(avail. June 17, 1985)
.... 15.05[3][a]

Salomon Brothers Inc.

(avail. Mar. 12, 1986)
.... 9.04[4]

Salomon Brothers Inc

(avail. Oct. 1, 1990)
.... 9.04[4]

Salomon Brothers Asset Management Inc.

(avail. Oct. 10, 1990)
.... 16.07

San Jose Capital Corporation

(avail. Feb. 14, 1983)
.... 15.06[2]

Sanofi-Synthelabo S.A.

(avail. June 10, 2004)
.... 9.05[9][b]

Sanpaolo IMI S.p.A.

(avail. Nov. 1, 2006)
.... 3.02[9][a][ii]

Sanwa-BGK Securities

(avail. Feb. 27, 1992)
.... 14.07[2][b][i]

Schering-Plough Corp.

(avail. Nov. 21, 1991)
.... 7.02[3][c]

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Seaman Furniture Co., Inc.

(avail. Oct. 10, 1989)
.... 9.04[5][b][iii]

SCP Private Equity Partners II, L.P.

(avail. June 6, 2006)
.... 15.06[1]

Second National Bank of Warren 6.04[1][a] (avail. Aug. 15, 1988) ....

Section 3(a)(9) Upstream Guarantees

(avail. Jan. 13, 2010) .... 10.06[2]

Securities Industry and Financial Markets Association

(avail. Jan. 9, 2015) .... 14.07[4][d]

Securities Industry Association

(avail. July 16, 1988) .... 14.07[2][a][i]

Securities Industry Association

(avail. Nov. 27, 1989) .... 16.08[1]

Securities Industry Association

(avail. June 12, 1992) .... 7.08[2], 14.07[2][b][i]

Securities Industry Association

(avail. Aug. 13, 1993) .... 14.07[2][b][i]

Securities Industry Association

(avail. Mar. 30, 1996) .... 7.08[2], 14.07[2][b][i]

Securities Industry Association

(avail. Aug. 16, 1999) .... 7.08[2]

Securities Industry Association

(avail. July 27, 2000) .... 7.08[2], 14.07[2][b][i]

Securities Industry Association

(avail. Feb. 12, 2004) .... 14.07[4][d]

Securities Industry Association

(avail. Dec. 16, 2005) .... 16.03[2][b]

Security Pacific Corp.

(avail. Apr. 1, 1988) .... 14.03[3][b][ii][A]

Security Pacific Corp.

(avail. July 7, 1988) .... 14.04[3][b]

Security Pacific Corp.

(avail. Oct. 14, 1976) .... 3.05[3]

Serono S.A.

(avail. Sept. 12, 2002) .... 9.05[9][b]

Service Corporation International

(avail. Oct. 6, 1998) .... 15.06[1]

Seward & Kissel

(avail. Oct. 12, 2005) .... 15.05[2]

Shearman & Sterling

(avail. July 2, 1993) .... 7.05[2]

Shearman & Sterling

(avail. Dec. 21, 1998) .... 10.06[1], 10.06[3]

Shearson Lehman American Express Inc.

(avail. Mar. 20, 1985) .... 15.05[3][a]

Sheraton Corp.

(avail. Nov. 24, 1978) .... 9.04[2]

Shinhan Financial Group Co., Ltd.

(avail. Mar. 5, 2009) .... 3.02[9][a][ii]

Singapore Telecommunications Limited

(avail. May 15, 2001) .... 9.05[13]

SMC Capital, Inc.

(avail. Sept. 5, 1995) 16.08

Société de Compensation des Marchés Conditionnels

(avail. June 17, 1996) .... 14.03[3][b][i]

Société Générale

(avail. Feb. 14, 1992) .... 15.05[1]

Société Nationale Elf Aquitaine

(avail. June 10, 1991) 3.02[9][a][i]

Songbird Estates PLC

(avail. Dec. 19, 2014) .... 9.05[2][a], 9.05[9][b]

Sonic Automotive, Inc.

(avail. July 24, 2012) .... 9.03[2]

Sony Capital Corp.

(avail. Apr. 27, 1992) .... 15.05[1]

Source Media, Inc.

(avail. Dec. 3, 1996) .... 9.05[4][a]

Spain Fund, Inc.

(avail. Mar. 28, 1988) .... 15.09[1]

Squadron, Ellenoff, Pleasant & Lehrer

(avail. Feb. 28, 1992) .... 7.02[6]

Stars & Stripes GNMA Funding

(avail. Apr. 17, 1986) .... 15.06[2]

State of Israel

(avail. Aug. 17, 1988) .... 15.05[3][a]

STATS ChipPAC Ltd.

(avail. Mar. 15, 2007) .... 9.05[1]

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Stephenson and Co.

(avail. Dec. 29, 1980) 16.06

Stichting Pensioenfonds ABP

(avail. May 7, 2004) .... 6.04[1][b]

Stock Exchange of Hong Kong Limited

(avail. June 27, 2000) .... 8.02[2]

Stolt Tankers and Terminals (Holdings) S.A.

(avail. Mar. 12, 1992) .... 6.04[1][e]

Sullivan & Cromwell

(avail. Dec. 29, 1997) .... 15.06[1]

Sulzer AG

(avail. Mar. 2, 2007) .... 9.05[2][a]

Sumitomo Bank

(avail. Oct. 29, 1984) .... 3.05[2]

Suncor Inc.

(avail. Mar. 11, 1982) .... 4.02[2]

Suncor Inc.

(avail. Feb. 25, 1992) .... 14.07[6][c]

Sun Healthcare Group, Inc.

(avail. Sept. 29, 2010) .... 4.11[2][b][i]

SunTrust Banks, Inc.

(avail. July 16, 1999) .... 9.04[5][b][iii]

Super-Sol Ltd.

(avail. Jan. 4, 1982) .... 4.02[2]

Swiss Bank Corp.

(avail. Jan. 17, 1997) .... 6.04[1][b]

SWX Swiss Exchange

(avail. July 3, 2002) .... 8.02[2]

Synergia Resources XX

(avail. Mar. 20, 1986) .... 14.07[6][c]

Syrus Associates, Ltd.

(avail. Oct. 23, 1981) .... 16.03[1][b]

System Dynamics

(avail. June 21, 1983) .... 16.03[3][b][ii]

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TABCORP Holding Ltd. 9.05[13]

(avail. Aug. 20, 1999) ....

TABCORP Holdings Ltd.

(avail. Aug. 27, 1999) .... 9.05[13]

TAC America Ltd.

(avail. July 25, 1984) .... 16.02[2]

Taiwan Stock Exchange Corp.

(avail. Dec. 14, 2004) .... 8.02[2]

Technology Capital Network, Inc.

(avail. June 5, 1992) .... 16.03[1][b]

Tel Aviv Stock Exchange Ltd.

(avail. May 12, 1999) .... 8.02[2]

Telecom Corp. of New Zealand

(avail. Feb. 25, 1998) .... 14.07[6][c]

Telefonica S.A.

(avail. June 5, 2000) .... 9.05[9][b]

Telemar Participaçöes S.A.

(avail. Oct. 9, 2007) .... 9.05[1]

Templeton Russia Fund Inc.

(avail. Apr. 18, 1995) .... 15.09[2]

Tenet Healthcare Corporation, In the Matter of

(avail. Apr. 19, 2007) .... 3.02[3][a][ii]

Textron, Inc.

(avail. Oct. 7, 2011) .... 9.03[2]

Thai Fund, Inc.

(avail. Nov. 30, 1987) .... 15.09[1]

Times Mirror Company

(avail. Nov. 15, 1994) .... 9.04[4]

Townsend Group, Inc.

(avail. July 9, 2008) .... 15.06[2]

Thomson Advisory Group, L.P.

(avail. Sept. 26, 1995) .... 16.02[2]

Thomson Financial Inc.

(avail. July 10, 2002) .... 14.10[2], 16.03[3][b][ii]

TMI Investment Systems Corp.

(avail. Apr. 15, 1978) .... 16.03[1][b]

TMX Group Inc.

(avail. June 14, 2011) .... 9.05[9][b]

TNT Limited

(avail. Apr. 21, 1994) 10.07

Tokyo Stock Exchange

(avail. July 27, 1999) .... 14.03[3][b][i]

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Tokyo Stock Exchange, Inc.

(avail. Nov. 15, 2002) .... 14.03[3][b][i]

Tokyo Stock Exchange, Inc.

(avail. Nov. 20, 2006) .... 14.03[3][b][i]

Tokyo Stock Exchange Inc.

(avail. Aug. 20, 2004) .... 8.02[2]

Topic Services, Inc.

(avail. Aug. 2, 1986) .... 14.03[3][b][iv]

Topic Services, Inc.

(avail. Nov. 28, 1986) .... 14.03[3][b][iv]

Topic Services, Inc.

(avail. June 3, 1987) .... 14.03[3][b][iv]

Topic Services, Inc.

(avail. Dec. 23, 1987) .... 14.03[3][b][iv]

Topic Services, Inc.

(avail. Oct. 4, 1989) .... 14.03[3][b][iv]

Top Alpha Capital S.M. Ltd.

(avail. Feb. 16, 2016) .... 9.05[9][b]

TOTAL

(avail. Oct. 18, 1991) .... 3.02[9][a][i]

TOTAL

(avail. June 23, 1992) .... 3.02[9][a][i]

TotalFina

(avail. Oct. 15, 1999) .... 9.05[9][b]

Touche Remnant & Co.

(avail. Aug. 27, 1984) .... 15.06[2]

Towers Watson & Co.

(avail. May 17, 2010) .... 9.05[1]

TransCanada Pipelines Limited Equity Offering

(avail. June 10, 1991) .... 3.02[9][a][i]

Transocean Inc.

(avail. Sept. 26, 2007) .... 4.02[3][a][iii]

Transportación Maritima Mexicana, S.A. de C.V.

(avail. June 8, 1992) .... 7.05[2]

Trio-Kenwood Corporation

(avail. Mar. 1, 1983) .... 4.11[2][b][i]

Turner Broadcasting System, Inc.

(avail. Feb. 6, 1990) .... 7.02[3][b]

TXU Corp.

(avail. Sept. 13, 2004) 9.03[2]

Tyler Capital Fund, L.P./South Market Capital

(avail. Sept. 28, 1987) .... 15.06[3][a]

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UBS AG

(avail. July 29, 2009) .... 9.04[4]

UBS AG

(avail. Sept. 22, 2000) .... 3.02[9][a][ii], 9.05[6]

Uniao de Bancos de Brasileiros S.A.

(avail. July 28, 1992) 16.01

Unibanco

(avail. July 28, 1992) .... 16.02[1][c], 16.02[2], 16.07, 16.08, 16.10, 16.11

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