TRAVERS SMITH

A Desktop Reference for Exempt US Securities Offerings

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Contents

THE "LONG ARM" OF US SECURITIES REGULATION

PRIMARY CONSIDERATIONS WHEN CHOOSING THE MARKET

IDENTIFYING THE EXEMPTION AND STRUCTURING THE TRANSACTION

OFFERING AND SELLING SECURITIES *OUTSIDE* THE UNITED STATES

OFFERING AND SELLING UNREGISTERED SECURITIES *WITHIN* THE UNITED STATES

SUMMARY OF US BROKER-DEALER RULES

A PRIMER ON US DUE DILIGENCE AND DISCLOSURE STANDARDS APPLIED IN RULE 144A OFFERINGS

NEW AIM RULES FOR ELECTRONIC SETTLEMENT OF CATEGORY & SECURITIES

GLOSSARY OF COMMONLY-USED US SECURITIES LAW TERMS

The "Long Arm" of US Securities Regulation

The "Long Arm" of US Securities Regulation

"...but if we already agreed that we do not want to engage in the expensive and time-consuming enterprise of registering our securities with the US Securities and Exchange Commission, why are we still required to hire US lawyers?"

This is a fairly common question. The members of the US Securities Law Group frequently encounter expressions of concern, consternation and even incredulity when clients and counterparties to proposed corporate finance transactions discover that certain of the US federal and even state securities laws are relevant to, and may impact the structure of, such transactions. It is our hope that this desktop reference goes some way towards clarifying why, and under which circumstances, this is the case.

Certain activity relating to the offer, sale or purchase of a security that either purposefully or inadvertently targets individuals in the United States (or, in some limited cases, US persons abroad), or otherwise has a significant nexus with the United States, may give rise to civil, administrative or even criminal liability under the US federal or state securities laws and regulations; but please note that this desktop reference only summarises the US federal securities laws.

Liability under the US federal securities laws generally arises when the offer, sale or purchase of a security is conducted in a manner which:

- does not provide sufficient federally mandated protection to individuals who are deemed to lack the technical or financial sophistication, experience or resources to "fend for themselves," (i.e., when a security is offered or sold in the United States neither on the basis of a registration statement which has been declared effective by the SEC nor in accordance with an exemption to, or "safe harbour" from, the registration requirement); or/and
- constitutes a fraud, misrepresentation or deceit.

The SEC, Department of Justice and other US agencies, as well as private parties, can under certain circumstances bring legal actions in US federal courts against individuals or organisations for alleged violations of the US securities laws. In order for such legal actions to be valid and binding on individuals or organisations residing outside of the United States, the extraterritorial scope of the US civil, administrative or criminal courts' jurisdiction must be, and typically is, sufficiently broad. A study of the US statutory and case law sources used to establish extraterritorial jurisdiction is beyond the scope of this desktop reference; but we list below some recent examples of the robust stance taken by US legislators in relation to the "long arm" effect of US securities regulation.

Recent Examples of US "Long Arm" Jurisdiction

The US Supreme Court decision in *Morrison v National Australia Bank* (2010) limited the extraterritorial scope of the application of the US antifraud statute

(Section 10(b) under the US Exchange Act of 1934) to offers and sales of securities on the US exchanges or to the purchase or sale of any other security *within* the United States. In response to that decision, the US Congress included Section 929(b) in the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010), which states: "The US district court will have subject matter jurisdiction over regulatory and criminal anti-fraud actions brought by the SEC or the United States where there has been either:

- conduct within the United States that constitutes significant steps in furtherance of a violation, even if the securities violation occurs outside the United States and involves only foreign investors; or
- conduct occurring outside the United States that has a foreseeable substantial effect within the United States."

In addition, in response to an order by the US Congress, the SEC conducted and published a "Study on the Cross-Border Scope of the Private Right of Action under Section 10(b) of the US Securities Exchange Act of 1934" (2012), which has been submitted to the US Congress for further consideration in relation to extending district court jurisdiction in civil actions brought by individuals or organisations on the same or similar basis as set out in Section 929(b). No legislative action has thus far been taken in relation to this study.

What is the practical effect of US "Long Arm" Jurisdiction?

In practical terms, the SEC and the US Department of Justice can initiate legal actions in US federal courts against individuals or organisations outside of the United States even when the securities transaction giving rise to any alleged violations of the US federal securities laws is or was principally conducted outside of the United States (i.e., on a foreign exchange and involving non-US sellers and buyers).

Therefore, the individuals involved in structuring and conducting securities transactions, even those which are not intended to implicate the US federal securities laws, must take appropriate steps to avoid incurring liability, either because (i) they have failed to register securities with the SEC or to comply with an available exemption or "safe harbour" from the requirement to register such securities, or (ii) because they have offered or sold securities on the basis of information that could be alleged to be materially inaccurate or misleading.

The threshold question is, "does the issuer, seller or distributor of securities intend to generate interest in the sale or purchase of any of such securities within the United States or among US persons?"

This desktop reference is designed to provide an overview of the general technical regulatory consequences of the answer to that question, whether affirmative or negative.

2

Primary Considerations when Choosing the Market

Primary Considerations when Choosing the Market

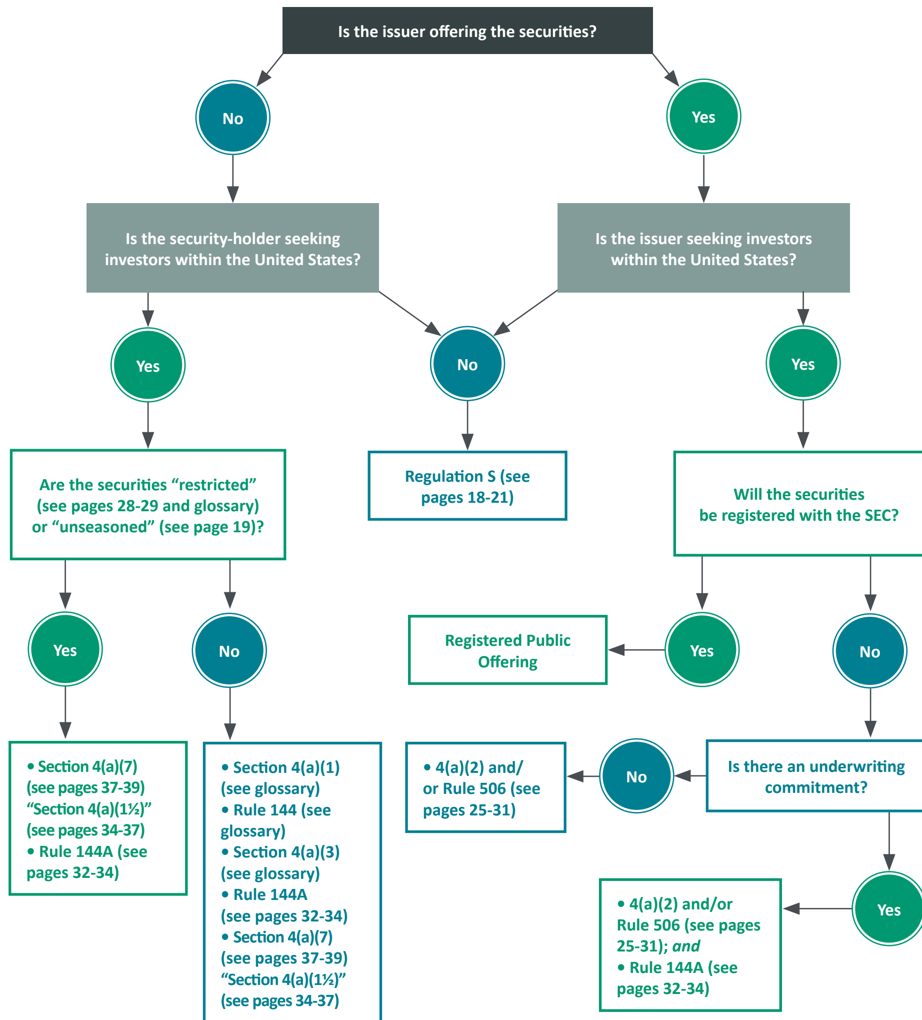
- **Offering and Selling Securities *outside* the United States:**
  - How to qualify for the "safe harbours" provided by Regulation S
  - "Offshore transactions"
  - Compliance with the limitations on publicity
  - Special considerations for US domestic issuers
  - Limitations on re-sales

- **Offering and Selling Unregistered Securities *within* the United States:**
  - In the absence of a statutorily available exemption, it is unlawful to offer or sell a security to investors within the United States unless a registration statement has been filed with, and declared effective by, the SEC
  - When offering a security for sale to investors within the United States, it is unlawful to do so by means of fraud, misrepresentation or deceit
  - Selecting the proper exemption
  - Compliance with limitations on publicity
  - Re-sale exemptions

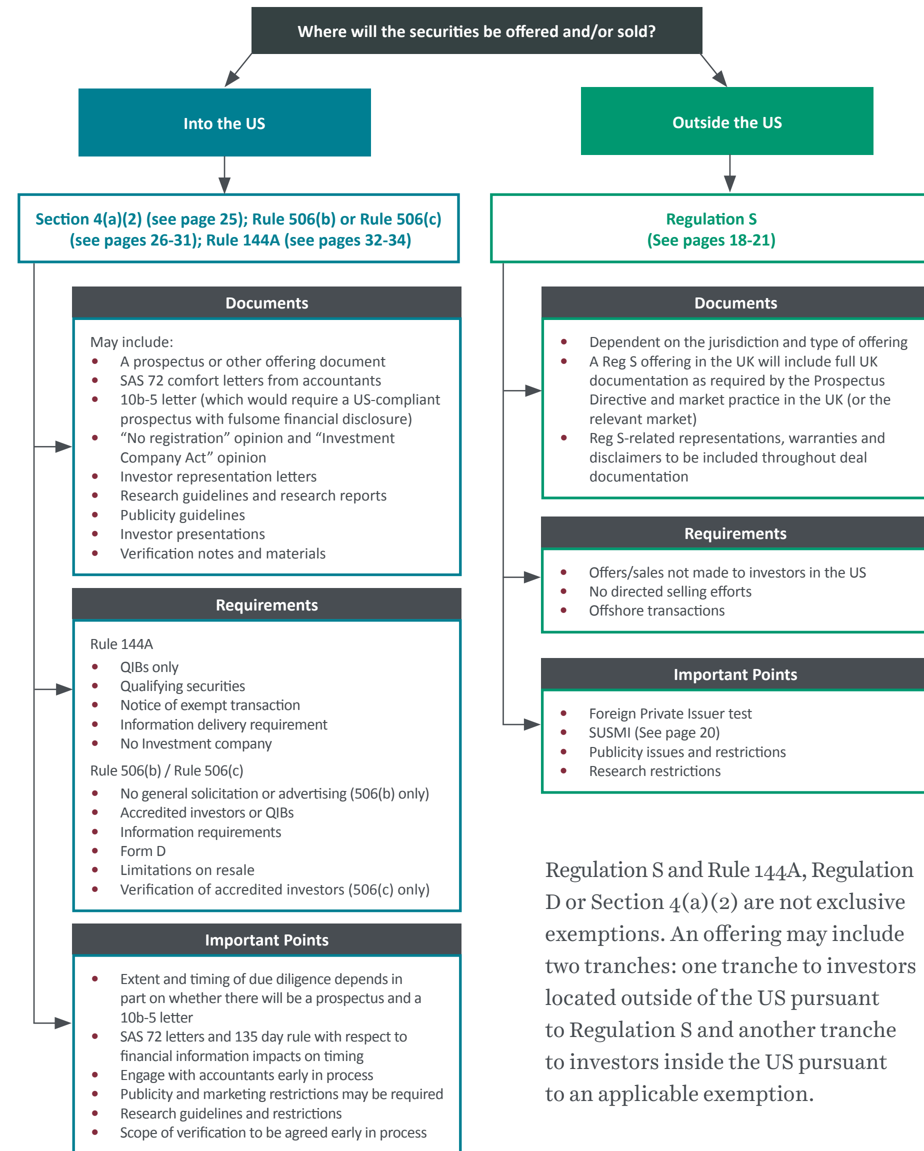
3

Identifying the Exemption and Structuring the Transaction

GENERAL OUTLINE FOR DETERMINING THE EXEMPTION OR MEANS OF OFFER AND SALE



FOR UNDERWRITERS: STRUCTURING AN OFFERING AND CHOOSING AN EXEMPTION



Regulation S and Rule 144A, Regulation D or Section 4(a)(2) are not exclusive exemptions. An offering may include two tranches: one tranche to investors located outside of the US pursuant to Regulation S and another tranche to investors inside the US pursuant to an applicable exemption.

Offering and Selling Securities *outside* the United States

4

Offering and Selling Securities *outside* the United States

In an effort to clarify the extraterritorial application of the registration requirements of the Securities Act, the SEC enacted Regulation S. The general statement of Regulation S provides that the registration requirements of the Securities Act do not apply to offers and sales of securities that occur outside the United States.

There are two non-exclusive "safe harbours" established under Regulation S: one for offers and *sales* by issuers, distributors (i.e., underwriters, placement agents, etc.) or their respective affiliates; and the other for offers and *resales* by persons other than the issuer, distributors or their affiliates (except those individuals who are affiliates of the issuer or distributor solely by virtue of their position as officer or director). An offer, sale or resale that satisfies the conditions of the applicable safe harbour under Regulation S is deemed to have been made outside of the United States and is not subject to the registration requirements under the Securities Act.

The SEC has stated that the safe harbours under Regulation S are not exclusive and are not intended to create a presumption that any transaction failing to meet their terms is subject to the registration requirements under the Securities Act; however, compliance with the requirements of Regulation S is always recommended and has been recognised as best practice for many years.

Regulation S: Requirements

The first threshold to consider has two components.

- **Offshore Transaction:** offers and sales must be made outside of the United States and may include offers and sales on non-US stock exchanges.
- **No Directed Selling Efforts:** "any activity undertaken for the purpose of, or which reasonably could be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance upon this Regulation S" (e.g. placing an advertisement in a publication with general circulation in the United States that refers to the Regulation S offering or mailing printed materials to US investors).

The second threshold to consider is whether the offer of the issuer's securities is likely to generate interest among investors in the United States or "US persons" such that the securities offered offshore are likely to flow back into the United States.

- **Anti-Flowback Provisions:** to prevent securities which are sold offshore from "flowing back" into the United States and perhaps undermining the protections of the Securities Act, a "distribution compliance period" is applied in the event 1) there is "substantial US market interest" (or "**SUSMI**", as further discussed below) in the securities being offered, or 2) the issuer of the securities is deemed to be a US "domestic issuer". During the applicable distribution compliance period, which can last from 40 days to 12 months depending on the type of issuer and securities issued, sales to US persons (including US persons located outside of the United States) are prohibited. Securities that are subject to the distribution compliance period are frequently referred to as "unseasoned".

- **Foreign Private Issuer:** a "foreign private issuer", for the purpose of the US federal securities laws, is essentially any issuer that has been incorporated or organised under the laws of any country outside of the United States, is not a government entity and is not majority-owned by residents of the United States (see Glossary for the statutory definition). Although domestic US issuers (other than certain investment companies) can offer and sell securities outside of the United States pursuant to Regulation S, such transactions are substantially more complicated and relatively uncommon in the European market (see pages 63-69). As a first step, it is advisable to confirm that the issuer is indeed a foreign private issuer.

Determining whether there is Substantial US Market Interest – "SUSMI"

For equity securities, there is SUSMI if the issuer reasonably believes that in the most recent fiscal year or the period since the issuer's incorporation (if less than one year):

- the securities exchanges in the United States constitute the single largest market for the class of securities; or
- 20% or more of all trading in the securities occurs in the United States and less than 55% of trading was in a single foreign country.

For debt securities, there is SUSMI if the issuer reasonably believes that, when the offering began:

- securities are held of record by 300 or more US persons;
- USD 1 billion or more of the principal amount outstanding of the debt is held of record by US persons; and
- 20% or more of the principal amount outstanding of the debt is held of record by US persons.

With respect to debt securities, if the issuer has less than USD 1 billion debt securities worldwide, there is *per se* no SUSMI. Further, if it has more than USD 1 billion debt securities worldwide but it (1) has not offered any securities in the United States; (2) does not have debt or equity securities listed on a US exchange or an SEC-registered over the counter ADR program; and (3) does not know of significant holdings of its debt securities by US investors, it is reasonable to conclude there is no SUSMI. Note also that commercial paper issued by the issuer is not included in the calculation of SUSMI for debt securities.

Offering and Selling Unregistered Securities *within* the United States

5

Offering and Selling Unregistered Securities *within* the United States

Securities may not be offered or sold in the United States absent registration under the Securities Act unless such securities are offered and sold in a transaction that is exempt from, or not subject to, the registration requirements under the Securities Act.

Which are the most common exemptions?

Issuer Private Placements

- Section 4(a)(2) of the Securities Act
  - Rule 506(b) of Regulation D under the Securities Act
  - Rule 506(c) of Regulation D under the Securities Act

Resales by Holders of Equity or Debt Securities

- Rule 144A under the Securities Act
- Section 4(a)(7) of the Securities Act
- "Section 4(a)(1½)" transactions

Issuer Private Placements: Section 4(a)(2)

Section 4 of the Securities Act provides that the obligation to file (and have declared effective) a registration statement with respect to any security before offering or selling it in the United States will not apply to transactions by an issuer not involving any public offering.

Unfortunately, the Securities Act does not define the expression "public offering" (and therefore, what would constitute a private placement); however, prior to the enactment of Regulation D under the Securities Act, market practice (based in part on guidance from the SEC) established the principal elements of an issuer private placement, which include some or all of the following:

- The offer is made to a relatively small number of sophisticated investors that can fend for themselves;
- No general solicitation or general advertising by the issuer or any person acting on its behalf (see page 27 for additional information on what constitutes general solicitation or general advertising);
- There is sufficient publicly-available information on the issuer;
- The issuer provides an offering memorandum, if one has been drafted, to the investors;
- Typically, the investors know the issuer or may invest in the issuer's business sector;
- Investors are given access to management before entering into a sale;
- The investors are looking to take the securities for the long term, and do not intend to turn around and sell the securities to other investors in the United States; and
- The transactions are typically confidential.

Issuer Private Placements: Regulation D

Regulation D under the Securities Act in a sense codified the market practice and established a non-exclusive "safe harbour" for determining whether a private placement of securities to investors in the United States qualifies for the exemption provided under Section 4(a)(2). Although issuers are not necessarily required to adhere to the letter of the guidelines set forth in Regulation D to establish a Section 4(a)(2) exemption,[1] most private placement offerings are patterned upon them as a matter of best market practice.

In securities offerings to investors in the United States that have an aggregate transaction value exceeding USD 5 million, issuers historically have relied on Rule 506 under Regulation D (Rules 504 and 505 deal with transactions having an aggregate value of up to USD 1 million and USD 5 million, respectively). Pursuant to the Jumpstart Our Business Start-Ups Act (the **"JOBS Act"**), the SEC adopted amendments to Rule 506 and there are now two exemptions under the rule: Rule 506(b) and Rule 506(c).

The Distinction between Rule 506(b) and Rule 506(c)

As detailed below, the primary difference between Rules 506(b) and 506(c) concerns whether the issuer or distributor intends to engage in general solicitation or general advertising and, as a corollary, to what extent the issuer is required to verify whether the investor is an accredited investor.

Furthermore, as noted above, Rule 506 historically functioned as a non-exclusive safe harbour so that, in the event that an offering or sale does not meet the specific requirements of Rule 506, Section 4(a)(2) might still be available as an exemption from registration. As the SEC expressly declined to change the prohibition on general solicitation and general advertising in section 4(a)(2), however, offerings which include general solicitation and general advertising but do not otherwise comply with rule 506(c) may not benefit from the exemption under Section 4(a)(2).

[1] See Rule 508. Insignificant Deviations From a Term, Condition or Requirement of Regulation D.

Rule 506(b) Requirements

- **No General Solicitation or Advertising:** Neither the issuer nor any person acting on its behalf (including a broker-dealer or placement agent) may offer or sell the securities by any form of general solicitation or advertising, which are defined as:
  - Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television, internet or radio; and
  - Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Issuers can encounter difficulties obtaining access to a sufficient number of accredited investors without violating this provision and should seek legal advice ***before*** engaging in activities that would engender investor interest in the United States in a particular securities offering.

- **Accredited Investors:** Although it is possible to offer securities to up to 35 non-accredited investors under Rule 506(b), Rule 502 of Regulation D requires that such investors receive a significant amount of US-standard disclosure, which most foreign issuers are keen to avoid. As a result, these transactions typically involve only accredited investors. There are two kinds of accredited investors:
  - *Institutional:* Includes banks, insurance companies, registered and small business investment companies, certain business development companies, certain employee benefit plans and organizations with total assets in excess of USD 5 million; and

- *Individuals:* Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his/her purchase exceeds USD 1 million (note that the Dodd-Frank Act has excluded the value of the person's primary residence from the calculation of net worth). It is also commonplace to find that foreign issuers do not make offers to individual accredited investors in order to avoid certain US state securities law issues.

- **Information Requirements:**
  - *Offering Document:* If an offering document is prepared, it should be delivered to all potential investors, whether non-accredited or accredited. For a number of reasons, it may be prudent to prepare an offering document even when offering and selling solely to accredited investors.
  - *Access to Management:* The issuer must in any event allow potential purchasers to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense.

- **Form D:**
  - Rule 503 of Regulation D requires that the issuer make a Form D filing with the SEC within 15 days of the first sale of securities pursuant to Regulation D. Many foreign issuers elect not to file Form D on the basis that Rule 506 under Regulation D does not specifically require it (and the SEC has concurred in public statements), and that it is sufficient to comply with the remainder of the applicable provisions of Regulation D. Specific legal advice should be sought before any decisions are made with respect to this requirement.

- **Limitations on Resale:** Because the purpose of the exemption is to allow a private placement to sophisticated investors who expect to become long term holders of equity or debt securities, the SEC has made it difficult to transfer any securities purchased in accordance with Regulation D.

Two resale elements to remember:

- The issuer should obtain a representation from the purchaser that it is not purchasing the securities with a view to distributing them to investors in the United States; and
- The securities sold in accordance with Regulation D are "restricted securities," and therefore may not be offered or sold to investors in the United States unless such securities are (i) registered with the SEC; (ii) offered and sold pursuant to an available exemption; and/or (iii) offered and sold after the passage of the applicable holding periods as provided under Rule 144 of the Securities Act.

Rule 506(c) Requirements

- **Requirements that remain unchanged between Rule 506(b) and Rule 506(c)**
  - The following requirements are the same as required under Rule 506(b):
    - Information requirements;
    - Form D; and
    - Limitations on resale.

- **Accredited Investors Only:** Rule 506(c) requires that the issuer must reasonably believe that each purchaser is an accredited investor (Rule 506(b) allows sales to a limited number of non-accredited investors (see page 27)).

- **Verification of Accredited Investor Status:** The must issuer takes reasonable steps to verify that each purchaser is an accredited investor. Rule 506(c) does not require specific verification procedures. However, it does specify non-exclusive and non-mandatory methods of verifying that a natural person is an accredited investor, such as:
  - reviewing any IRS form that reports the person's income for the two most recent years;

- obtaining a written representation that the person reasonably expects to reach the income level required to qualify as an accredited investor in the current year;
- reviewing one or more of certain documents (including bank statements, brokerage statements and tax assessments) dated within the past three months;
- reviewing a report from one of the national consumer reporting agencies and obtaining a written representation that the person has disclosed all liabilities necessary to make a net worth determination;
- obtaining a written confirmation from a certain type of third party (a registered broker-dealer or investment advisor, a licensed attorney in good standing or a CPA registered and in good standing) that the third party has taken reasonable steps to verify the person's accredited investor status within the past three months and has determined that the person is an accredited investor.

Rule 506(c): Other Points and Best Practice

- **Verification of Accredited Investor Status**
  - As mentioned, Rule 506(c) does not require specific verification procedures. Whether an issuer's steps are reasonable is a principles-based determination, and what is reasonable depends on the particular facts and circumstances of the transaction. The SEC has provided three inter-related factors issuers should consider when determining if verification steps are reasonable:
    - The nature of the purchaser and the type of accredited investor it claims to be (e.g. a natural person or an entity like a registered broker-dealer);
    - The amount and type of information that the issuer has about the purchaser;
    - The nature of the offering, such as the manner of the solicitation and the terms of the offering.
  - As issuers have the burden of demonstrating that their offerings are entitled to an exemption from registration, it is important for them to retain adequate records of the steps they have taken to verify the status of the accredited investors that have purchased securities.
  - The steps taken to verify the purchasers accredited investor status do not satisfy the standard if the issuer knows that the person in question is not an accredited investor.

Re-sales by Holders of Unregistered Equity or Debt Securities (including Underwriters)

In circumstances when holders of "restricted securities" or "unseasoned securities" seek to sell such securities to institutional investors in the United States, Rule 144A can be an extremely effective way of accessing the US private offering market.

Rule 144A has become the principal method by which equity and debt issuances by foreign companies or large sell-offs by foreign shareholders or bondholders are accessible to US institutional investors through US registered broker-dealers.

Foreign issuers or their shareholders/bondholders, whose home retail markets may lack sufficient liquidity to absorb large securities offerings, have been able to tap into the US private offering market through firm commitment underwritings or best/reasonable efforts placements by investment banks with US institutional investor clients. This has proven time and again to be a crucial element for a successful securities offering. In such instances, the investment banks and/or the foreign security holders rely on Rule 144A to resell the securities, as described below.

Rule 144A: Re-sales of Securities

Rule 144A under the Securities Act provides a non-exclusive exemption from registration under the Securities Act for re-sales of securities of eligible issuers to eligible institutional investors in the United States.

- **Re-sales to Qualified Institutional Buyers ("QIBs") Only:**
  - Rule 144A requires that the securities must be sold only to a QIB or to an entity that the seller or its agent reasonably believes is a QIB. The rule also provides guidance to assist sellers or their agents to make a reasonable determination of the status of the investor (Rule 144A(d)(1)).
  - Note that the JOBS Act amended Rule 144A. Previously Rule 144A had provided that all offers and sales be made only to QIBs. The amended Rule 144A removes the QIB status requirement for offerees. This effectively allows general solicitation and general advertising in relation to Rule 144A offerings, so long as all of the purchasers of the securities offered are reasonably believed by the seller to be QIBs.
- **Qualifying Securities: Securities that are offered and sold must not be:**
  - Of the same class as securities listed on a US national exchange or quoted in a US automated inter-dealer quotation system. Certain securities that are convertible into or exchangeable with such securities are caught under this category; and
  - Securities of an open-end investment company, unit investment trust or face-amount certificate company that is or is required to be registered under Section 8 of the Investment Company Act.
- **Notice of Exempt Transaction:** The seller and its agent must take reasonable steps to ensure that the purchaser is aware that the seller or its agent may rely upon an exemption from the registration requirements under the Securities Act.
- **Information Delivery**

  If the issuer is not a US reporting company, Rule 144A requires it to provide information to investors by one of the following means:
  - Exchange Act Rule 12g3-2(b), which provides that a foreign issuer who maintains a listing in a foreign market (or markets) that constitutes (or constitute) the primary trading market for its securities may promptly publish and regularly update, in English, on its website and/or through an electronic delivery system generally available to the public in its primary trading market, such information:
    - as it is required to make public under the laws and regulations of its country of incorporation and under the rules and regulations of the stock exchange of its primary trading market;

    - it has distributed or has been required to distribute to holders of its equity or debt securities; and
    - that is otherwise material to a decision to buy, sell or hold a security of the issue.
- Rule 144A(d)(4) requires that, in the event that an issuer is not a US reporting company or has not published information in compliance with Rule 12g3-2(b), any holder may obtain from the issuer and any prospective purchaser must have obtained from the issuer or the seller a very brief English-language business description and the most recently available financial statements and financial statements as at and for the two most recent fiscal years.

Alternative Offers and Sales of Unregistered Equity and Debt Securities: Market Practice and Recent Legislative Developments

Rule 144A has become a fundamental vehicle for private placements of securities with US institutional investors, either in conjunction with an issuer private placement with a firm underwriting, or in sell-offs or sell-downs by major shareholders/bondholders with or without an underwriting commitment. Local capital markets in jurisdictions where FPIs are located or listed may lack sufficient liquidity or breadth to absorb large securities offerings or support active trading in such securities. In such cases FPIs or their shareholders/bondholders have sought to tap into the US private offering market through financial intermediaries which have US institutional investor buy-side clients and access to a US registered broker-dealer. Since its promulgation in 1990, the annual aggregate capital raised in the US capital markets by the offer and sale of securities in accordance with Rule 144A (often in conjunction with an issuer private placement under Section 4(a)(2) of the Securities Act) has grown to hundreds of billions of US dollars.

In some cases, however, it may be difficult or impossible to conduct a resale of unregistered securities in accordance with Rule 144A or another exemption.[2] It is frequently the case, for example, that issuers of such securities may not have them listed on a recognised stock exchange or quotation system (and therefore are not providing regular or fulsome disclosure to the market), or may otherwise be unable or unwilling to provide up to date information to the seller or prospective buyer of such securities as required under Rule 144A(d)(4). In addition, for any number of reasons, holders of unregistered securities may not be able to generate sufficient (or any) interest in such securities among qualified institutional buyers, whereas among smaller investors with different risk profiles or sector focus the interest may be strong.

In these circumstances, sellers (typically institutional investors) have relied on the "Section 4(a)(1½)" transaction[3], a structure created by the US private securities bar and capital markets participants on the basis of case law, which has been derived largely from the interplay between the exemptions available under Section 4(a)(1) and Section 4(a)(2) of the Securities Act. These Sections provide, respectively, that the registration requirements of the Securities Act shall not apply to transactions (i) by any person other than an issuer, underwriter or dealer and (ii) by issuers not involving a public offering.

[2] For example, it may be possible for a shareholder/bondholder to resell their securities under Securities Act Rule 144, when such securities are considered "seasoned". Such is the case for securities held by non-affiliates of a reporting company after the passage of six months from the acquisition of the securities from the issuer or an affiliate of the issuer, and by non-affiliates of a non-reporting company after the passage of one year. For affiliates of either, however, Rule 144 sets out amount, time and manner conditions that make it difficult or impossible to resell large quantities of securities to investors in the United States, including in the context of a public offering made outside the United States.

[3] This was formerly (and sometimes currently) referred to as a "Section 4(1½)" transaction, reflecting the name of the section of the Securities Act before the implementation of the provisions of the JOBS Act.

While it may be a simple matter for a seller to show that it is neither an issuer nor a dealer, for an institutional investor it may be more difficult to show that it is also not an underwriter. Section 2(11) of the Securities Act provides a very broad definition of the term: "the term 'underwriter' means 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 [...]." The US securities bar and the market participants have reasoned that if it can be shown that an eligible purchaser in a private placement conducted in accordance with an exemption from registration under the Securities Act did not in fact "purchase with a view to distribute" (and was therefore not acting as an underwriter), then a resale exemption analogous to Sections 4(a)(1) and 4(a)(2) should be available to it.

Until now, this practice had never been formally adopted as a safe harbour by the SEC; however, these transactions were typically structured so that, in the event a holder of privately placed (and restricted) securities were to decide to reduce or eliminate its current investment (or exposure), it could resell the securities to other investors (invariably accredited investors or qualified institutional buyers) which would have been eligible to purchase the securities in the original private placement.

The following terms and conditions were commonly found in such private placements:

- Offers of the securities were not made through any general solicitation or advertising;
- Sales of securities were to a limited number of institutional accredited investors or qualified institutional buyers;
- Purchasers were required to have such knowledge and experience in financial and business matters that they were capable of evaluating the merits and risks of the investment, to have the ability to bear the risk of the investment and to possess sufficient information to make an informed investment decision;
- Purchasers were required to represent that they were not purchasing with a view to distribute the securities;
- Sellers were required to represent that they are not selling on behalf of the issuer, nor on the basis of material, non-public information;
- Successive purchasers were required to agree to the same restrictions on resales of the securities; and
- The issuer could not be involved in the direct solicitation of purchasers (although its management could be involved in disclosing information about the issuer in roadshow presentations with affiliates who are sellers).

The New Securities Act Section 4(a)(7): Reforming Access for Investments in Start-up Enterprises

The new Section 4(a)(7) represents a significant improvement in obtaining greater legal certainty in relation to secondary trades in the securities of private companies, irrespective of their size – in effect, it partially codifies the "Section 4(a)(1½)" transaction.[4] Section 4(a)(7) provides that unregistered securities may be resold under the following conditions:

- The purchasers must be accredited investors, as defined in Rule 501 under the Securities Act;
- The securities may not be offered or sold by any form of general solicitation or general advertising;

[4] See SEC "Recommendation Regarding the '4(1½) Exemption'" (June 2015).

- In the event that the issuer of the securities is neither a SEC-reporting company nor exempt from reporting under Section 12g3-2(b)[5], the seller must obtain and make available to the prospective purchaser certain information relating to the issuer and its business, its management, results of operations and financial condition, and the securities being offered; and if the seller is a person who has the power to direct the management and policies of the issuer, whether through its shareholding, contract or otherwise, it must disclose the nature of that affiliation and represent to the prospective purchaser that it has no reasonable grounds to believe that the issuer is in violation of the federal securities laws or regulations;
- Neither the issuer of the securities, nor a direct or indirect subsidiary of the issuer, may rely on the exemption;
- The issuer must be actively engaged in business operations or activities, it must not be in bankruptcy or receivership, nor may it be a company formed for indefinite purposes, including the acquisition of an unidentified target;
- The securities being offered must not constitute the whole or part of an unsold allotment to, or a subscription or participation by, a broker or dealer as an underwriter of the security or a redistribution;
- Neither the seller nor the broker-dealer or other intermediary must fall into the “Bad Actor” definition set out in Rule 506 under the Securities Act; and

[5] Rule 12g3-2(b) is an exemption that allows non-reporting FPIs to forego filing a registration statement with the SEC in relation to a class of securities so long as the principal trading market for such securities is a non-US securities exchange, the FPI provides timely and fulsome disclosure to that securities exchange and to the market in accordance with the applicable regulatory framework, and it makes such disclosures in the English language available to investors either through the regulatory information service or its Internet website.

- The securities must be of a class that has been authorised and outstanding for at least 90 days prior to the date of the contemplated transaction.

The exemption will also be included under Section 18 of the Securities Act, which exempts certain federally-mandated transactions from the application of US state securities laws (so-called “Blue Sky” laws). Please note, however, that the securities sold pursuant to Section 4(a)(7) will be deemed to be restricted securities, and therefore will be subject to resale limitations. Investors should consult US legal counsel to determine whether the securities they hold are restricted.

Because the information requirements of Section 4(a)(7) are similar to those of Rule 144A(d)(4), we believe that it is likely that the Section 4(a)(1½) transaction will continue to be utilized, especially in block trades.

US Broker-Dealer Rules

6

Foreign Broker-Dealer Exemption: Rule 15a-6

- Under Section 15 of the Exchange Act, broker-dealers must register with the SEC if they are physically present in the United States or if, regardless of their location, they effect, induce, or attempt to induce securities transactions with US investors.
- Thus, if a foreign broker-dealer sends research into the United States, or executes a transaction involving a US person, the foreign broker-dealer would be triggering US jurisdiction, requiring either registration with the SEC or compliance with the exemption under Rule 15a-6.
- Rule 15a-6 provides an exemption from registration for foreign broker-dealers who have limited contacts with certain US persons, principally Major Institutional Investors and Institutional Investors. Rule 15a-6 does not provide any exemption for foreign broker-dealers to contact non-institutional investors (i.e. the retail public).

- **Failure to follow the exemptive provisions of Rule 15a-6 could:**
  - Subject a foreign broker-dealer to the obligation of registration;
  - Result in the rescission of any transactions effected between an unregistered foreign broker-dealer and a US person; and
  - Subject the foreign broker-dealer to legal or disciplinary action by a US regulator.

- **Unsolicited Transactions and Non-direct Contacts**

Rule 15a-6(a)(1) provides that a foreign broker-dealer is not required to register in the United States to the extent that the foreign broker-dealer, "effects transactions in securities with or for persons that have not been solicited by the non-US broker or dealer."

"Solicitation" is, however, defined very broadly by the SEC and includes any affirmative effort by a broker-dealer, whether directed to a single transaction or to developing an ongoing business relationship (including, generally, the distribution of research reports) intended to induce transactional business for the broker or its affiliates, such as:

- calls from a foreign broker-dealer to a customer encouraging use of the broker-dealer to effect transactions;
- Radio, TV or other advertising in the United States; and
- conducting investment seminars for US investors.

It is difficult for a foreign broker-dealer to rely on the exemption for unsolicited transactions and non-direct contacts if there is any ongoing contact with the US investor. For example, distribution of research in the United States, as discussed below, can complicate the use of this exemption.

- **Distributing Research and Non-direct Contacts**

The SEC views the provision of non-fee research to clients and potential clients in the United States as a solicitation of the investors, thereby typically triggering the broker-dealer registration requirements.

However, subject to a number of conditions, an unregistered foreign broker-dealer may send research reports to Major Institutional Investors if the research is not provided pursuant to an express or implied understanding that the investor would direct commission income to the foreign broker-dealer (i.e., "soft dollar" payment).

As a practical matter, foreign broker-dealers need on-going direct contact with institutional investors in order to establish a useful relationship. Foreign broker-dealers generally are therefore unable to take advantage of the "unsolicited transactions" and "non-direct contacts" exemption.

As a result, foreign broker-dealers will seek to engage in the "direct" contacts discussed below. This usually requires the foreign broker-dealer to use a US broker-dealer as intermediary or establish a US registered affiliate broker-dealer.

- **Direct Contacts with Institutional Investors**

The type of "direct" contacts that are permissible between foreign broker-dealers and investors in the United States generally depends on:

- the status of the investors (i.e. Major Institutional Investor or Institutional Investor);
- the type of contact (i.e. telephone/email contact, accepting orders for transactions);
- the time of day when the contact occurs (i.e. during or outside of NYSE trading hours); and
- whether a chaperone will participate.

Because of the limitations on direct contacts with Institutional Investors, many foreign broker-dealers seek to deal only with Major Institutional Investors.

The type of contact that is permissible is discussed in more detail below. Please note, however, that the restrictions on foreign broker-dealers' contact with US investors are complex and not discussed in full in this handbook.

- **Direct Contacts with Major Institutional Investors**

The type of direct contact with Major Institutional Investors in the United States which may be initiated by the foreign broker-dealer is broadly broken down into two categories:

- **Non "in-person" contact:** A foreign broker-dealer may initiate telephonic, email or similar direct contact from outside of the United States with a Major Institutional Investor without participation of a chaperone.
- **"In-person" direct contact:** A foreign broker-dealer may also conduct un-chaperoned in-person visits to the United States with Major Institutional Investors if the number of days on which such in-person contacts occur does not exceed 30 per year, but
  - the foreign broker-dealer engaged in such in-person contacts cannot accept orders to effect securities transactions while in the United States.
- A foreign broker-dealer may also conduct unlimited chaperoned in-person visits to the United States with Major Institutional Investors.

A US registered broker-dealer must effect and book any transaction which results from contact initiated by the foreign broker-dealer. In addition, there are a number of other restrictions on how and when a foreign broker-dealer can accept transaction orders from Major Institutional Investors.

US registered broker-dealer must also perform a number of other activities, not discussed in this handbook.

A Primer on US Due Diligence and Disclosure Standards Applied in Rule 144A Offerings

7

Introduction

To begin, there are two threshold issues that arise under the US federal securities laws (defined below) in an offering of securities to investors in the United States:

- in the absence of a statutorily available exemption, it is unlawful to offer or sell a security to investors within the United States unless a registration statement has been filed with, and declared effective by, the SEC; and
- when offering a security for sale to investors within the United States, it is unlawful to do so by means of fraud, misrepresentation or deceit.

With regard to the first issue, we will limit our discussion in this primer to private offerings of securities into the United States which are underwritten by one or more investment banks ("**underwriters**") and offered (a) on the basis of an offering document (a "**prospectus**") prepared by the company issuing the securities (the "**issuer**"), the underwriters and their respective advisers and (b) pursuant to a statutorily available exemption (in this case a "**Rule 144A Offering**"[1]).

The aim of this primer is to deal with the second issue, however, by providing a summary description of the anti-fraud provisions under the US federal securities laws and explaining the concepts and standards of "due diligence" and "disclosure" in the context of a Rule 144A Offering.

Sources of Applicable US Federal Law

The body of US federal law[2] that generally regulates securities offerings in the United States, as well as the activities of due diligence and disclosure, comprises the following:

- the US Securities Act of 1933, as amended (the "**Securities Act**") and the rules, regulations and guidelines promulgated thereunder;
- the US Securities Exchange Act of 1934, as amended (the "**Exchange Act**") and the rules and regulations promulgated thereunder;
- the rulemaking, interpretations and guidance provided by the US Securities and Exchange Commission[3] (the "**SEC**");
- US federal case law.

For the purpose of this primer, the bullet points set out above shall together be referred to as the "**US federal securities laws**".

[1] Securities Act Rule 144A is an exemption from registration under the Securities Act for the resale of securities to qualified institutional buyers "QIBs" (as defined in Rule 144A) in the United States. In private placements into the United States, it is common practice for investment banks to agree both to procure subscribers for (pursuant to a reasonable efforts placement under Section 4(a)(2) of the Securities Act and/or Regulation D thereunder) and, failing that, to subscribe for themselves (a firm underwriting), the securities being offered. Rule 144A allows the underwriters to resell such underwritten securities, and is often used as a shorthand description of the US offering.

[2] This note does not address the securities laws, or "blue sky" laws, of the individual US states.

[3] The stated mission of the SEC is, among other things, to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

General Anti-Fraud Rule

Exchange Act Rule 10b-5 is one of several iterations of the general anti-fraud principles under the US federal securities laws and, as we explain below, it is applicable to Rule 144A Offerings. Rule 10b-5 provides that "[i]t shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) *to make any untrue statement of a material fact or to omit 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 (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

It would be fair to say that the language underlined in (b) above is less than eloquent; however, the SEC and federal court judges have generally agreed that the statutory language makes it unlawful knowingly or recklessly to offer and/or sell a security to an investor in the United States through fraud, misrepresentation or deceit in a prospectus or in any other form of communication. The prohibition set out in Exchange Act Rule 10b-5 can be applicable, under the right circumstances, to any person, anywhere.[4]

Prospectus Liability

Depending on the circumstances of a Rule 144A Offering (e.g., primary or secondary offering), if an investor (or the SEC) alleges a violation of the antifraud rules in a prospectus, it could bring an action against one or more of the following persons or entities involved in the preparation of a prospectus:

- the issuer of the securities;
- the selling shareholder;
- persons controlling the issuer;
- directors and certain officers of the issuer;
- experts providing expert information in a prospectus (e.g., accountants or appraisers);
- underwriters; and
- certain others who may have participated in the preparation of a prospectus.

[4] In 2010, the US Supreme Court held in *Morrison Et Al. v. National Australia Bank Ltd. Et Al.* 130 S. Ct. 2869 (2010) that Section 10(b) and Rule 10b-5 under the Exchange Act apply only to purchases and sales of securities in the United States. The holding limits the extraterritorial application of the US antifraud laws in so-called "foreign cubed" cases where, formerly, redress may have been available for non-US plaintiffs suing US and non-US defendants in relation to a non-US securities transaction on the basis either (i) that the securities fraud had an effect on the United States or on US persons, or (ii) that a significant and material part of the fraudulent conduct occurred in the United States. However, the holding by the US Supreme Court does not appear in any way to impair the application of Section 10(b) or Rule 10b-5 to conduct that these laws explicitly prohibit. Under the Dodd-Frank Act, the US Congress specifically granted jurisdiction to the US federal courts to hear causes of action brought by either the SEC or the Department of Justice. That power does not yet extend to actions brought by private individuals.

Origins of the "Due Diligence Defence" in a Rule 144A Offering

Under the US federal securities laws, the fraud statutes are applied principally on the basis of a determination whether a securities offering is public or private.[5] In public offerings, the US federal securities laws impute strict liability on the issuer unless it can show that the plaintiff knew of the material misstatement or omission giving rise to the cause of action at the time of the acquisition of the security in question; however, other persons or parties (including underwriters, controlling persons, directors and officers and any selling shareholder ("**eligible defendants**") may avoid liability if they can prove the following:

- With regard to any information in the prospectus that was not provided by an expert, such person had, after reasonable investigation, reasonable grounds to believe, and did believe, that the information was true, accurate and complete in all material respects[6];
- With regard to information in the prospectus provided by an expert, such person (other than the expert) had no reasonable grounds to believe, and did not believe, that such information was untrue, inaccurate or incomplete in any material respect.[7]

In light of the burden of proof set out above, market participants involved in US public offerings developed the "due diligence defence," the purpose of which being to demonstrate, in a cause of action brought against an eligible defendant, that such defendant had conducted a reasonable investigation and had otherwise conducted itself reasonably under the circumstances.

[5] In 1995, the US Supreme Court held in *Gustafson v. Alloyd*, 513 US 561 (1994) that Section 12(2) of the Securities Act applies only to a prospectus used in connection with a public offering of securities in the United States. In addition, Section 11 of the Securities Act applies solely to registration statements filed with the SEC and Section 17 is not available for private causes of action.

[6] Paraphrasing Securities Act Section 11(b)(3)(A)

[7] Paraphrasing Securities Act Section 11(b)(3)(C)

Because Rule 144A Offerings are private offerings, plaintiffs must rely on Exchange Act Rule 10b-5 to allege securities fraud. The federal courts have, however, held that such plaintiffs may not rely merely on a determination that the issuer or other eligible defendants have failed to meet the burden of proof applicable in public offerings, as set out above; they must also affirmatively show that such defendants knowingly or recklessly made the misstatement or omission (proving so-called "scienter").[8] Recklessness has been defined by US federal courts as "an extreme departure from the standards of ordinary care [...] which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the defendant must have been aware of it."[9]

In light of the higher burden of proof set by the US federal courts in the application of Rule 10b-5, many market participants outside the United States concluded in the mid-1990's that the "due diligence defence" was not necessary in Rule 144A Offerings. That misapprehension was appropriately dispelled by the US securities bar, which recognized the strong likelihood that a US federal judge would find a way to impute liability under Rule 10b-5 to underwriters who offer and sell securities in the United States "without knowing, or apparently caring, whether the disclosures regarding those securities are accurate,"[10] as surely such behaviour would be regarded at a minimum as reckless. As a result, and despite the higher burden of proof in Rule 10b-5 liability cases, underwriters, market participants and the US securities bar will normally prepare the prospectus in a Rule 144A Offering applying the same standard of due diligence and disclosure that is found in offerings registered with the SEC.

[8] *Ernst & Ernst v. Hochfelder*, 425 US 185 (1976)

[9] *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976)

[10] *David W. Bernstein,* "Due Diligence and the Legacy of Gustafson" in *International Financial Law Review* (August 1995).

No Small Comfort?

Because of its critical role as intermediary between the issuer and the securities markets and investors, an underwriter's reasonable investigation must be extensive, more so perhaps than any other eligible defendant. As a consequence, the due diligence process, described more fully below, has been developed by and among underwriters, US legal counsel, independent accountants/auditors and other experts. In particular, as market practice has evolved, underwriters have required that certain parties provide written "comfort" to support their due diligence defence:

- "***10b-5 letters***" (sometimes called "negative assurance" or "disclosure" letters) are provided by US securities lawyers engaged by the issuer and the underwriter. A 10b-5 letter provides generally that nothing has come to the attention of the US securities lawyer that would cause her or him to believe that the prospectus is not accurate and complete in all material respects. A 10b-5 letter can only be given by US counsel, however, if: (i) fulsome management and documentary due diligence has been conducted on the issuer's group with the involvement of the US securities lawyers, (ii) the US securities lawyers have been involved in the drafting and vetting of the prospectus and, most importantly, (iii) nothing has, in fact, come to the US lawyer's attention that would cause her or him to believe that the prospectus is not complete and accurate in all material respects; and
- "***Comfort letters***" are provided by the issuer's independent accountant/auditors and generally state that: (i) they are independent, (ii) they have audited year-end (and perhaps interim) consolidated financial statements of the issuer and, under certain circumstances (iii) they may also have subjected interim consolidated financial statements to limited review, reviewed certain principal line items in the issuer's consolidated financial statements prepared by the issuer for periods subsequent to the interim period and spoken with certain officials of the issuer about such financial information. Under those circumstances, the comfort letter would also then indicate whether anything has come to the independent auditor's attention to cause it to believe that (a) any material amendment to the interim financial statements is necessary or the interim financial statements do not conform with the applicable accounting principles, or (b) such principal line items have changed materially since the date of the last audit or limited review.

It is nevertheless incumbent upon the underwriters to conduct their own reasonable investigation of the issuer and its group companies (e.g., its business, results of operations, financial condition, prospects and operating and legal risks), as the SEC and federal courts warn against undue reliance on 10b-5 letters or comfort letters, and even on information provided by experts, such as an audit opinion.[11] It is, in fact, not entirely clear to what extent a 10b-5 letter and/or a comfort letter would constitute a significant part of a due diligence defence; but the involvement of US securities lawyers and the issuer's independent accountants in the due diligence and disclosure process is viewed by market participants as a key component of best practice.

[11] For a reasonably thorough explanation of the duty of underwriters to conduct a reasonable investigation, see *In re Worldcom, Inc. Securities Litigation,* 346 F. Supp.2d 628 (S.D. New York 2004)

Due Diligence and Disclosure Defined

Therefore, the term "due diligence" embodies the obligation under the US federal securities laws of any underwriter, controlling person or any selling shareholder, director or officer of an issuer and certain other individuals engaged in the preparation of an offering document to conduct a reasonable investigation of the issuer and its group companies (e.g., its business, results of operations, financial condition, prospects and operating and legal risks).

The US federal securities laws provide that, for the purposes of determining what constitutes a reasonable investigation, the standard of reasonableness shall be that required of a prudent man in the management of his own property—but as mentioned above, the underwriter's role as intermediary between the issuer and the securities markets and investors, as well as its level of sophistication and experience, mean that the reasonableness of its behaviour will very likely be heavily contextualized by a US federal judge.

The term "disclosure" refers to any information that is provided by an issuer, its subsidiaries or affiliates, and any of its or their directors, officers, employees or agents, to potential investors, current shareholders or bondholders, securities analysts, the press, or to any regulatory body or stock exchange in the context of a securities offering or in the context of ongoing regulatory compliance. The principal disclosure document in the context of an offering of securities is the prospectus, in which underwriters may also provide a very limited amount of information relating to their legal names, business names, addresses and roles in the Rule 144A Offering (this is sometimes referred to as "blood letter" information).

Conducting Due Diligence and Proper Disclosure in a Rule 144A Offering

As a preliminary matter, it is important to establish parameters by which the issuer, its subsidiaries and other affiliates, its or their directors, officers and employees (the "**Issuer's Group**") can facilitate the disclosure of all material information to the underwriters, underwriters' counsel, issuer's counsel, the auditors and any other party engaged for the purpose of preparing the prospectus and, more generally, for the purpose of conducting a Rule 144A Offering (together with the Issuer's Group, the "**Working Group**").

The disclosure of material information by the Issuer's Group generally occurs under the following circumstances:

- the preparation, maintenance and updating of a documentary "data room" until the completion of the transaction;
- the participation in meetings and discussions with the Working Group (kick-off meetings, management presentations and management due diligence meetings, drafting sessions and conference calls) where matters relating to the Rule 144A Offering, the securities, the business, results of operations, financial condition, material economic and other contractual relationships and business risks relating to the Issuer's Group and the prospectus are disclosed and discussed; and
- the preparation, drafting, review, amendment, verification and updating (and perhaps even supplementing) of the prospectus.

Identifying Material Information

Under the US federal securities laws, a fact is material if there is a substantial likelihood that proper disclosure of that fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available to the investor at the time the investment decision was made. This is a "qualitative" evaluation that is difficult to apply at the beginning of the Rule 144A Offering, when many parties in the Working Group may know very little about the Issuer's Group.

As a practical solution to assist the due diligence process, and in part based on standards applied by the accounting profession and guidance provided by the SEC[12], market participants have developed a "quantitative" threshold by which materiality may be determined on a preliminary basis. However, the quantitative threshold is put in place solely to facilitate the preparation and updating of the data room and the ongoing management due diligence. At the end of the day, the qualitative determination of what information is material, as defined in the preceding paragraph, governs the detail and depth of disclosure that must be provided in the prospectus in order to meet the standards established by the US federal securities laws. The documents that should be prepared for review should regard any obligation (or series of related obligations), occurrence (or series of related occurrences), or agreement (or series of related agreements) that, *individually or in the aggregate*, has a value or impact (potential or actual) that exceeds the materiality threshold described below.

It is possible that documents that do not meet such threshold may nevertheless be material because they contain information that a buyer or seller of the company's shares would want to know, or if known, would affect the market value of the shares. For example, facts, circumstances or documents that reflect on the integrity of key managers or that would restrict or prohibit the company from selling company shares or conducting its business may be material regardless of the amounts involved. In addition, debt obligations will be relevant if they exceed any cross-default thresholds in the Issuer Group's primary lending agreements, and change of control clauses or clauses otherwise triggered by the contemplated securities offering may be material.

[12] See 17 CFR Part 211 [Release No. SAB 99] SEC Staff Accounting Bulletin No. 99

Material Documents

For most issuers, a general rule of thumb is to consider 5% of pre-tax income as the overall materiality threshold. Given that the disclosure in the prospectus must contain all material information, generally speaking, the documents reviewed in connection with the diligence exercise should be limited to "material" documents only. Therefore, with respect to contracts, assets or liabilities (including tax or other litigation, environmental liabilities, etc.), the review is generally limited to those that, unless otherwise material, exceed the quantitative materiality threshold.

Counsel for the underwriters normally will furnish the issuer with a document request list that indicates what documents are being sought. It is likely that such a request list will be geared to the particular business activity or activities that the issuer is engaged in, and will be guided by precedent securities offerings by comparable businesses. Such lists may not, however, specifically request all documents that may be material to the issuer's business, so it will be incumbent upon the Issuer's Group to help guide the documentary review in such instances.

Finally, with respect to the period of review, it is generally expected that materials for the Group's last three full fiscal years and for the interim period subsequent to the full fiscal year, through the closing of the offering, should be made available (n.b. there may be some circumstances where the look-back period should be up to 5 years).

Material Subsidiaries

A general rule of thumb is to treat Issuer Group companies as material for the purposes of the due diligence income if their contribution to the Issuer Group is greater than 5% of either total assets or pre-tax income.

Disclosing Material Information: Sources of Form and Substance

There are a number of sources in the US federal securities laws that provide guidance on what information is required to be disclosed in a prospectus, and how such information is required to be disclosed, principal among which are the following:

- Regulation S-X, which provides guidance on the disclosure of financial information in a prospectus;
- Regulation S-K, which provides guidance on the contents of a prospectus, including a description of the business and the securities of the issuer, the presentation of certain financial information, disclosure on management and certain security holders, and riskfactors;
- Industry Guides 3 through 7 under the Securities Act (dealing generally with disclosure on bank holding companies, oil and gas programs, real estate, insurance and mining, respectively);
- Form 20-F, which is used by foreign private issuers who file a registration statement with, or report annually to, the SEC;
- The Plain English Rules under the Securities Act, which provide those preparing a prospectus with guidance on diction and the presentation of information concisely and clearly; and
- SEC guidance on drafting risk factors and the Operating and Financial Review section of a prospectus.

In the preparation of a prospectus in a Rule 144A Offering, some or all of these resources may have to be taken into consideration in order to meet the disclosure standards under the US federal securities laws.

Conclusion

The due diligence and disclosure process in a Rule 144A Offering is iterative, requires a significant commitment of time and effort from all members of the Working Group and has been known to engender no small measure of consternation in certain circumstances. We believe, however, that given the high level of securities litigation in the United States, the evolving liability thresholds and the willingness of US federal courts to ensure that underwriters observe standards of behaviour that support the legislative intent of the US antifraud rules, the process will continue to be worthwhile.

New AIM rules for electronic settlement of category & Securities

8

A Brief Summary

On 7 August 2015, the London Stock Exchange (the "**LSE**") published AIM Notice 41 and issued corresponding guidance in Inside AIM concerning equity securities issued by US domestic companies (as well as other companies that do not qualify as "foreign private issuers" under US federal securities laws) to investors outside of the United States in "offshore transactions" ("**Category 3 Equity Securities**").

As a general rule, securities that are admitted to trading on AIM must be eligible for electronic settlement in the CREST system ("**CREST**") operated by Euroclear UK and Ireland ("**EUI**"). Until now, however, Category 3 Equity Securities have not been eligible for electronic settlement and were held in certificated form in reliance on derogations from AIM Rule 36.

Following the introduction of new EU regulations in January 2015 requiring all transactions in transferable securities to be settled electronically, the LSE and the EUI have proposed a solution that will allow Category 3 Equity Securities to be settled electronically. The proposal also provides for settlement of Category 3 Equity Securities that are eligible for resale to "QIBs" in the United States pursuant to Rule 144A together with Category 3 Equity Securities, "**Restricted Securities**")

As a result of the proposal, from 1 September 2015, derogations under AIM Rule 36 will no longer be available.

A Closer Look

AIM Rule 36 requires that all AIM securities must be eligible for electronic settlement. However, Restricted Securities were historically not eligible for electronic settlement in the CREST system operated by EUI due to the transfer restrictions and other procedures required in relation to such securities.

The restrictions applicable to Category 3 Equity Securities are extensive, including:

- offers and sale of the securities must be made in an "offshore transaction" (as defined in Regulation S);
- "directed selling efforts" (as defined in Regulation S) are prohibited;
- offers or sales may not be made to or for the account or benefit of a "US Person" (as defined in Regulation S) during the distribution compliance period, which is 12 months (or 6 months for a US domestic "reporting issuer") for Category 3 Equity Securities as opposed to 40 days for equity securities issued pursuant to Category 2 of Regulation S (for a reporting foreign issuer) or zero days for Category 1 for a foreign issuer with no substantial market interest in its equity securities;
- during the distribution compliance period, various certifications and undertakings are required from a party acquiring the securities, including that the party is not a US Person and is not acquiring the securities for the benefit of a US Person (or that it is a US Person that purchased securities in a transaction that did not require registration under the Securities Act);
- the Category 3 Equity Securities must contain a legend to the effect that the transfer of the securities is prohibited except in accordance with Regulation S, pursuant to registration under the Securities Act, or pursuant to an available exemption from registration, and that "hedging transactions" involving the securities may not be conducted unless in compliance with the Securities Act; and the issuer is legally obligated

to refuse to register any transfer of the securities not made in accordance with Regulation S, pursuant to registration under the Securities Act, or pursuant to an available exemption from registration. In addition, as a further condition, in the case of an offer or sale of Category 3 Equity Securities prior to the expiration of the distribution compliance period by a dealer or a person receiving a selling concession, fee or other remuneration in respect of the securities offered or sold:

- neither the seller nor any person acting on its behalf knows that the offeree or buyer is a US Person; and
- if the seller or any person acting on its behalf knows that the purchaser is a dealer or a person receiving a selling concession, fee or other remuneration in respect of the Category 3 Equity Securities sold, the seller or a person acting on the seller's behalf must send to the purchaser a confirmation or other notice stating that the Category 3 Equity Securities may only be offered or sold during the distribution compliance period only in accordance with the provisions of Regulation S, pursuant to registration of the securities under the Securities Act or pursuant to another available exemption from the registration requirements.

Rule 144A Securities are subject to the restrictions discussed above in relation to Category 3 Equity Securities, save that they may be offered and sold to US Persons who are "qualified institutional buyers" as defined in, and pursuant to, Rule 144A if the securities are eligible for offers and sales under Rule 144A and the transaction meets the additional requirements set out in Rule 144A.

Prior to the change provided by AIM, in order to meet the requirements of Category 3, issuers of Restricted Securities issued their securities in certificated form and requested derogations from AIM Rule 36 to allow such securities to settle outside of CREST. These securities traded in certificated form for at least 6-12 months following the issuance, at which time they could be dematerialized by the issuer. The result has been longer settlement periods and significantly reduced liquidity, which can have an adverse effect on the desire of such issuers to have Restricted Securities admitted to trading on AIM listing or on the price of Restricted Securities.

However, the EU Regulation on Central Securities Depositories (Article 3(2)) issued in January 2015 requires transactions in transferable securities that take place on a trading venue (such as AIM) to be recorded in book entry form in a CSD (i.e. settled electronically). As a result, derogations from AIM Rule 36 and settlement of transferable certificated securities were no longer a viable solution and the LSE has since established a solution that will enable electronic settlement through Crest of Restricted Securities from 1 September 2015. As a result, derogations from Rule 36 of the AIM Rules will no longer be available for such securities.

How will it work?

In order to facilitate CREST members' and issuers' compliance with the restrictions summarised above, the CREST system will include the following:

- appropriate identifiers in the security type, security abbreviation and security description fields which identify whether the security is a 'Reg S Cat 3' or 'Reg S Cat 3/Rule 144A' security;
- access to the text of the legends and restrictions applicable under Category 3 of Regulation S, and, where relevant, under Rule 144A. The text of these legends is contained in Annex 1 to the Whitebook issued by the EUI in May 2015 (the **"Whitebook"**); and validation which prevents the settlement of certain transactions (essentially, transactions which may result in the transfer of legal ownership of the security) in Restricted Securities unless the member proposing to acquire the securities provides the required certifications.

- The text of these certifications is contained in Annex 1 to the Whitebook. Where the distribution compliance period for a Restricted Security has come to an end and the security is not otherwise subject to any transfer restrictions under the Securities Act, it will cease to be a Restricted Security and the restrictions and procedures described in the Whitebook will no longer be applicable.

It will be the responsibility of the issuer (and, in the case of an AIM company, together with its nominated adviser) to monitor the distribution compliance period of the Restricted Securities and whether any other transfer restrictions are applicable in respect of the securities. Although the intended date of the end of the distribution compliance period may be provided for the Restricted Security, this date will be for information purposes only and the move from "restricted" to "unrestricted" status will not be automatic. Securities will continue to be treated by the LSE as restricted until it receives a request for removal of the restricted status from the issuer (or, in the case of AIM companies, its nominated adviser).

Issuers often issue more than one tranche of securities under the same International Securities Identification Number ("**ISIN**"). As currently envisioned, it will not be possible to have Restricted Securities and securities that are not restricted under the same ISIN. As a result, if issuers seek to issue more than one tranche of securities but wish to remove the restriction from a line of securities as soon as the distribution compliance period expires and when the security ceases to be subject to any other restrictions on transfers arising under the Securities Act, they should consider using separate ISINs for each tranche.

Restricted Shares held by affiliates and other parties will remain certificated

As a result of restrictions in respect of Category 3 Equity Securities, the electronic settlement service will not be available to affiliates (as defined in Rule 405 under the Securities Act) of the issuer of the Category 3 Equity Securities. In addition, due to the fact that EUI is not registered as a clearing agency in the United States, electronic settlement for Restricted Securities will not be available to (a) natural persons with US residences; (b) companies 4 whose registered offices, principal places of business or executive offices are located in the United States (including non-US branches thereof); (c) US banks (and any non-US branches thereof); or (d) broker-dealers registered with the US Securities and Exchange Commission (even if such broker-dealers do not have a US residence).

As a result, affiliates (which may include executive officers, directors, large stockholders, subsidiaries, parent entities and sister companies) and parties located in the United States would continue to hold their Restricted Securities in certificated form.

Health Warning

It is worth noting that there has been no definitive guidance from the US Securities and Exchange Commission as to whether the proposed solution meets the necessary standard for compliance with the US federal securities laws. As such, guidance should be sought from US legal counsel in the event that an issuer of Restricted Securities seeks to have such securities admitted to trading on AIM.

Glossary of Terms

9

- **ACCREDITED INVESTOR:** The term Accredited Investor is defined in Rule 501(a) under the Securities Act and is significant to offerings made in reliance on Rules 505 or 506 of Regulation D under the Securities Act (see pages 26-31). It includes eight categories of purchasers, such as banks, insurance companies, employee benefit plans, investment companies, and registered brokers and dealers. Many of the purchasers specified in Rule 501(a) are also included in the definition of qualified institutional buyers under Rule 144A under the Securities Act. There are, however, two significant differences, as follows:
  - There is no threshold requirement that an accredited investor owns and invests at least USD 100 million in securities.
  - The term Accredited Investor includes non-institutional investors, such as the following:
    - any of the issuer's directors, executive officers, or general partners;
    - any natural person whose individual net worth, or joint net worth with their spouse, is greater than USD 1,000,000 at the time of the purchase; and
    - any natural person who had individual income greater than USD 200,000 in each of the two most recent years, or joint income with their spouse greater than USD 300,000 in each of those years, and has a reasonable expectation of achieving the same income in the current year. See Rule 501(a)(1) - (8) under the Securities Act for a complete description of Accredited Investor.

Note that with respect to a natural person's net worth, the Dodd-Frank Act proposes the exclusion of the value of the natural person's primary residence from the calculation of net worth.

- **ACCREDITED INVESTOR TRANSACTIONS:** Transactions in which an issuer offers or sells securities only to an accredited investor. Essentially, these are offers or sales to institutional investors, such as banks, insurance companies, investment companies, and employee benefit plans.
- **AFFILIATE:** An affiliate of, or person affiliated with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified. Securities Act, Rule 405. Control, however, does not necessarily mean equity ownership. The SEC will view a transaction or arrangement as a whole in making this determination. Exchange Act, Rule 13e-3(a)(1).
- **AMERICAN DEPOSITARY RECEIPTS (ADRs):** ADRs represent shares in a corporation that is incorporated outside the United States. A US bank holds the underlying foreign security, known as Depositary Shares, in one of its branches abroad. A negotiable receipt covering the foreign Depositary Shares is then issued and traded on the US exchanges. (The Morgan Guaranty Trust Company and the Bank of New York are large issuers of ADRs.) The ADR holders retain almost all of the rights that shareholders of the underlying securities do, but dividends and share pricing are in US dollars. In the past, ADR trading was done almost exclusively on the over-the-counter (OTC) market, but both NASDAQ and the NYSE now have numerous ADR listings.
- **BENEFICIAL OWNER:** A person that, directly or indirectly, has or shares either voting power or investment power with respect to a security. Exchange Act, Rule 13d-3(a). This direct or indirect ownership can be in the form of any type of arrangement or relationship. A person may also be deemed to be a beneficial owner if that person has the right to acquire beneficial ownership of a security by the exercise of an option, the conversion of a security, the revocation of a trust, or the automatic termination of a trust. Exchange Act, Rule 13d-3(d)(1)(i).

The general rule states that a beneficial owner means any person that has or shares a direct or indirect pecuniary interest in the equity securities through any contract, arrangement, understanding, or relationship. This broad definition encompasses both direct and indirect arrangements. The definition of pecuniary interest and indirect pecuniary interest are key issues in this rule. Exchange Act, Rule 16a-1(a)(2).

- **BEST-EFFORTS BASIS:** With respect to a securities offering, a commitment by the investment bank or group to sell or place as many of the securities as possible (without any guarantee of the outcome) as an agent of the selling party, rather than a commitment to underwrite the entire offering.
- **BLOOD LETTER:** A letter or representation from the underwriters (or initial purchasers) to the issuer confirming the accuracy of the information contained in the prospectus that was supplied by the underwriters (or initial purchasers). The blood letter is delivered in connection with the indemnification provisions of the underwriting agreement in which the underwriters (or initial purchasers) agree to indemnify the issuer for losses arising out of any misstatements or omissions arising out of information that they have supplied for the registration statement or any prospectus.
- **BLUE SKY LAWS:** A popular name for state securities laws, the first of which was enacted in Kansas in 1911. Predating federal securities regulation, state securities laws provided for the regulation and supervision of securities offerings and sales in order to protect citizen-investors from investing in fraudulent companies. These state laws became known as blue sky laws when a judge of the period stated that certain speculative securities schemes had no more substance than so many feet of "blue sky." Most blue sky laws require the registration of new issues of securities with a state agency that reviews selling documents for accuracy and completeness. Blue sky laws often regulate securities brokers and salespersons. Section 18 of the Securities Act provides exemptions from the application of blue sky laws to certain transactions, but such laws can be implicated inadvertently if care is not taken.
- **BROKER:** Any person engaged in the business of effecting transactions in securities for the account of others, not including a bank. Exchange Act, Section 3(a)(4). Generally speaking, a broker is a market participant that acts solely as an investor's agent, takes no position in securities being traded and, in return for these services, receives a fee or commission.
- **BROKER-DEALER:** A person or a securities brokerage firm, usually registered with the SEC (a "US registered broker-dealer") and with the state in which it does business, engaging in the business of buying and selling securities for its customers or its own account.
- **CATEGORY 1 SECURITY:** In relation to Regulation S transactions and based on the type of securities being offered and sold, whether the issuer is domestic or foreign, whether the issuer is a reporting issuer under the Exchange Act and whether there is a "SUSMI", category 1 transactions are those in which the securities are least likely to flow back into the United States. Therefore, the only restrictions are that the transaction must be an "offshore transaction" and that there be no "directed selling efforts" in the United States.
- **CATEGORY 2/CATEGORY 3 SECURITY:** In relation to Regulation S transactions and based on the type of securities being offered and sold, whether the issuer is domestic or foreign, whether the issuer is a reporting issuer under the Exchange Act and whether there is a "SUSMI", category 2 and 3 transactions are subject to an increasing number of offering and transactional restrictions for the duration of the applicable "distribution compliance period." The period ranges from 40 days to six months for reporting issuers or one year for equity securities of non-reporting issuers.

- **COMFORT LETTER:** See SAS 72 Comfort Letter, SAS 72 Lookalike Comfort Letter and ICMA Comfort Letter.
- **CONTROL:** The term control (including the terms controlling, controlled by and under common control with) means 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. Securities Act, Rule 405.
- **CONTROL PERSON LIABILITY:** Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under Section 11 or 12 of the Securities Act, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist. Securities Act, Section 15.
- **DISTRIBUTOR:** Any underwriter, dealer, or other person who participates, pursuant to a contractual arrangement, in the distribution of securities.
- **DEALER:** Any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. Exchange Act, Section 3(a)(5).
- **DIRECTED SELLING EFFORTS:** Any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S under the Securities Act (Rule 901 through Rule 905, and Preliminary Notes). Such activity includes placing an advertisement in a publication "with a general circulation in the United States" that refers to the offering of securities being made in reliance upon this Regulation S. Securities Act, Rule 902.
- **DODD-FRANK REGULATORY REFORM BILL:** US legislation passed in 2010 following the financial crisis earlier in the decade that aims to increase government oversight of trading in complex financial instruments; revises the powers and structure of the Securities and Exchange Commission, credit rating organizations, and the relationships between customers and broker-dealers or investment advisers; and expands the jurisdiction of US courts to include conduct occurring outside the United States that has a foreseeable substantial effect within the United States.
- **DUE DILIGENCE DEFENCE:** This defence requires that a defendant prove it conducted a reasonable investigation and had reasonable grounds to believe and, in fact, did believe that the statements in the prospectus/registration statement were true and that no material facts were omitted. The due diligence defence varies somewhat depending on whether the false statement or omission was made by an expert or non-expert. Securities Act, Section 11(b)(3). See Page 47 — A Primer of US Due Diligence And Disclosure Standards Applied in Rule 144A Offerings.
- **EXEMPT TRANSACTIONS:** Section 4 of the Securities Act exempts from the registration requirements of the Securities Act securities transactions by persons that are not issuers, underwriters, or dealers; non-public offerings by issuers; certain dealer transactions; certain broker transactions; offers or sales of promissory notes secured by real estate liens; and certain offers or sales by issuers to accredited investors having an aggregate value of less than USD 5 million.

- **FIRM COMMITMENT UNDERWRITING:** With respect to a securities offering, a commitment by the investment bank or group to sell or place the securities as an agent of the selling party, or, failing such a sale or placement of all of the securities offered, to purchase any remaining securities.
- **FOREIGN BROKER OR DEALER:** Any non-US resident that is not an office or branch of, or a natural person associated with, a registered broker or dealer whose activities would meet the definition of a broker or dealer under Sections 3(a)(4) or 3(a)(5) of the Exchange Act if these activities were conducted in the United States. The term foreign broker or dealer also includes a US person who is a broker or dealer but whose business is completely outside the United States.
- **FOREIGN CORRUPT PRACTICES ACT OF 1977 (FCPA):** Prohibits US companies from making corrupt payments to foreign officials for the purpose of obtaining or retaining business. Section 13(b)(2) of the FCPA requires publicly traded companies to comply with accounting and control standards.
- **FOREIGN PRIVATE ISSUER:** A foreign private issuer is any foreign or non-US issuer other than a foreign government. The term does not apply if US residents control the issuer in one of the following two ways:
  - if more than 50 percent of the issuer's outstanding voting securities are held by a US resident, either directly or indirectly, through voting trust certificates or depositary receipts. A security holder's status as a resident is determined by the address that appear on the issuer's records. If that address is located in the US, then the security holder is a US resident.
  - if there are major connections between the foreign issuer and the United States, the issuer will not be classified as a foreign private issuer when, for example:
    - the majority of the foreign issuer's executive officers or directors are US citizens or residents;
    - more than half of the foreign issuer's assets are located in the United States; or
    - the foreign issuer's business is administered principally in the United States. See Securities Act, Rule 405.
- **ICMA COMFORT LETTER:** A comfort letter which is similar to a SAS 72 Comfort Letter and is issued in accordance with the standard form provided by the International Capital Market Association.
- **INSTITUTIONAL INVESTORS:** Large investors, including mutual funds, pension funds, insurance companies, which usually pool smaller investments and trade in large quantities of securities or other significant investments.
- **INVESTMENT COMPANY ACT OF 1940, AS AMENDED (INVESTMENT COMPANY ACT):** Federal statute that regulates investment companies and contains various registration and prospectus requirements. The SEC's Division of Investment Management is responsible for administering this legislation.
- **INVESTMENT DISCRETION:** Section 3(a)(35) of the Exchange Act states that a person exercises investment discretion with respect to an account if, directly or indirectly, such person (a) is authorized to determine what securities or other property shall be purchased or sold by or for the account; (b) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions; or (c) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of

investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder.

- **ISSUER:** The term issuer is broadly defined in Section 2(4) of the Securities Act to include any person who issues or plans to issue any security. With respect to an american depositary receipt (ADR), the term issuer means the issuer of the deposited shares that are represented by the ADRs. Exchange Act, Rule 15c-211(e)(4).
- **ISSUER PRIVATE PLACEMENT:** An offering which is not a public offering which is made to a limited number of persons, usually sophisticated investors, which is generally not registered with the SEC. Such offerings are usually carried out pursuant to Section 4(a)(2) of the Securities Act in accordance with Regulation D thereunder.
- **LOOK-THROUGH PROVISION:** Under the definition of "securities held of record" in Rule 12g5-1 under the Exchange Act, issuers are required to "look through" the record ownership of brokers, dealers, banks, or nominees holding securities for the accounts of their customers to determine the residency of those customers. The application of this look-through provision is limited to voting securities held of record in the United States in the issuer's home jurisdiction and in the primary trading market for the issuer's securities if different from the issuer's home jurisdiction.
- **NO REGISTRATION OPINION:** A legal opinion provided by a US lawyer to the effect that, on the basis of certain factual representations and assumptions, certain securities do not need to be registered with the SEC.
- **NEGATIVE ASSURANCE:** This concept is applicable both to SAS 72 comfort letters (as well as SAS 72 lookalike comfort letters) provided by an auditor and 10b-5 letters provided by a US qualified lawyer.
  - With respect to a SAS 72 comfort (and lookalike) letter, it is a statement that nothing came to the attention of the auditor to cause it to believe that (i) the financial statements need to be modified, (ii) the unaudited financial information is not prepared on the same basis as the audited financial information, (iii) during a specified period, there were no changes to certain line items other than as disclosed in the prospectus; and
  - With respect to a 10b-5 letter, it is a statement that nothing has come to the attention of the relevant law firm to cause the belief that the prospectus, as of certain dates, contained any untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading.
- **MATERIALITY:**
  - Qualitative definition: A fact is material if there is a substantial likelihood that proper disclosure of that fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available to the investor at the time the investment decision was made.
  - Quantitative definition: Common rules provided by market practice are variable but 5% of normal pre-tax income for companies with income exceeding USD 2 million is the most commonly applied "rule of thumb".
- **OFAC (OFFICE OF FOREIGN ASSET CONTROL):** A department of the US Treasury that enforces economic and trade sanctions against countries and groups of individuals involved in terrorism, narcotics trafficking and other disreputable activities.
- **OFFERING RESTRICTIONS:** Requirements of Regulation S under the Securities Act by which distributors agree that all offers and sales before

a 40-day period (the distribution compliance period) will not be made to a US person or for the account or benefit of a US person (other than the distributor), but will be made in an offshore transaction pursuant to Rule 904 of Regulation S, or pursuant to registration under the Securities Act or pursuant to an applicable exemption.

- **OFFSHORE TRANSACTION:** Defined in Rule 902(i) under the Securities Act, an offshore transaction is an offer or sale of securities in which the offer is not made to a person in the United States. One of the following two alternative conditions must also exist:
  - At the time the buy order is originated, the buyer is located outside the United States, or the seller (or person acting on the seller's behalf) must reasonably believe that the buyer is located outside the United States; or
  - If the issuer-distributor safe harbor in Rule 903 under the Securities Act is being relied on, the transaction must be executed on the physical trading floor of an established foreign securities exchange located outside the United States; if the resale safe harbor in Rule 904 is being relied on, the transaction must be executed on a designated offshore securities market. The seller (and any person acting on its behalf) must not know that the transaction has been prearranged with a US buyer.
- **PASSIVE FOREIGN INVESTMENT COMPANY (PFIC):** A foreign-based corporation that has one of the following attributes:
  - At least 75% of the corporation's income is considered "passive", which is based on investments rather than standard operating business; or
  - At least 50% of the company's assets are investments that produce interest, dividends and/or capital gains.

  PFICs include foreign-based mutual funds, partnerships and other pooled investment vehicles that have at least one US shareholder. Most investors in PFICs must pay income tax on all distributions and appreciated share values, regardless of whether capital gains tax rates would normally apply.
- **PRELIMINARY PROSPECTUS:** A prospectus that is filed with the SEC, usually with the registration statement, and that is distributed to investors, and that does not contain the offering price of the security. It includes a "prospectus subject to completion" as used in 17 CFR 230.434(a). A preliminary prospectus is also known as a red herring or, in the UK, a "pathfinder prospectus".
- **PRIVATE PLACEMENT:** The sale of securities to a limited number of large institutional investors or otherwise sophisticated investors without registering with the SEC, often conducted pursuant to Rule 144A under the Securities Act, Section 4(a)(2) of the Securities Act, a "4(a)(1½) transaction" and more recently Section 4(a)(7), as well as Regulation D under the Securities Act. An eligible private placement is exempt from SEC registration, subject to certain restrictions, because it is not offered to the general public.
- **PROSPECTUS:** Also known as an "offering memorandum" or "offering document", a written communication that, as a matter of law, constitutes an offer for sale of a company's transferable securities. A prospectus will generally contain information describing (i) the terms and conditions of the securities being offered, and (ii) the company's business, its products and/or services, its customers and/or clients, its results of operations and financial condition, its operating and legal risks, and its principal markets and competitors. While a prospectus makes an offering of securities, it should not be considered a "marketing" document in a colloquial sense, because any information that constitutes "hype" or which would tend to create an "enhanced" perception by a prospective investor of the results of operations, financial condition or prospects of an issuer could be construed, as a matter of law or equity, as a false or misleading statement, which could result in civil, administrative or criminal liability for the issuer and certain other participants in an offering.

- **PUBLICITY GUIDELINES (PUBLICITY MEMORANDUM):** A set of guidelines drafted by counsel detailing restrictions on publicity and communication in certain jurisdictions throughout the period in which the offering of securities is underway.
- **PUBLIC OFFERING:** The offering of securities to the general public, in contrast to a private offering or placement. Generally, public offerings in the United States are regulated by federal and state laws and regulations.
- **QUALIFIED INSTITUTIONAL BUYER (QIB):** An entity (such as an insurance company, employee benefit plan, and investment company) that owns and invests on a discretionary basis at least USD 100 million in securities of non-affiliated issuers. Banks must satisfy this USD 100 million threshold test and also satisfy a USD 25 million net worth requirement. The term qualified institutional buyer also includes certain dealers that are registered under the Exchange Act. Dealers, however, need only own and invest on a discretionary basis at least USD 10 million in securities, or act in a riskless principal transaction on behalf of a qualified institutional buyer.
- **QUALIFIED PURCHASER:** Under the Investment Company Act of 1940 means:
  - any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under Section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than USD 5,000,000 in investments, as defined by the Commission;
  - any company that owns not less than USD 5,000,000 in investments and that is owned directly or indirectly by or for two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;
  - any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or
  - any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than USD 25,000,000 in investments.
- **REASONABLE INVESTIGATION:** The statutes and rules offer only limited guidance as to what constitutes a reasonable investigation. Section 11(c) of the Securities Act merely states that a reasonable investigation is based on a standard of reasonableness required of a "prudent man in the management of his own property." But see Rule 176 under the Securities Act for some general factors that may be used to determine whether an investigation is reasonable within Section 11(c)'s definition.
- **REGISTRATION:** A process set up pursuant to the Securities Act and Exchange Act whereby securities that are to be sold to the public are reviewed by and registered with the SEC.
- **REGISTRATION STATEMENT:** A legal document filed with the SEC to register securities for public offering that details the purpose of the proposed public offering. The statement outlines financial details, a history of the company's operations and management, and other facts of importance to potential buyers.
- **REGULATION D:** A regulation under the Securities Act that establishes a non-exclusive "safe harbour" for determining whether a private placement

of securities to investors in the United States qualifies for the exemption provided under Section 4(a)(2) of the Securities Act. Although issuers are not required to adhere to the guidelines set forth in Regulation D to establish a Section 4(a)(2) exemption, most private placement offerings are patterned upon them as a matter of best market practice.

- **REGULATION S:** Set out in Rules 901 through 905 under the Securities Act, this regulation sets out the rules governing offers and sales of securities made outside of the United States which are not required to be registered under the Securities Act.
- **RESEARCH GUIDELINES:** Guidelines drafted by underwriters' counsel, and circulated to members of the underwriting syndicate, in relation to the distribution of research reports. Research guidelines typically include information concerning periods in which research reports cannot be distributed, information to be included or excluded from research reports, communication between the issuer and connected research analysts and review by certain parties of draft research reports.
- **RESTRICTED SECURITIES:** Restricted securities are securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer. Investors typically receive restricted securities through private placement offerings under 144A, Regulation D offerings, employee stock benefit plans, as compensation for professional services, or in exchange for providing "seed money" or start-up capital to the company. Rule 144(a)(3) under the Securities Act identifies what sales produce restricted securities.
- **RULE 138:** A rule under the Securities Act regarding the publication or distribution by brokers or dealers of research reports relating to debt or equity securities other than those which such brokers or dealers may currently be distributing.

- **RULE 139:** A rule under the Securities Act regarding the publication or distribution by brokers or dealers of research reports regarding a certain issuer or business sector published in the ordinary course of business and in conformity with prior practice of the broker or dealer.
- **SANCTIONED COUNTRY:** A country subject to sanctions or similar such measures imposed by the United States (under OFAC), the European Union or the United Nations.
- **"SAS 72 COMFORT LETTER":** A letter provided by an accounting firm confirming the procedures conducted to ensure the accuracy of the numbers in an offering document (to be used in relation to the US tranche of an offering) and providing negative assurance as to the content and quality of unaudited interim financial statements and to changes subsequent to the period ended in the most recent financial statements. Note that auditors typically require that underwriters provide a representation letter before the auditor will address a SAS 72 Comfort Letter to the underwriter in question.
- **"SAS 72 LOOKALIKE COMFORT LETTER":** Similar to the SAS 72 letter except this letter is used in relation to the non-US tranche of an offering and does not typically require a representation letter.
- **"SAS 72 REPRESENTATION LETTER":** A letter from an underwriter to an auditor stating that the underwriter has reviewed the information to be provided to investors and has performed due diligence which was (or will be) substantially consistent with the due diligence review process that it would perform if the offering of securities were being registered pursuant to the Securities Act. The underwriter also states that it is knowledgeable with respect to the due diligence review process that would be performed if the offering were being registered pursuant to the Securities Act.

- **SEC:** The US Securities and Exchange Commission. The stated mission of the SEC is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. It is the responsibility of the SEC to interpret and enforce federal securities laws; issue new rules and amend existing rules; oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies; oversee private regulatory organizations in the securities, accounting, and auditing fields; and coordinate US securities regulation with federal, state, and foreign authorities.
- **SECURITIES ACT OF 1933, as amended (SECURITIES ACT):** Regulates the offering and sale of securities. The Securities Act provides for the registration of securities that are to be sold to the public and for complete information as to the issuer and the stock offering. The Securities Act requires disclosures concerning offers and sales of securities. The SEC's Division of Corporate Finance renders interpretations of the Securities Act and regulations.
- **SECURITIES EXCHANGE ACT OF 1934, as amended (EXCHANGE ACT):** Regulates the secondary trading of securities that are issued and outstanding. The Exchange Act also includes rules for periodic disclosures by registered companies, the proxy process, and insider trading.
- **SELF-REGULATORY ORGANIZATION (SRO):** Defined in Section 3 (a)(26) of the Exchange Act, the term SRO means a national securities exchange, registered securities association, or registered clearing agency. The term also includes the municipal securities rulemaking board (MSRB), which was established in Section 15B. The SEC's Division of Market Regulation is responsible for the registration and regulation of SROs and the Office of Compliance Inspections and Examinations is responsible for examining and inspecting them. All broker-dealers registered with the SEC in accordance with Section 15 of the Exchange Act must also be a member of a SRO which is registered under Section 15A of the Exchange Act.

- **"STUB PERIOD":** A period of time between the date of the last audited or reviewed accounts (for purposes of SAS 71 and SAS 100) and the cut-off date provided in the SAS 72 comfort letter and/or a SAS 72 lookalike comfort letter.
- **SIGNIFICANT SUBSIDIARY:** According to Rule 1-02 of Regulation S-X under the Securities Act, the term "significant subsidiary" means a subsidiary, including its subsidiaries, which meets any of the following conditions:
  - The registrant's and its other subsidiaries' investments in and advances to the subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year (for a proposed combination between entities under common control, this condition is also met when the number of common shares exchanged or to be exchanged by the registrant exceeds 10 percent of its total common shares outstanding at the date the combination is initiated); or
  - The registrant's and its other subsidiaries' proportionate share of the total assets (after intercompany eliminations) of the subsidiary exceeds 10 percent of the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year; or
  - The registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes, extraordinary items and cumulative effect of a change in accounting principle of the subsidiary exclusive of amounts attributable to any non-controlling interests exceeds 10 percent of such income of the registrant and its subsidiaries consolidated for the most recently completed fiscal year.

- **SOX (SARBANES-OXLEY ACT OF 2002):** An act passed by US Congress in 2002 to protect investors from the possibility of fraudulent accounting activities by corporations. The Sarbanes-Oxley Act (SOX) mandated strict reforms to improve financial disclosures from corporations and prevent accounting fraud including:
  - A mandate that requires senior management to certify the accuracy of the reported financial statement; and
  - A requirement that management and auditors establish internal controls and reporting methods on the adequacy of those controls.
- **SUBSTANTIAL US MARKET INTEREST (SUSMI):** SUSMI has different meanings depending on whether the securities are equity or debt securities:
  - SUSMI, with respect to a class of an issuer's equity securities, means that either the securities exchanges and interdealer quotation systems in the United States constituted the single largest market for the securities (during the previous fiscal year or the period since the issuer's incorporation, whichever is shorter); or 20 percent or more of all trading in the class of equity securities took place through securities exchanges and interdealer quotation systems in the US, and less than 55 percent of all trading took place through the securities markets of a single foreign country (during the previous fiscal year or the period since the issuer's incorporation, whichever is shorter). Securities Act, Rule 901(n)(1).
  - SUSMI, with respect to a class of the issuer's debt securities, means that the aggregate of an issuer's debt securities and non-participating preferred stock are held by 300 or more US persons of record; USD 1 billion or more of the aggregate of an issuer's principal amount outstanding of debt securities, the greater of liquidation preference or par value of non-participating preferred stock, and the principal amount or balance of asset-backed securities is held by US persons of record; and 20 percent or more of the aggregate of an issuer's principal amount outstanding of debt securities, the greater of liquidation preference or par value of non-participating preferred stock, and the principal amount or balance of asset-backed securities is held by US persons of record. Securities Act, Rule 901(n)(2).
- **US PERSON:** Includes natural persons residing in the United States; partnerships or corporations organized or incorporated under US law; estates that have US persons as executor or administrator; trusts that have US persons as trustee; agencies or branches of foreign entities located in the United States; nondiscretionary accounts (other than estates or trusts) held by a dealer or other fiduciary for the benefit or account of a US person; discretionary accounts (other than estates or trusts) held by a dealer or other fiduciary organized, incorporated, or residing in the United States; and partnerships or corporations organized or incorporated under foreign law but formed by a US person primarily for investing in non-registered securities (unless owned by accredited investors as defined in Rule 501(a) under the Securities Act).

  Defined in Rule 902(o) under the Securities Act as natural persons residing in the United States; partnerships or corporations organized or incorporated under US law; estates that have US persons as executor or administrator; trusts that have US persons as trustee; agencies or branches of foreign entities located in the United States; nondiscretionary accounts (other than estates or trusts) held by a dealer or other fiduciary for the benefit or account of a US person; discretionary accounts (other than estates or trusts) held by a dealer or other fiduciary organized, incorporated, or residing in the United States; and partnerships or corporations organized or incorporated under foreign law but formed by a US person

primarily for investing in nonregistered securities (unless owned by accredited investors as defined in Rule 501(a)).

- **3(c)(7) EXEMPTION:** A portion of the Investment Company Act of 1940 that permits the exclusion of investment companies from standard registration requirements with the SEC if all US investors are considered to be "qualified purchasers".
- **Rule 15(a)(6):** A rule under the Exchange Act which governs exemptions from registration and other actions in relation to certain foreign broker-dealers.
- **Rule 144:** Rule 144 under the Securities Act is a safe harbor which provides for a resale of "restricted" and "control" securities to the public, subject to a number of conditions including a holding period.
- **Rule 144A:** Rule 144A under the Securities Act provides a non-exclusive exemption from registration under the Securities Act for re-sales of securities of eligible issuers to eligible institutional investors in the United States. See page 32.
- **"4(a)(1)":** Section 4(a)(1) of the Securities Act provides for a resale of securities by a party other than the issuer to a sophisticated investor or investors which does not require registration under the Securities Act.
- **"4(a)(2)":** Section 4(a)(2) of the Securities Act provides for a private placement by the issuer, not involving a public offering, to a limited number of sophisticated investors in the United States which does not require registration under the Securities Act.
- **"4(a)(1½)":** A resale of restricted securities by a party other than the issuer to a sophisticated investor or investors in a transaction that would not be considered a "distribution" under the Securities Act, which does not require registration under the Securities Act.
- **"4(a)(3)":** Section 4(a)(3) of the Securities Act provides for a resale by a US or foreign securities dealer to investors in the United States, subject to certain limitations (including holding periods), which does not require registration under the Securities Act.
- **"4(a)(7)":** Section 4(a)(7) is a resale exemption available to shareholders or bondholders to accredited investors.
- **10b-5 letter:** A "negative assurance" letter provided by a US lawyer stating that nothing has come to the attention of the relevant law firm to cause the belief that the prospectus, as of certain dates, contained any untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading.

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