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One Year On: Electronic Settlement of Category 3, Regulation S Securities

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 U.S. domestic companies (as well as other companies that do not qualify as “foreign private issuers” under U.S. 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 (“**Euroclear**”). Due to the restrictions and requirements set out in Regulation S under the U.S. Securities Act of 1933, as amended (“**Regulation S**”), Category 3 Equity Securities had not been eligible for electronic settlement. As a result, these securities were issued, held and traded in certificated form for at least 6-12 months, at which time they could be dematerialized. The result had been longer settlement periods and significantly reduced liquidity, which had adverse effect on the price of the securities and on the desire of issuers to have them admitted to trading on AIM.

The electronic settlement procedures proposed by the LSE and Euroclear discussed below (and more fully in our original note available [here](#)) provide for settlement of both Category 3 Equity Securities and Category 3 Equity Securities that are also eligible for resale to “qualified institutional buyers” in the United States pursuant to Rule 144A (“**Rule 144A**”) under the U.S. Securities Act of 1933, as amended (“**Rule 144A Securities**”) and, together with Category 3 Equity Securities, “**Crest Restricted Securities**”).

Having been operational for over one year, it is clear that the procedures represent a step forward for U.S. issuers seeking to raise funds from UK institutional investors through an AIM; and the procedures do facilitate aftermarket trading by such investors. Problems remain, however, as neither resales by U.S. holders of the issuer’s securities nor resales by affiliates can be carried out directly through Crest. Secondary capital raisings by issuers and resales by affiliates are also complicated by the requirements of Category 3.

A Closer Look

Category 3 Equity Securities were historically not eligible for electronic settlement in CREST due to the applicable transfer restrictions and other required procedures set out in Regulation S, including:

1. during the distribution compliance period, various certifications and undertakings are required from a purchaser, including that it is not, and is not acquiring the securities for the benefit of, a U.S. Person (as defined in Regulation S);
2. the Category 3 Equity Securities must contain a legend setting out transfer and other restrictions; and
3. the issuer is legally obligated to refuse to register any transfer of the securities not made in accordance with the transfer restrictions.

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 U.S. Persons who are "qualified institutional buyers" (as defined in, and pursuant to, Rule 144A ("QIBs")), so long as the securities are eligible for offer and sale under Rule 144A and the transaction meets the additional requirements set out in Rule 144A.

How does it work?

In order to facilitate compliance with the restrictions imposed by U.S. federal securities laws, the electronic settlement procedures includes the following:

- appropriate identifiers which identify 'Reg S Cat 3' or 'Reg S Cat 3/Rule 144A' securities;
- access to the text of the legends and restrictions applicable under Category 3 and Rule 144A; and
- certifications and validation which prevent the settlement of prohibited transactions.

It is the responsibility of the issuer to monitor the distribution compliance period of the Crest Restricted Securities. The intended date of the end of the distribution compliance period may be provided for information purposes but lifting the restrictions will not be automatic. Crest Restricted Securities will continue to be treated as subject to the distribution compliance period until the issuer (or its nominated adviser) provides a request for removal of the restricted status.

Issuers often issue more than one tranche of securities under the same International Securities Identification Number ("ISIN"). As currently envisioned, it is not possible to have Crest Restricted Securities and securities that are not subject to the distribution compliance period under the same ISIN. As a result, if an issuer has removed the restrictions from a line of securities after the distribution compliance period has ended, and then would like to issue another tranche of Crest Restricted Securities, separate ISINs for each tranche would be necessary. In addition, as discussed below, resales by certain affiliates will trigger a new distribution compliance period and, potentially, the use of multiple ISINs.

Crest Restricted Shares held by affiliates and other parties will remain certificated

As a result of restrictions in respect of Crest Restricted Securities, the electronic settlement service is not available to affiliates (as defined in Rule 405 under the Securities Act) of the issuer of the Crest Restricted Securities.

In addition, due to the fact that Euroclear is not registered as a clearing agency in the United States, electronic settlement for Crest Restricted Securities is not be available to natural persons, companies or banks in the United States, or U.S. registered broker dealers.

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

Complications with resales by U.S. holders and affiliates

For purposes of the discussion below, resales of Category 3 Equity Securities are assumed to be made outside of the United States pursuant to Rule 903 or Rule 904 of Regulation S, as applicable.

As noted above, affiliates of the issuer and non-QIB U.S. Persons must hold their Crest Restricted Securities in certificated form. These securities cannot be sold, cleared and settled through Crest, which has a negative impact on their liquidity. Holders can, however, resell the securities in certificated form, at which point the securities can be dematerialized (assuming the purchaser is able to do so). As discussed below, however, there are a number of issues that complicate such sales and subsequent dematerializations.

Rule 144A Securities can be sold and resold through Crest to QIBs who are not affiliates of the issuer. However, given that U.S. Persons are not able to use the settlement procedures, QIBs can only purchase and hold Rule 144A Securities in Crest through a nominee or other structure, in which the holder has a Crest account and is able to make the necessary representations on behalf of the QIB.

Difficulty in engaging a willing broker for sales by non-institutional U.S. holders

U.S. broker-dealer rules restrict the activities that foreign broker-dealers may undertake in the United States without becoming subject to the broker-dealer registration requirements of the Securities Exchange Act of 1934.

As a result of these rules, non-U.S. brokers will not directly solicit non-institutional holders who are in the United States. To date, at least one such broker has been amenable to facilitating trades between such sellers and non-U.S. Persons, but only if the U.S. seller inquires with or contacts the non-U.S. broker directly. The non-U.S. broker holds the certificated securities for the period of time during which it attempts to find a buyer. If a buyer is found, the securities can be dematerialised and credited to the Crest account of the buyer (assuming the buyer is not an affiliate or a U.S. Person). Otherwise, the certificated securities will be returned to the seller. These will necessarily be one-off transactions and the details would be set out in the relevant documentation between the seller and the non-U.S. broker.

It is worth noting, however, that such transactions can be costly and time-consuming, with U.S. legal opinions likely being required by the non-U.S. broker. Furthermore, many non-U.S. brokers may still be unable or unwilling to engage non-institutional clients in the United States in order to facilitate the transactions. Given the costs, it is likely that larger trades, potentially by multiple sellers simultaneously, will be more efficient in terms of costs and time for both the sellers and the non-U.S. broker.

Such sales by non-institutional U.S. holders also raise other issues around the restricted nature of the securities and renewal of the distribution compliance period, as discussed below.

Sales by affiliates

Crest Restricted Securities sold by an affiliate of the issuer (excluding any person who is an affiliate solely by virtue of being an officer or director of the issuer) would trigger a new distribution compliance period.

Following the expiration of any applicable lock-up period, if an affiliate of the issuer (who is an affiliate for reasons other than being an officer or director) wishes to sell its securities at any point, including after the expiration of the original distribution compliance period, those securities would be sold pursuant to Rule 903 of Regulation S and would be subject to a new 12 month distribution compliance period. As a result, if the issuer plans to lift or has lifted the distribution compliance period restrictions for the Crest Restricted Securities, the securities sold by the affiliate must be given a separate ISIN if they have been dematerialized by the purchasers so that the distribution compliance period can remain in place for those securities until the end of the period. This would be true for each sale by any affiliate (who is an affiliate for reasons other than being an officer or director) for shares that have been dematerialized, and could theoretically result in the issuer's securities having multiple ISINs.

As a result, it may be that issuers may choose not to notify Crest that the distribution compliance period has ended, thereby leaving in place the restrictions within Crest, in order to avoid confusion for potential purchasers (particularly those purchasing from affiliates), to enable affiliates to sell Crest Restricted Securities more easily and to avoid triggering the requirement for multiple ISINs.

Rule 144 restrictions

Resales of Crest Restricted Securities by sellers who are affiliates solely by virtue of being an officer or director pursuant to Rule 904 of Regulation S would not trigger a new 12 month distribution compliance period but such securities sold by any affiliate would be "restricted securities" for purposes of Rule 144 under the Securities Act. The Rule 144 restricted securities could again be resold during the restricted period set out in Rule 144 either: (i) outside of the United States in "offshore transactions" pursuant to Regulation S; (ii) within the United States to QIBs pursuant to Rule 144A; or (iii) within the United States pursuant to an exemption under Rule 144.

For any subsequent resales of these securities under Rule 904 (assuming not made by an affiliate officer or director), the shares will retain the original Rule 144 restricted status but the 12 month period will continue running and will not restart upon resale.

In contrast to the distribution compliance period, which will be enforced through the Crest procedures, the Rule 144 restricted status of the securities should initially be disclosed to the purchasers of the securities and any subsequent purchasers must be made aware of such restrictions until the end of the Rule 144 restricted period.

What are the options for issuers?

Due in large part to the illiquidity of certificated stock, the potential for additional 12 month distribution compliance periods and the Rule 144 "restricted" status of the securities, resales by U.S. Persons and affiliates of securities issued by U.S. domestic companies that are admitted to trading on AIM is difficult. Given the inability of most of these trades to occur through the Crest system, one potential solution would be to pursue a "block trade" trade transaction, facilitated by a UK broker, to purchasers in transactions pursuant to Regulation S. Such a transaction may include multiple sellers and multiple purchasers and could more easily include the sale of certificated securities. Although the issues around the "restricted" status and the distribution compliance period would remain, identifying purchasers willing to acquire certificated stock (and potentially dematerialize the stock post-acquisition) may be more realistic through such a transaction. This type of sell-down may be conducted alongside a follow-on fundraising by the issuer to non-U.S. Persons, thereby aligning the distribution compliance period and restricted periods for the newly issued and resold securities.

However, so long as the issuer of the Crest Restricted Securities is a U.S. domestic issuer, resales of certificated securities by U.S. Persons and affiliates will be difficult, and liquidity of the issuer's securities will be more limited than would be expected for a foreign private issuer with a London listing. Therefore, it may be that an initial fundraising through AIM by a U.S. domestic issuer is considered to be an interim step. Depending on the trajectory and growth of the company, the issuer may consider restructuring such that it becomes a foreign private issuer for purposes of U.S. federal securities laws or moving the location of the issuer's listing.

Health Warning

It is worth noting that there has been no definitive guidance from the U.S. Securities and Exchange Commission (the "SEC") as to whether the proposed solution meets the necessary standard for compliance with U.S. federal securities law. On 8 December 2016, however, the SEC did provide guidance relating to the new procedures through its Compliance and Disclosure Interpretations ("CD&Is"), which comprise the staff interpretations of the rules adopted under the Securities Act. This guidance is provided in full below:

"Question: Can the certification and agreement required under Regulation S (such as those required under Category 3 and those required with respect to warrants) be provided electronically?

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Answer: There are no specific requirements under Regulation S relating to the manner in which certifications and agreements are made. As a result, issuers and distributors may use electronic procedures to obtain the certifications and agreements. Such processes may be implemented by third parties and issuers and distributors may rely on those procedures to the same extent and in the same manner as when certifications and agreements are obtained in paper."

Although this guidance is useful, it does not amount to a sign-off by the SEC of the electronic procedures discussed in this note. The SEC specifically states that the interpretations presented in the CD&Is "reflect the views of the staff of the Division of Corporation Finance. They are not rules, regulations, or statements of the Commission. Further, the Commission has neither approved nor disapproved these interpretations."

Advice from U.S. legal counsel therefore should be sought in the event that an issuer of Crest Restricted Securities seeks to have such securities admitted to trading on AIM.

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