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Painting Bridges and Filling Potholes: The SEC and Congress Finally Address Infrastructural Problems in the Secondary Markets for the Securities of Private Companies

On 4 December 2015, President Obama signed into law the Surface Transportation Reauthorisation and Reform Act of 2015 (H.R. 3763, or the "Transportation Act"). Ordinarily, legislation of this nature would be unlikely to arouse attention, much less interest, by participants in the capital markets; but among the various and sundry provisions of the Transportation Act are those containing reforms proposed by the Securities Exchange Commission and congressional committees in relation to capital raising by, and secondary market transactions in the securities of, private start-up and emerging growth companies.

The reforms fall into two principal categories[1]:

- improving access to capital for so-called emerging growth companies ("EGCs"), which were created under the JOBS Act (See our Client Briefings of May 2012 here and September 2012 here); and

- reforming access for investments in start-up enterprises, which codifies the long-standing practice in secondary trades among sophisticated investors known as "Section 4(a)(1½)" transactions.

In relation to the former, we summarise below the key amendments to the provisions of the JOBS Act, which we believe are of limited benefit to companies that are formed in, and principally held by residents of, jurisdictions outside of the United States ("Foreign Private Issuers" or "FPIs"). In relation to the latter, we dedicate a bit more time contextualising the changes in relation to secondary market practice and the other resale transactions that are exempt from the registration requirements of the US Securities Act of 1933, as amended (the "Securities Act").

[1] The Transportation Act also makes provision for the modernisation and simplification of disclosure under the US Securities Exchange Act of 1934, as amended (specifically Form 10-K, Form S-1, and Regulation S-K thereunder) in relation to EGCs, accelerated filers, smaller reporting companies and other smaller issuers, as well as for the SEC to conduct a study and advise on the requirements contained in Regulation S-K to determine how best to modernise and simplify them. The SEC is required to submit a report on its findings within 360 days from the date of the enactment of the Transportation Act.

Improving Access to Capital for EGCs

The provisions established to improve access to capital for EGCs are as follows:

- EGCs will be allowed more time to prepare or amend its disclosure in advance of investor roadshows before it must publicly file its confidential submission (the deadline has been changed from 21 to 15 days);

- Any company that ceases to qualify as an EGC ***after*** it has submitted a confidential registration statement or publicly filed a registration statement under the provisions of and otherwise in compliance with the JOBS Act will be deemed to maintain its EGC status through the consummation of its IPO, or for a period of one year from the date such company no longer qualified as an EGC, whichever occurs first; and

- A registration statement submitted for confidential review or publicly filed with the SEC may omit financial information for historical periods otherwise required under the disclosure rules, so long as (i) the issuer reasonably believes that such information will not be required in the registration statement at the time of the contemplated offering, and (ii) the registration statement is amended to include all required financial information before a preliminary prospectus or pathfinder is distributed to prospective investors.

Reforming Access for Investments in Start-up Enterprises

We consider these reforms to be of more interest to FPIs and their shareholders/bondholders, as well as to certain financial intermediaries and legal practitioners involved in cross-border corporate finance transactions, as they represent a significant improvement in obtaining greater legal certainty in relation to secondary trades in the securities of private companies (i.e., issuers which have offered and sold their securities to investors in the United States in reliance on an exemption from the registration requirements of the Securities Act), irrespective of their size. Such unregistered securities are treated as "restricted" securities[2] and, in the absence of another less onerous exemption[3], are typically resold in the US secondary market for such securities pursuant to the resale exemption provided under Rule 144A under the Securities Act, or in a "Section 4(a)(1½)" transaction.[4]

Rule 144A has become a fundamental component of private placements of securities with U.S. 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 U.S. private offering market through financial intermediaries which have U.S. 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 U.S. 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.

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[2] Restricted securities include securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering in the United States.

[3] 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.

[4] This was formerly (and is 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.

In some cases, however, it may be difficult or impossible to conduct a resale of unregistered securities in accordance with Rule 144A. 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, 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.

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.

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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 Exemption: Section 4(a)(7)

The Transportation Act adds new subsection (a)(7) to Section 4 of the Securities Act, and is aimed at codifying the "Section 4(a)(1½)" transaction.[5] 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;
- In the event that the issuer of the securities is neither a SEC-reporting company nor exempt from reporting under Section 12g3-2(b)[6], 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
- 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 U.S. 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.

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

[6] 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.

Conclusion and Health Warning

We believe that new Section 4(a)(7) is a long-overdue development for the establishment of greater legal certainty in secondary market transactions involving unregistered securities in the United States. We expect this will facilitate the growth of that market and will be received with enthusiasm by accredited investors and the facilitators of such trading.

It bears repeating that Section 4(a)(7) is not available as a resale alternative for financial intermediaries which act, or which are deemed under the US federal securities laws to act, as underwriters. In such cases, Rule 144A will remain the way forward for the time being.

IF YOU HAVE ANY QUESTIONS IN RELATION TO THIS LEGAL BRIEFING, OR OTHER MATTERS INVOLVING PRIVATE PLACEMENTS UNDER THE US FEDERAL SECURITIES LAWS, PLEASE DO NOT HESITATE TO CONTACT:

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