LATHAM & WATKINS LLP

The Latham FPI Guide

Accessing the US Capital Markets From Outside the United States

2025 Edition

The Latham FPI Guide: Accessing the US Capital Markets From Outside the United States

Fabry-Pérot Interferometer, SA is a highly successful non-US company known to the world as FPI. FPI is considering doing a debt or equity offering in the United States. What are the key legal issues it, and its underwriters or financial advisors, are likely to face? This book was written to help answer that question. Our aim is to help the FPIs of the world and their investment bankers understand better the regulatory regime applicable to capital-raising activities in the United States.

US regulation of securities offerings is quite complex and may appear overwhelming to an issuer accessing the US capital markets for the first time. In order to make the maze of US regulations a bit more manageable, we have chosen in this book to focus only on those aspects of US law that, in our experience, are most relevant to US capital markets transactions involving non-US companies. Taking this approach means we have had to be selective – for example, we do not address the separate regimes that apply to offerings by certain Canadian-domiciled issuers, non-US governments, and registered investment companies. And we do not attempt to provide a detailed analysis of every legal issue or every regulatory regime (such as, for example, those that may apply to companies engaged in business in highly regulated areas like banking, communications, or utilities) that a non-US company may face. But we think our approach strikes the appropriate balance between a simple issues outline and a typical multi-volume treatise and, as such, hope you will find this book to be a useful – and more user-friendly – resource for those wishing to enter and navigate these waters.

Before we delve further into our topic, just an additional word about format. We have included various “Practice Points” throughout the book to highlight certain key items we think are helpful to keep in mind as the proposed transaction takes shape and you begin to formulate your strategy. As a necessary evil, we have also included extensive endnotes, which include references to the primary source materials and are quite handy when trying to recall the basis for, or evolution of, a particular position. (Of course, the underlying statutes, rules, regulatory interpretations, and the like are subject to change and should always be consulted anew for each proposed transaction, and this book should not be relied on as providing definitive advice with respect to any particular transaction or situation.)

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CHAPTER 1

Background

There are a few primary federal statutes that we will be talking a lot about in this guide. Here is a summary to get things started.

US Securities Act of 1933; US Securities Exchange Act of 1934

The two Depression-era US federal statutes at the center of our discussion are the US Securities Act of 1933 and the US Securities Exchange Act of 1934. The Securities Act generally governs the initial offer and sale of securities in the United States, while the Exchange Act generally regulates the post-issuance trading of securities, the activities of public companies, including reporting obligations and M&A transactions, and the activities of certain market participants (such as underwriters).

The US Securities and Exchange Commission, the regulatory body in charge of the Securities Act and the Exchange Act, has issued a comprehensive body of rules and regulations under those Acts that have the force of law. The SEC and its Staff have also provided interpretive guidance on a wide range of questions under the securities laws.

JOBS Act

In April 2012, the Jumpstart Our Business Startups Act became law. The JOBS Act made significant changes to the IPO process and other aspects of the US securities laws. Above all, it created a new category of issuer, called an emerging growth company, or EGC. EGCs benefit from a transition period, or on-ramp, from private to public company. Non-US companies can be EGCs, and we discuss the JOBS Act in more detail below.

Foreign Private Issuers

The reference to “issuer“ means an entity (a corporation, a plc, an SA, an SE, an SpA, an AG, or any of a myriad other types of business organizations) that issues securities (presumably in the US capital markets) while the reference to “private” is only designed to draw a distinction with foreign governmental (i.e., “public interest“) entities – it has nothing to do with the difference between publicly traded and privately held companies. Importantly, a non-US company that is publicly traded can still be a foreign private issuer.

We’ll start with some basic concepts – what is a foreign private issuer and how does it differ from its US domestic relative?

What Is a “Foreign Private Issuer”?

A foreign private issuer is an entity (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside of the US unless:[1]

- more than 50% of its outstanding voting securities are directly or indirectly owned of record by US residents; and
- any of the following applies:
  - the majority of its executive officers or directors are US citizens or residents;

– more than 50% of its assets are located in the United States; or

– its business is administered principally in the United States.

> PRACTICE POINT
>
> An issuer that has more than 50% US ownership can still be a foreign private issuer. To fail to qualify as a foreign private issuer, a company needs to be both majority owned by US residents and meet any one of the three additional tests noted above.

How Is US Ownership of Record Determined?

In order to determine the percentage of outstanding voting securities held "of record" by US residents, a company should begin with a review of the addresses of its security holders in its records.[2] But the inquiry does not end there. In particular, the company first needs to look through institutional custodians (such as the Depository Trust Company, or DTC, and its nominee, Cede & Co.) and other commercial depositories (such as Euroclear and Clearstream) to identify participants in those systems (such as broker-dealers, banks, and nominees). Then, it must drill down beyond certain "street name" accounts – that is, accounts held of record by a broker-dealer, bank, or nominee located in:[3]

- the United States;
- the company's jurisdiction of incorporation; and
- the jurisdiction that is the company's primary trading market for its voting securities (if different than the jurisdiction of incorporation).

In the case of these securities, the number of separate accounts for which the securities are held should be counted.[4]

A company may rely in good faith on the information supplied by the broker-dealer, bank, or nominee.[5] If, after reasonable inquiry, the company is unable to obtain information about the amount of securities represented by accounts of customers resident in the United States, it may assume that these customers are residents of the jurisdiction in which the nominee has its principal place of business.[6]

When Is Foreign Private Issuer Status Determined and What Are the Consequences of Gaining or Losing That Status?

Under the foreign private issuer definition, for a company that is registering with the SEC for the first time, the determination of whether an issuer qualifies as a foreign private issuer is made as of a date within 30 days prior to the filing of the initial registration statement.[7] Thereafter, it must test its status annually, at the end of its most recently completed second fiscal quarter.[8]

Once a company qualifies as a foreign private issuer after the relevant test date, it is immediately able to use the forms and rules designated for foreign private issuers. For example, a company that reports as a domestic US issuer but subsequently determines that it qualifies as a foreign private issuer as of the end of its second fiscal quarter would no longer need to continue making Form 8-K and Form 10-Q filings for the remainder of that fiscal year. Instead, it could immediately begin furnishing reports on Form 6-K and would file an annual report on Form 20-F (rather than Form 10-K).

By contrast, if an issuer does not qualify as a foreign private issuer at the end of its second fiscal quarter, it nonetheless remains eligible to use the forms and rules for foreign private issuers until the end of that fiscal year – in other words, it does not lose its status as a foreign private issuer until the first day of the next fiscal year. Once an issuer fails to qualify as a foreign private issuer, it will be treated as a domestic US issuer unless and until it requalifies as a foreign private issuer as of the last business day of its second fiscal quarter.

Take the example of a calendar year company that does not qualify as a foreign private issuer as of the end of its second fiscal quarter in 2025. It would not become subject to quarterly reporting on Form 10-Q during 2025. However, it would be required to file its annual report on Form 10-K in 2025 in respect of its 2025 fiscal year on the same timetable as a domestic US company. It would also become subject to the proxy rules, reporting of beneficial ownership of securities by officers, directors, and beneficial owners of more than 10% of a class of equity securities of the issuer, and reporting on Form 8-K and Form 10-Q as of the first day of 2026.[9]

What Are Some of the Benefits of Being a Foreign Private Issuer?

Foreign private issuers are allowed a number of key benefits not available to domestic US issuers, including the following:

Ability to Use US GAAP, IFRS, or Local GAAP

Domestic US issuers must file financial statements with the SEC in accordance with US generally accepted accounting principles.[10] The financial statements of foreign private issuers, however, may be prepared using US GAAP; International Financial Reporting Standards, or IFRS; or home-country generally accepted accounting principles (local GAAP).[11] In the case of foreign private issuers that use the English-language version of IFRS as issued by the International Accounting Standards Board, or IASB IFRS, no reconciliation to US GAAP is needed.[12] By contrast, if local GAAP or non-IASB IFRS is used, the consolidated financial statements (both annual and required interim statements in a prospectus) must include information in a footnote that provides a reconciliation to US GAAP.[13]

Quarterly Reporting on Form-10-Q Not Required; Current Reporting on Form 8-K Not Required

Unlike domestic US issuers, foreign private issuers are not required to file quarterly reports (including quarterly financial information) on Form 10-Q.[14] They also are not required to use Form 8-K for current reports, and instead furnish (not file) current reports on Form 6-K with the SEC.[15] Some foreign private issuers, however, choose (or are required by contract) to file the same forms with the SEC that domestic US issuers use. In that case, they must comply with the requirements of the forms for domestic issuers (and would file quarterly reports on Form 10-Q and current reports on Form 8-K, in addition to annual reports on Form 10-K).[16] However, they may file financial statements prepared under IASB IFRS or in local GAAP with a reconciliation to US GAAP.[17]

Financial Information Goes "Stale" More Slowly

The SEC's rules also allow a foreign private issuer's registration statement to contain financial information that is of an earlier date than that allowed for domestic US issuers. In particular, foreign private issuers can omit interim unaudited financial statements if a registration statement becomes effective within nine months after the end of the last audited fiscal year (unless the issuer has already published more current interim financial information).[18] After that time, a foreign private issuer must provide interim unaudited financial statements (which may be unaudited) covering at least the first six months of the fiscal year, together with comparative financial statements for the same period in the prior year.[19]

Exempt From Proxy Rules

Foreign private issuers are exempt from the US proxy rules (which specify the procedures and required documentation for soliciting shareholder votes).[20]

Exempt From Regulation FD

Regulation FD provides that when a domestic US issuer, or someone acting on its behalf, discloses material nonpublic information to certain persons (including securities analysts, other securities market professionals, and holders of the issuer's securities who could reasonably be expected to trade on the basis of the information), it must make simultaneous public disclosure of that information (in the case of intentional disclosure) or prompt public disclosure (in the case of non-intentional disclosure). Foreign private issuers are exempt from Regulation FD.[21]

> PRACTICE POINT
>
> Several recent rulemakings have eroded the SEC's historical practice of providing accommodations to FPIs that defer to home country disclosure and governance practices. This has resulted in additional and unfamiliar compliance burdens for FPIs. In particular, FPIs should have controls in place to comply with rules that have recently taken effect requiring them to track trading by insiders[22] and recover erroneously paid incentive-based compensation in the event of a restatement.[23]

> PRACTICE POINT
>
> Foreign private issuers that file reports with the SEC typically choose to comply with Regulation FD (at least in part), particularly since the restrictions in their home jurisdictions in many cases overlap with Regulation FD's requirements.

> PRACTICE POINT
>
> Regardless of the exemption from Regulation FD, foreign private issuers remain exposed to potential liability from selective disclosure, for example from "tipping" securities analysts or selected shareholders.

Affiliates, Directors, and Officers Are Exempt From Beneficial Ownership Reporting and Short-Swing Profit Recapture Rules

Under Section 16(a) of the Exchange Act, anyone who owns more than 10% of any class of equity security registered under the Exchange Act, or who is an officer or director of an issuer of such a security, must publicly file a statement of beneficial ownership with, and publicly report changes in beneficial ownership to, the SEC. In addition, Section 16(b) requires any such shareholder, officer, or director to disgorge to the issuer profits realized on purchases and sales within any period of less than six months. Securities of foreign private issuers are exempt from Section 16.[24]

Have More Time to File Annual Reports

Annual reports on Form 10-K by domestic US issuers are due within 60, 75, or 90 days after the end of the issuer's fiscal year, depending on whether the company is a "large accelerated filer," "accelerated filer," or a non-accelerated filer.[25] By contrast, the deadline for foreign private issuers to file annual reports on Form 20-F is four months after the end of their fiscal year.[26]

Exempt From Certain Aspects of Sarbanes Oxley

The US Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) made broad revisions to the US federal regulation of public companies and their auditors. Although the Act itself generally did not distinguish between domestic US issuers and foreign private issuers, the SEC has, in its rules implementing Sarbanes-Oxley, made a number of significant exemptions for the benefit of foreign private issuers.

Ability to Follow Home-Country Governance Practices

Foreign private issuers can follow home-country governance practices as long as the differences between those practices and US practices are disclosed to investors.[27]

Registered and Unregistered Offerings

The Securities Act requires registration with the SEC of any transaction involving the offer or sale of a security, unless the security is of a type that is exempt from registration or the transaction is structured to take advantage of an available exemption from registration. The terms "offer," "sale," and "security" are very broadly defined.

As we discuss in more detail below, registered transactions involve filing a registration statement with the SEC and meeting detailed disclosure and financial statement requirements. In addition, registered transactions trigger the wide-ranging provisions of Sarbanes Oxley and a comprehensive liability scheme.

By contrast, the requirements of unregistered transactions are generally – but not invariably – less demanding. A foreign private issuer will not typically become subject to Sarbanes-Oxley merely by issuing securities in an unregistered transaction, and the liability regime governing unregistered transactions is more circumscribed.

The decision whether to issue securities in a registered or unregistered transaction involves balancing business, timing, and legal objectives. Broadly speaking, registered transactions are more complex, time-consuming, and carry greater liability risks. However, not all securities issuances can take the form of an unregistered transaction. For example, if a foreign private issuer wishes to list its securities on a US securities exchange, or to make a public offering of securities to retail investors in the US, the transaction will have to be registered.

ENDNOTES

1 Securities Act Rule 405; Exchange Act Rule 3b-4.

2 Instruction to paragraph (c)(1) of Exchange Act Rule 3b-4; Instructions to paragraph (1) of the definition of "Foreign private issuer" in Securities Act Rule 405. Note that these instructions send the reader to Exchange Act Rule 12g3-2(a), which in turn refers to Exchange Act Rule 12g5-1.

3 Instruction to paragraph (c)(1) of Exchange Act Rule 3b-4; Instructions to paragraph (1) of the definition of "Foreign private issuer" in Securities Act Rule 405.

4 Exchange Act Rule 12g3-2(a)(1).

5 *Id*.

6 Instruction (i) to paragraph (c)(1) of Exchange Act Rule 3b-4; Instruction (b) to paragraph (1) of the definition of "Foreign private issuer" in Securities Act Rule 405. *Cf. Final Rule: International Disclosure Standards,* Release No. 33-7745 (Sept. 30, 2000) at II.E (issuer may rely on a presumption that customer accounts are held in the nominee's principal place of business if the nominee's charge for supplying the information would be unreasonable).

7 Securities Act Rule 405, clause (2); Exchange Act Rule 3b-4(d).

8 Securities Act Rule 405, clause (3); Exchange Act Rule 3b-4(e).

9 *See* SEC Division of Corporation Finance, *Financial Reporting Manual,* Section 6120.2 [*Financial Reporting Manual*]

10 *See* Regulation S-X (S-X) Rule 4-01(a)(1) (financial statements of domestic US issuers not prepared in accordance with "generally accepted accounting principles" are presumed to be misleading or inaccurate); *see also Financial Reporting Manual*, Section 1410.1 (US domestic issuers must follow Regulation S-X and US GAAP).

11 S-X Rule 4-01(a)(2).

12 *Final Rule: Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Accounting Standards Without Reconciliation to US GAAP*, Release No. 33-8879 (Dec. 21, 2007) [*IFRS Reconciliation Release*]; *see also Financial Reporting Manual*, Section 6310.1. In this case, the accounting policy footnote must state compliance with IASB IFRS, and the auditor's report must opine on compliance with IASB IFRS. *Financial Reporting Manual*, Section 6310.2.

13 *See* Form 20-F, Items 17(c), and 18.

14 Exchange Act Rule 13a-13(b)(2).

15 *See* Exchange Act Rule 13a-11(b); *see also* Exchange Act Rule 13a-16(c) (reports on Form 6-K are furnished, not filed).

16 *See Financial Reporting Manual*, Section 6120.1 (if a foreign private issuer elects to do so, "it must comply with all the requirements of the 'domestic company' forms").

17 *See id.* Section 5120.6.

18 *See* Form 20-F, Item 8.A.5; *Financial Reporting Manual*, Sections 6220.1, 6220.6.

19 *See* Form 20-F, Item 8.A.5.

20 Exchange Act Rule 3a12-3(b).

21 Regulation FD, Rule 101(b)(ii).

22 *See* our Client Alert *Amended Rule 10b5-1 and New Insider Trading Disclosure: Frequently Asked Questions* (Jan. 23, 2023) and Item 6.F of Form 20-F.

23 *See* the discussion of Incentive-Based Compensation Clawbacks in the chapter "The US Sarbanes-Oxley Act" and Item 6.F of Form 20-F.

24 Exchange Act Rule 3a12-3(b). These securities remain subject to the beneficial ownership reporting requirements of Exchange Act Sections 13(d) and 13(g).

25 *See* Form 10-K, General Instruction A(2); *see also* Exchange Act Rule 12b-2 (defining the terms "large accelerated filer" and "accelerated filer").

26 Form 20-F, General Instruction A(b).

27 *See* NYSE Listed Company Manual 303A.00, Nasdaq Rule 5615(a)(3), Form 20-F, Item 16G.

CHAPTER 2

Unregistered Global Offerings – Regulation S, Rule 144A, and Traditional Private Placement Transactions

Global offerings that are not registered in the United States with the SEC are typically structured to take advantage of a combination of exemptions. The portion of the transaction sold to investors outside the United States will be designed to comply with the safe harbor for offshore transactions provided by Securities Act Regulation S. At the same time, the portion sold to US investors will be structured to comply with the safe harbor of Securities Act Rule 144A for resales to certain large US institutional investors known as qualified institutional buyers, or QIBs, or (generally for smaller transactions), the private placement exemptions of Section 4(a)(2) of the Securities Act, or Securities Act Regulation D.

We discuss these exemptions below.

Regulation S – Background

Regulation S provides a safe harbor from Securities Act registration requirements for certain offerings outside the United States and offshore resales of securities. If the conditions of Regulation S are met, the transaction is deemed to take place outside the United States and hence does not trigger the registration requirements of Section 5 of the Securities Act.[1]

All Regulation S transactions start with the same basic requirements, set out in Rule 903. Then Regulation S layers on additional restrictions depending on the nature of the issuer.

The basic requirements (we refer to them below as the Regulation S Basic Conditions) are that:

- the offer or sale must be made in an "offshore transaction;" and
- there must be no "directed selling efforts" in the United States.

An "offshore transaction" is defined as an offer that is not made to a person in the United States, and either:[2]

- at the time the buy order is originated, the buyer is outside the United States, or the seller (and any person acting on the seller's behalf) reasonably believes that the buyer is outside of the United States;
- for purposes of the issuer safe harbor, the transaction is executed in, on, or through the physical trading floor of an established foreign securities exchange located outside of the United States (this would be a rare occurrence today); or
- for purposes of the resale safe harbor, the transaction is executed in, on, or through the facilities of a designated offshore securities market, and neither the seller (nor any person acting on the seller's behalf) knows that the transaction has been prearranged with a buyer in the United States.

The term "directed selling efforts" is defined broadly to include any activities that have, or can reasonably be expected to have, the effect of conditioning the market in the United States for the securities being offered in reliance on Regulation S.[3] Prohibited efforts include mailing offering materials into the United States, conducting promotional seminars in the United States, granting interviews about the offering in the United States (including by telephone), or placing advertisements with radio or television stations broadcasting in the United States.[4] Importantly, selling activities in the United States in connection with concurrent US offerings –

whether registered or exempt – do not constitute directed selling efforts.[5] More generally, offshore transactions in compliance with Regulation S are not integrated with registered or exempt US domestic offerings.[6]

Regulation S Safe Harbor for Sales by an Issuer, Underwriter, or Affiliate

Rule 903 of Regulation S provides a safe harbor for sales by issuers, "distributors" (essentially, entities that act as underwriters for the issuer) and most affiliates of the issuer (other than certain officers and directors). Bear in mind that the term "affiliate" is defined very broadly, and it is not always simple to determine precisely who is and who is not an affiliate.

Under Rule 903, there are three levels or "categories" of requirements, with Category 1 being the least burdensome and Category 3 being the most restrictive.

Category 1

Category 1 has no requirements other than the Regulation S Basic Conditions. It is available for:

- securities offered by foreign issuers[7] who reasonably believe at the commencement of the offering that there is no "substantial US market interest"[8] in the securities offered;
- securities offered and sold in an "overseas directed offering;"[9]
- securities backed by the full faith and credit of a foreign government; or
- securities offered and sold pursuant to certain employee benefit plans established and administered under the laws of a foreign country.

> PRACTICE POINT
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> Even if Category 1 is available, market practice for debt offerings is often to follow Category 2 restrictions where there is a concurrent Rule 144A offering.

Category 2

Category 2 covers securities that are not eligible for Category 1 and that are either (1) equity securities[10] of a foreign issuer that is a reporting company under the Exchange Act or (2) debt securities[11] of Exchange Act reporting issuers (domestic or foreign) and non-reporting foreign issuers. Category 2 (and Category 3) contain additional restrictions not found in Category 1, including restrictions against offers and sales to "US persons," which are defined as individuals who are resident in the United States, and corporations and other entities formed under US law, subject to a long list of exclusions and inclusions covering specific circumstances.

Issuers in Category 2 may take advantage of the safe harbor if the following conditions are met along with the Regulation S Basic Conditions:

- Certain "offering restrictions"[12] must be adopted, including:
  - Each distributor must agree in writing that all offers and sales during a 40-day distribution compliance period may be made only in accordance with safe harbors under Regulation S, pursuant to registration under the Securities Act, or an exemption from registration.
  - Prospectuses, advertisements, and all other offering materials and documents (other than press releases) used in connection with offers and sales during the distribution compliance period must disclose that the securities are not registered under the Securities Act and cannot be sold in the United States or to US persons (other than distributors) unless so registered or an exemption from registration is available.[13]

- During the 40-day distribution compliance period, offers and sales of the security cannot be made to a US person other than a distributor.
- Any distributor selling securities to another distributor, dealer, or person receiving a selling commission must deliver, during the 40-day distribution compliance period, a confirmation or notice to the purchaser stating that the purchaser is subject to the same resale restrictions as the distributor.

The 40-day distribution compliance period begins on the later of the date of the closing or the date on which securities were first offered to persons other than distributors (generally, the pricing date).[14]

Category 3

Category 3 is a catch-all and has the most restrictive conditions. It includes all securities that are not eligible for Category 1 or 2, such as any securities of a non-reporting domestic US issuer, equity securities of a reporting domestic US issuer, and equity securities of a non-reporting foreign issuer (with substantial US market interest in the equity securities of that issuer). In addition to the Regulation S Basic Conditions, an issuer must also meet the following requirements:

- Each of the offering restrictions described above for Category 2 must be met,[15] except that a one-year distribution compliance period (or six-month distribution compliance period for reporting issuers) applies to offerings of equity securities and a 40-day distribution compliance period applies to offerings of debt securities.
- During the applicable distribution compliance period, offers or sales cannot be made to a US person other than a distributor (although exempt sales, such as those pursuant to Rule 144A, may be made) and, in the case of equity securities:
  - the purchaser (other than a distributor) must certify that it is not a US person;
  - the purchaser must agree to resell the securities only in accordance with Regulation S, pursuant to registration under the Securities Act, or an exemption from registration; and
  - certain other restrictions must be satisfied, including a prohibition against corporate registration of transfers not made in accordance with Regulation S.
- Debt securities generally must be represented upon issuance by a temporary global security not exchangeable for definitive securities until the expiration of the 40-day distribution compliance period and, for persons other than distributors, until certification of beneficial ownership by a non-US person.
- Any distributor selling the securities to another distributor, dealer, or person receiving a selling commission must deliver, during the applicable distribution compliance period, a notice or confirmation to the purchaser stating that the purchaser is subject to the same resale restrictions as the distributor.

> PRACTICE POINT
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> Equity securities issued by a domestic US issuer (whether reporting or non-reporting) pursuant to Regulation S are considered “restricted securities”[16] subject to limitations on resale, and they remain restricted securities even after an exempt resale pursuant to Regulation S.[17] As a practical matter, these restrictions have limited the use of Regulation S for exempt sales of equity securities by domestic US issuers.

PRACTICE POINT

A foreign private issuer that is a reporting issuer with the SEC may be required to furnish a copy of an offering memorandum relating to a Regulation S offering on Form 6-K (if, for example, it files that offering memorandum with a stock exchange on which its securities are listed, and the exchange makes the offering memorandum public). This will generally not constitute directed selling efforts.[18]

PRACTICE POINT

The safe harbors of Regulation S are not exclusive and parties may use any other applicable exemptions provided by the Securities Act.[19] Regulation S only applies to the registration requirements of the Securities Act and does not limit the applicability of the US federal antifraud laws or any state laws relating to securities offerings.[20]

Consequences of Not Following the Regulation S Safe Harbor Conditions

The consequences of a breach of the conditions for use of Regulation S could be significant, since this would potentially allow buyers of the securities to rescind their purchases.[21] If an issuer, distributor, any of their respective affiliates, or any person acting on their behalf fails to comply with the Regulation S Basic Conditions, then the issuer safe harbor will not be available to any person in connection with the offer or sale of the securities. However, if any of these persons fails to comply with any of the other issuer safe harbor requirements (in other words, other than the Regulation S Basic Cotnditions), then only the party who fails to comply (as well as its agents and affiliates) will be unable to rely on the issuer safe harbor exemption. In that case, the fact that there may have been a breach on the part of the issuer or distributor, or their affiliates or agents (other than certain officers or directors relying on the resale exemption) does not generally negate a resale safe harbor exemption for an unaffiliated person.[22]

Rule 144A Transactions

Although market participants often refer to Rule 144A offerings, as a technical matter most Rule 144A transactions involve two steps. These are sales to initial purchasers under an exemption such as Regulation S or Regulation D (discussed below), followed by resales to QIBs under Rule 144A. As a result, Rule 144A transactions follow various limitations not found directly in Rule 144A itself as well as the explicit requirements of Rule 144A.

PRACTICE POINT

Securities purchased under Rule 144A are deemed restricted securities and can only be resold pursuant to Rule 144A or another exemption (including the Regulation S resale safe harbor described below).[23]

Rule 144A Requirements

The requirements for a valid Rule 144A transaction include:

- *Sales to QIBs*: the securities must be offered and sold only to QIBs or to a person who the seller (and any person acting on its behalf) “reasonably believes” is a QIB;

- *Notice to buyers*: the seller (and any person acting on its behalf) must take "reasonable steps" to ensure that the buyer is aware that the seller may be relying on Rule 144A (generally by so noting either in the offering memorandum or, in the case of an undocumented offering, in the trade confirmation);
- *Fungibility*: the securities must not be, when issued, of the same class as securities listed on a US national securities exchange (or, in the case of convertible or exchangeable securities, have an effective conversion premium of 10% or more); and
- *Information delivery*: if the issuer is a reporting company under the Exchange Act or is exempt from reporting under Exchange Act Rule 12g3-2(b), a seller wishing to resell the securities is not obligated to furnish the purchaser with information concerning the issuer. However, if the issuer is not a reporting company and is not exempt under Exchange Act Rule 12g3-2(b), a holder or the purchaser must have the right to obtain from the seller or the issuer, upon request, certain minimal "reasonably current" information concerning the business of the issuer and its financial statements.

General Solicitation

As revised pursuant to Title II of the JOBS Act, Rule 144A(d)(1) requires simply that securities must be sold – not *offered* and sold, as under Rule 144A as in effect prior to the JOBS Act – only to QIBs or to purchasers that the seller and any person acting on behalf of the seller reasonably believe are QIBs. As a result, the Rule 144A exemption is now available even where general solicitation is actively used in the marketing process or has occurred inadvertently.

Definition of QIB

A QIB is defined in Rule 144A to include any of the following entities acting for its own account or the account of other QIBs that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the QIB:

- corporations, partnerships, and business trusts;
- US-regulated insurance companies;
- investment companies registered under the US Investment Company Act of 1940;
- small business investment companies licensed by the US Small Business Administration;
- certain employee benefit plans;
- certain trusts;
- certain tax-exempt organizations;
- certain registered investment advisers;
- certain registered broker-dealers;
- US banks and savings and loan associations, and non-US banks, savings and loan associations, and equivalent institutions; and
- Accredited Institutional Investors as defined in Securities Act Rule 501(a) that are not otherwise defined in Rule 144A.

A/B Exchange Offers

Rule 144A is particularly popular for global offerings of non-convertible debt securities. On occasion, a Rule 144A debt offering will include registration rights under which QIBs can effectively swap their Rule 144A securities, which are not freely tradeable, with identical but SEC-registered debt securities. This swap is allowed under a line of SEC Staff no-action letters that permits issuers who have sold debt securities to QIBs pursuant to Rule 144A subsequently to register an exchange offer of identical securities for the Rule 144A securities.[24] This procedure allows QIBs, subject to limited exceptions, to obtain freely tradable registered securities in exchange for the restricted, legended securities they obtained in the Rule 144A offering. Because the exchange offer will go through the SEC registration process, most issuers and underwriters seek to conform the original Rule 144A offering memorandum as closely as possible to the requirements of a full registration statement.

The availability of this exchange procedure allows issuers and underwriters to complete transactions quickly under Rule 144A to take advantage of market conditions, but with the expectation that the issuer will promptly register an exchange of identical securities. As a result, purchasers generally do not require the liquidity discount they would otherwise demand if the securities were to remain private (though there is typically an interest rate bump in the event the issuer does not effect the registered exchange within the specified time frame). In addition to promising public registration under the Securities Act, the issuer also typically agrees to file periodic reports with the SEC under the Exchange Act, thereby enhancing public information and liquidity.

Foreign private issuers that are not registered with the SEC may also use the A/B exchange offer technique for Rule 144A offerings of equity securities and convertible debt securities in the United States.[25]

Traditional Private Placements – Section 4(a)(2)

Section 4(a)(2) of the Securities Act exempts "transactions by an issuer not involving any public offering." The term "public offering" is not defined in the Securities Act, and the scope of the Section 4(a)(2) exemption has largely evolved through case law, SEC pronouncements, and market practice.

The core issue is whether the persons to whom securities are offered need the protection of the Securities Act – that is, whether they are sufficiently sophisticated so as to be able to fend for themselves.[26] In determining whether a transaction is a public offering, relevant factors include the number of offerees and their relationship to each other and the issuer, the number of securities being offered, the size of the offering, and the manner in which the offering is conducted.[27] All of the surrounding circumstances must be considered in this analysis.[28]

> PRACTICE POINT
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> Section 4(a)(2) is only available for offers and sales by an issuer; resales of securities acquired from an issuer require a separate exemption (such as Rule 144A).

Private placements under Section 4(a)(2) typically consist of, among other things:

- a nonpublic offering (that is, an offering without any form of general solicitation or advertising);
- to a limited number of offerees;
- who are buying for investment and not with a view to distribution; and
- who are sophisticated investors and have been provided with or have access to information about the issuer.[29]

In addition, the securities issued in a private placement generally include restrictions on resales by the purchasers (such as through the use of stop-transfer orders, restrictive legends, and the like).[30]

Regulation D Private Placements

Rule 506 Safe Harbor

As you can see, it is not possible to map the borders of Section 4(a)(2) with precision. Securities Act Regulation D helps give some certainty in this area, and it also establishes various safe harbors from Securities Act registration.

Foreign private issuers are most likely to look to Rule 506 of Regulation D, which is not limited to offering amount (other parts of Regulation D are limited to offerings of up to $5 million, for example). If the conditions of Rule 506 are met, the transaction is deemed not to be a public offering within the meaning of Section 4(a)(2).

Under Rule 506:

- *Accredited Investors and others*: There is no limit to the number of accredited investors, or AIs, who may participate in the transaction, and up to 35 non-AIs may purchase securities. In addition, each non-AI must demonstrate to the issuer's reasonable belief that it, "either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[31] Issuers and their placement agents typically satisfy this requirement by having potential investors complete "investor questionnaires" demonstrating their accredited status or their sophistication.
- *Information requirements*:[32] There is no specific information requirement for AIs such as a prospectus, although antifraud considerations of course come into play. By contrast, non-AIs must receive extensive information about the issuer. If the issuer is not an Exchange Act reporting company, that information includes non-financial and financial information substantially equivalent to that which it would have been required to provide in a registration statement under the Securities Act (for example, Form F-1 in the case of a first-time foreign registrant). For a foreign private issuer that is a reporting company, it may provide its most recent annual report on Form 20-F. The issuer must also make available to each purchaser the opportunity to ask questions about the offering or the issuer.

> PRACTICE POINT
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> Regulation D's information requirements effectively mean that financial information provided by a foreign private issuer to a non-AI must be prepared in accordance with US GAAP or IASB IFRS, or if prepared in local GAAP/non-IASB IFRS, be reconciled to US GAAP.

- *General solicitation/general advertising only permitted under certain circumstances*: "General solicitation" or "general advertising" may only be used to offer or sell the securities under certain circumstances spelled out in Rule 506(c).
- *Limitation on resale*:[33] Securities acquired in a Regulation D transaction are "restricted securities" that cannot freely be resold absent registration or an exemption from registration. The issuer must take reasonable care to make sure that purchasers would not be deemed to be statutory underwriters (that is, engaged in a distribution of the securities), which is typically satisfied by requiring purchaser representations about investment intent, restrictive legends on certificates, and restrictions on transfer.
- Form D:[34] The issuer must file a notice with the SEC on Form D no later than 15 days after the first sale of securities. Form D must be filed electronically on the SEC's EDGAR system.[35]

Accredited investors include:[36]

- certain US financial institutions such as banks, savings and loan associations, broker-dealers, and the like;

- corporations or partnerships not formed for the specific purpose of acquiring the securities being offered with assets over $5 million;
- directors, executive officers, and persons holding similar positions with or in the issuer;
- natural persons with a net worth (alone or with that person's spouse) exceeding $1 million, excluding the value of the primary residence of the investor;
- natural persons with individual income in excess of $200,000 per year or, with that person's spouse, in excess of $300,000 per year;
- any entity in which all the equity owners are themselves AIs;
- any entity that owns "investments" within the meaning of Investment Company Act Rule 2a51-1(b) greater than $5 million, (e.g., Indian tribes, governmental bodies, and foreign entities);
- Limited Liability Companies (LLCs) with total assets in excess of $5 million;
- any natural person holding in good standing a professional certification, designation, or credential that the SEC has designated by order as qualifying for AI status (e.g., General Securities Representative license (Series 7), the Private Securities Offerings Representative license (Series 82), and the Investment Adviser Representative license (Series 65));
- "knowledgeable employees" within the meaning of Investment Company Act Rule 3c-5(a)(4), including trustees, advisory board members, and employees who participate in the investment activities of a private fund under Investment Company Act Section 3(c)(1) or Section 3(c)(7);
- Investment advisers (IAs) registered with the SEC under Section 203 of the Advisers Act, state-registered IAs, and IAs qualifying as an "exempt reporting adviser" under Advisers Act Section 203(m) (advisers to private funds) or Section 203(l) (advisers to venture funds); and
- certain family offices with greater than $5 million in assets under management, and their family clients.

Deviations From Regulation D

- Under Rule 508, a person may establish the existence of an exemption under Regulation D with respect to any purchaser even if the person failed to meet one or more of the requirements of Regulation D. In this case, the person must show that:
- the failure to comply did not pertain to a term, condition, or requirement directly intended to protect the purchaser;
- the failure to comply was "insignificant to the offering as a whole;" and
- the person made a good faith and reasonable attempt to comply with the relevant requirements of Regulation D.

Rule 506(c) Offerings

Rule 506(c), adopted under Section 201 of the JOBS Act, permits general solicitation in connection with certain Regulation D offerings. In particular, Rule 506(c) permits exempt offerings to use general solicitation if:

- the issuer takes "reasonable steps to verify" that purchasers are accredited investors;
- all purchasers are accredited investors, or the issuer reasonably believes that they are, at the time of the sale; and

- all requirements of Rules 501 (definitions), 502(a) (integration), and 502(d) (resale restrictions) are met.

Whether verification steps are reasonable depends on facts and circumstances. Rule 506(c) includes four specific non-exclusive, non-mandatory methods to verify accredited investor status:

- for an individual using the *income* test, reviewing for the two most recent fiscal years any IRS forms that report the individual's income and obtaining a written representation from the individual confirming expected income for the current year;
- for an individual using the *net worth* test, reviewing bank, brokerage, and similar documents and obtaining a written representation from the individual disclosing all liabilities; and
- obtaining written confirmation from an SEC-registered broker-dealer or investment adviser, a licensed attorney, or a CPA who has taken reasonable steps to verify that, within the prior three months, the purchaser is an accredited investor.[37]

Latham obtained the first and only no-action relief from the SEC Staff establishing a bright line to satisfy "reasonable steps to verify" based on minimum investment amounts of $200,000 for natural persons and $1.0 million for legal entities. The minimum investment must be accompanied by written representations from the purchaser as to:

- the purchaser's accredited investor status under Rule 501, and
- confirmation that the purchaser's minimum investment amount is not financed by any third party for the specific purpose of making the particular investment in the issuer.[38]

Separately, the SEC has confirmed that privately offered pooled investment vehicles relying on the qualified purchaser (Section 3(c)(7)) or 100-holder (Section 3(c)(1)) exclusions under the Investment Company Act may engage in general solicitation under Rule 506(c).

"Bad Actor" Disqualification From Rule 506 Offerings

In 2013, the SEC adopted final rules as directed by Section 926 of the Dodd-Frank Act to disqualify an issuer from relying on the Rule 506(b) or (c) exemptions if that issuer had committed securities fraud or various other violations of financial regulatory and antifraud laws.

Under Rule 506(d), an issuer will not be able to rely on the Rule 506 exemptions if certain "covered persons" have been subject to one or more disqualifying events, such as a conviction for securities fraud. Individuals and entities that are "covered persons" include:

- the issuer;
- a predecessor of the issuer;
- affiliated issuers, unless the event occurred prior to the commencement of the affiliation, and the affiliated issuer is not under the issuer's control and is not "under common control with the issuer by a third party that was in control of the affiliated entity at the time of such events;"
- beneficial owners of 20% or more of the issuer's voting equity securities (calculated on the basis of voting power);
- an issuer's directors, executive officers, and other officers, as well as general partners and managing members, who participate in the offering; and
- any person who has received or will receive direct or indirect compensation for solicitation of purchasers in connection with a securities offering.

The disqualifying events include:

- criminal convictions in connection with the purchase or sale of a security or involving the making of a false filing with the SEC, or arising out of the conduct of certain types of financial intermediaries. The criminal conviction must have occurred within five years of the proposed sale of securities in the case of the issuer and its predecessors and affiliated issuer, or within 10 years for other covered persons;
- court injunctions and restraining orders in connection with the purchase or sale of a security, or involving the making of a false filing with the SEC, or arising out of the conduct of the business of an underwriter, an SEC-regulated entity such as a broker-dealer. The injunction or restraining order must have occurred within five years of the proposed sale of securities;
- final orders from certain federal or state regulators that bar the issuer from associating with a regulated entity, or engaging in the business of securities, insurance, or banking or in savings association or credit union activities or that are based on fraudulent, manipulative, or deceptive conduct, and issued within 10 years of the proposed sale of securities;
- certain unexpired SEC disciplinary orders relating to regulated entities in the securities industry and their associated persons;
- unexpired SEC cease-and-desist orders related to violations of scienter-based antifraud provisions of the federal securities laws or the Securities Act Section 5 registration requirements that were entered within five years before the proposed sale of securities;
- previously filing or being named as an underwriter in a registration statement that, within five years before such sale, was the subject of a refusal order, stop order, or suspension order, or is, at the time of such sale, the subject of an investigation or proceeding to determine whether issuance of such an order is appropriate;
- suspension or expulsion from membership in a self-regulatory organization (SRO) or association with an SRO member for violating just and equitable principles of trade; and
- US Postal Service false representation orders issued within five years of the proposed sale of securities.

Any disqualifying events that occurred prior to the effectiveness of the rules (September 23, 2013) will not prevent an issuer from relying on Rule 506, though they will be subject to mandatory disclosure requirements. For disqualifying events occurring after the effectiveness of the rules, an issuer may nevertheless rely on Rule 506 if the SEC determines upon a showing of good cause that denial of an exemption is not necessary under the circumstances, the court or regulator that issued the disqualifying order advises the SEC in writing that the exemption should not be denied, or the issuer can demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event existed.

The SEC has published guidance as to the factors it will consider when evaluating a waiver request. These factors include: (1) who was responsible for the misconduct; (2) what was the duration of the misconduct; (3) what remedial steps have been taken; and (4) the impact if the waiver is denied. The SEC has noted that no single factor is dispositive.[39] When they are granted, waiver requests can be expected to take several weeks to process through the SEC and are made publicly available. Waiver requests have been subject to controversy and can be difficult to obtain.[40]

Restrictions on Communications in Connection With Unregistered Global Offerings

As discussed above, directed selling efforts or general solicitation in the United States can destroy the availability of certain exemptions from registration. In addition, publicity about an unregistered transaction can

amount to an illegal offer of securities. Accordingly, communications about a planned or pending unregistered transaction are subject to certain limitations.

In particular, a foreign private issuer may:

- continue to advertise products and services and to issue press releases regarding factual business and financial developments in accordance with past practice;[41]
- distribute a preliminary and final offering memorandum to certain investors;
- conduct certain press activities outside the United States under Securities Act Rule 135e; and
- if available, make a limited notice within the United States under Securities Act Rule 135c.

Offshore Press Activity – Securities Act Rule 135e

Rule 135e provides a safe harbor from the definition of offer for FPIs, and offshore press activity meeting Rule 135e does not constitute general solicitation or directed selling efforts.[42]

Rule 135e allows an FPI to provide journalists with access to: (1) its press conferences held outside the United States; (2) meetings with issuer (or selling security holder) representatives conducted outside the United States; and (3) written press-related materials released outside the United States at or in which the issuer discusses its intention to undertake an offering. To take advantage of Rule 135e, the offering must not be conducted solely in the United States – that is, the issuer must have a bona fide intent to make an offering offshore concurrently with the US offering. The issuer must also provide access to both US and non-US journalists, and ensure that any written press releases are distributed to journalists (including US journalists) outside the United States and contain a specified legend.

> PRACTICE POINT
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> Note that even if Rule 135e is otherwise available, an issuer may not rely on it to provide internet access to its offshore press conferences or written press-related materials issued offshore, unless it implements procedures to ensure that only persons physically located outside the US will have access to the press conferences or materials.[43]

Limited Notices of Unregistered Offerings – Securities Act Rule 135c

Rule 135c provides that a company subject to the reporting requirements of the Exchange Act (and certain non-reporting FPIs) will not be deemed to make an offer of securities under Section 5(c) if it issues a press release about a proposed or completed unregistered offering. Rule 135c is the safe harbor relied on for the press release announcing the commencement of a private offering by a public company.

A Rule 135c notice – which can take the form of a press release or a written communication directed to shareholders or employees – does not constitute "general solicitation" or "directed selling efforts."[44]

In order to take advantage of Rule 135c, the notice must:

- state that the securities offered have not been or will not be registered under the Securities Act and may not be offered absent registration or an exemption from registration;
- contain only limited information, including:
  - the name of the issuer;

  - the title, amount, and basic terms of the securities being offered;
  - the amount of the offering, if any, being made by selling shareholders;
  - the time of the offering;
  - a brief statement of the manner and purpose of the offering, *without naming the underwriters*; and
- be filed on Form 8-K (or furnished on Form 6-K, in the case of a foreign private issuer).

> PRACTICE POINT
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> Even though Rule 135c is not technically available to voluntary filers, most practitioners behave as if it were. The policy concerns underlying Rule 135c – namely, that a reporting company has a legitimate interest in communicating with its security holders about its financings activities – apply with equal force to voluntary filers. Conversely, Rule 135c is not available to private companies that are not registered with the SEC even if there is a limited trading market for their securities.

Research Reports

The issuance of a research report regarding an issuer or its securities around the time of an unregistered offering raises the question of whether such a report could be viewed as directed selling efforts and/or general solicitation in respect of the offering – the presence of which may result in the loss of an available registration exemption. For this reason (and because of general liability concerns), many broker-dealers will not allow research to be distributed in the United States in connection with unregistered offerings in which they are participating unless a separate exemption is available for the dissemination of that research under the safe harbor provisions of Securities Act Rule 138 or 139.[45] This is the case even for Rule 144A offerings (conducted either separately or concurrently with a Regulation S offering) where, pursuant to Title II of the JOBS Act, there is no longer a prohibition against general solicitation in such offerings.[46]

Securities Act Rule 138 provides that if the conditions of the rule are otherwise met, publication of ordinary-course research by a broker-dealer (including one that is participating as an underwriter or placement agent in the offering) will not be considered to be an offer or to constitute general solicitation in the context of a Rule 144A offering. Likewise, the publication would not be seen as prohibited directed selling efforts in connection with a Regulation S transaction.

Similarly, if the other conditions of Securities Act Rule 139 are met, ordinary-course research may be published during Rule 144A or Regulation S offerings without fear of being treated as general solicitation or directed selling efforts.

Other issues regarding the distribution of research around the time of an offering must still be considered, however, including restrictions applicable to US broker-dealers (and, in certain cases, their affiliates) under the rules imposed on member firms by the Financial Industry Regulatory Authority, or FINRA.[47]

Use of the Internet for Unregistered Global Offerings

If a foreign private issuer wants to conduct an unregistered global offering of securities over the internet, or to make available via the internet offering documentation that goes beyond the limited category of information that is permissible under US publicity restrictions, it should implement the following procedures:

Offshore Offering With No Concurrent US Offering

A foreign private issuer that is planning an offshore offering under Regulation S with no concurrent US offering (registered or unregistered) must:[48]

- include a prominent disclaimer on its website making clear that the offer is directed only to countries other than the United States. For example, the website can state that the securities are not being offered in the United States or to US persons; and
- implement procedures on its website that are reasonably designed to guard against sales to US persons. Before allowing a prospective investor to view materials online, for example, the investor should be required to certify non-US status and to provide an address or telephone number outside the United States. The website should automatically reject any person who refuses to provide the certification (and preferably should be set up to reject any person who provides a US address).

Offshore Offering With Concurrent US Unregistered Offering

A foreign private issuer that is planning a Regulation S offering in combination with an unregistered offering in the US (such as a Rule 144A offering) must:[49]

- implement the restrictions for an offshore offering discussed above;
- either exclude US persons from the website or take steps to ensure that only QIBs (in the case of a Rule 144A offering) or AIs (in the case of a Regulation D private placement) have access to the website, for example, by limiting access in the US to those investors who have been provided with a password; and
- to the extent practicable, limit information posted on the website to information about the offshore offering, and only include information on the private US offering that is required by foreign law. (This may, however, be difficult to accomplish if a single offering memorandum is used for the global offering, as is commonly the case.)

State Blue Sky Issues in Unregistered Global Offerings

The United States has a federal system of government, and securities transactions are regulated at the state level as well as at the federal level. The body of state securities law is often referred to as “blue sky” laws.

Section 18 of the Securities Act preempts various elements of state blue sky laws in connection with certain securities and transactions.[50] These include:

- securities sold in Rule 144A offerings where the issuer is an SEC reporting company; and
- securities sold in Regulation D offerings complying with Rule 506.

There are, however, some significant exceptions to preemption relevant to unregistered global offerings. In particular:

- Private offerings that are not conducted in compliance with Rule 506 of Regulation D do not qualify for federal preemption. For example, in a global offering where the US portion is being made under Section 4(a)(2) to institutional AIs, each relevant state’s law should be reviewed to confirm that all investors are exempt institutional investors under the applicable state securities statute.
- Rule 144A offerings for issuers that are not reporting companies do not qualify for federal preemption. This can present blue sky issues in particular for secondary offerings conducted in reliance on these exemptions by foreign private issuers that include retail (or non-institutional) investors.

> PRACTICE POINT
>
> Blue sky requirements are not necessarily preempted for guarantees of securities even if the offering of the underlying security is preempted.

FINRA Filing Requirements for Private Placements

FINRA Rule 5123 generally requires FINRA members that sell securities in private placements to file certain information with FINRA within 15 calendar days following the date of first sale.[51] This 15-day period tracks the Form D filing requirements applicable to issuers under Regulation D and the rule is intended to provide FINRA with more timely information about the private placement activities conducted by member firms on behalf of non-affiliated issuers.[52] In particular, Rule 5123 requires member firms to file with FINRA within the specified time period any offering documents distributed to potential investors, as well as any material amendments to those originally filed documents. If no offering documents are used in connection with a particular offering, then the member firm need only indicate the absence of such offering document in its FINRA filing. Importantly, in a departure from the original proposal issued by FINRA, the member firm is not required to provide its own disclosure document to prospective investors if one has not been prepared by the issuer.

The rule's filing requirements are subject to an extensive set of exemptions, including exemptions for Rule 144A and Regulation S offerings and for private placements to certain categories of investors. Given the large number of exemptions, the impact of the rule should be limited primarily to private placements involving individual accredited and non-accredited investors.

ENDNOTES

1 Securities Act Rule 901.

2 Securities Act Rule 902(h).

3 Securities Act Rule 902(c)(1).

4 Securities Act Rule 902(c).

5 *Final Rule: Offshore Offers and Sales*, Release No. 6863, text at n.64 (Apr. 24, 1990).

6 *Id.*, text at n.145.

7 Securities Act Rule 902(e). A "foreign issuer" is any foreign government or foreign private issuer.

8 Securities Act Rule 902(j) defines "Substantial US Market Interest."

9 Securities Act Rule 903(b)(ii) defines what is considered an "overseas directed offering."

10 Securities Act Rule 405 defines the term "equity securities." Note that this includes debt securities convertible into equity securities.

11 Securities Act Rule 902(a) defines the term "debt securities" as all securities that are not equity securities and includes non-participating preferred stock and asset-backed securities.

12 Securities Act Rule 902(g) defines the term "offering restrictions."

13 Securities Act Rule 902(g).

14 Securities Act Rule 902(f).

15 Securities Act Rule 903(b)(3)(i).

16 Securities Act Rule 144(a)(3) defines the term "restricted securities."

17 Securities Act Rule 905.

18 *See Coral Gold Corp.*, SEC Staff No-Action Letter, 1991 SEC No-Act LEXIS 320 (Feb. 19, 1991).

19 Regulation S, Preliminary Note 5.

20 *Id.* Preliminary Note 1.

21 Securities Act Section 12(a).

22 *Final Rule: Offshore Offers and Sales*, Release No. 6863, text at n.144 (Apr. 24, 1990).

23 Securities Act Rule 144A, Preliminary Note 6.

24 *See Exxon Capital Holdings Corp.*, SEC Staff No-Action Letter, 1988 SEC No-Act LEXIS 682 (May 13, 1988); *Shearman & Sterling*, SEC Staff No-Action Letter, 1993 SEC No-Act LEXIS 853 (July 2, 1993); *Morgan Stanley & Co. Inc.*, SEC Staff No-Action Letter, 1991 SEC No-Act. LEXIS 762 (June 5, 1991).

25 *See Grupo TMM, S.A. de C.V.* SEC Staff No-Action Letter, 2002 SEC No-Act. LEXIS 640 (June 27, 2002); *Grupo Financiero InverMexico, S.A. de C.V.* SEC Staff No-Action Letter, 1995 SEC No-Act. LEXIS 428 (Apr. 4, 1995); *Corimon C.A., S.A.C.A.*, SEC Staff No-Action Letter, 1993 SEC No-Act. LEXIS 555 (Mar. 22, 1993); *Vitro, Sociedad Anónima*, SEC Staff No-Action Letter, 1991 SEC No-Act. Lexis 1311 (Nov. 19, 1991).

26 *See SEC v. Ralston Purina Co.*, 346 US 119, 125 (1953) ("the applicability of the [private placement exemption] should turn on whether the particular class of persons affected needs the protection" of the Securities Act; an offering to those "who are shown to be able to fend for themselves" is a private placement).

27 *See* Release No. 33-285, 1935 SEC LEXIS 485 (Jan. 24, 1935).

28 *See* Release No. 33-4552 (Nov. 6, 1962), 1962 SEC LEXIS 166 (all the surrounding circumstances must be considered "including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type, and manner of the offering").

29 Certain courts have held that this information must be comparable to the information investors would have received in a public offering. *See,* e.g.*, Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 903 (5th Cir. 1977).

30 Securities sold under Section 4(a)(2) are restricted securities that may not be freely resold to the public. Securities Act Rule 144(a)(3).

31 Securities Act Rule 506(b)(2)(ii); Securities Act Rule 501(h) defines "purchaser representative."

32 Securities Act Rule 502(b).

33 Securities Act Rule 502(c).

34 Securities Act Rule 503.

35 Regulation S-T, Rule 101(a)(1)(xiii).

36 Securities Act Rule 501(a).

37 *See also* Securities Act Rules Compliance and Disclosure Interpretations (C&DIs) Question 256.35. An additional method of verification includes obtaining a certification of accredited investor status at the time of sale from an individual who invested in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c), for any Rule 506(c) offering conducted by the same issuer. Because the prior investment would have occurred prior to 2013, the method is rarely used.

38 *See* SEC No-Action Letter to Latham & Watkins LLP, *Request for Rule 506(c) Interpretative Guidance* (Mar. 12, 2025); *see also* Securities Act Rules C&DIs Question 256.36, which confirms that:

> if the terms of the offering require a high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor may be sufficiently high such that, absent any facts that indicate that the purchaser is not an accredited investor, it may be reasonable for the issuer to take fewer steps to verify or, in certain cases, no additional steps to verify accredited investor status other than to confirm that the purchaser's cash investment is not being financed by a third party.

See also Client Alert, *Latham Letter Begins New Era for Private Capital Fundraising* (Mar. 12, 2025), https://www.lw.com/admin/upload/SiteAttachments/Latham-Letter-Begins-New-Era-for-Private-Capital-Fundraising.pdf, and related *FAQs on the Latham Letter for Exempt Offerings with General Solicitation Under Rule 506(c)*, https://wowlw.com/Article/Index/32.

39 *SEC Guidance: Process for Requesting Waivers of "Bad Actor" Disqualification Under Rule 262 of Regulation A and Rules 505 and 506 of Regulation D* (Mar. 13, 2015), https://www.sec.gov/divisions/corpfin/guidance/262-505-waiver.htm.

40 *See,* e.g.*, Dissenting Statement Regarding Certain Waivers Granted by the Commission for Certain Entities Pleading Guilty to Criminal Charges Involving Manipulation of Foreign Exchange Rates* (May 21, 2015) available at https://www.sec.gov/news/statement/stein-waivers-granted-dissenting-statement.html; *SEC's Stein Blasts Waiver Grants To Felon Banks*, Law360 (May 22, 2015).

41 *See Guidelines for the Release of Information by Issuers Whose Securities Are in Registration*, Release No. 33-5180 (Aug. 16, 1971).

42 Securities Act Rules 502(c), 902(c)(3)(vii).

43 *SEC Guidance: Use of Electronic Media*, Release No. 33-7856, n.68 (Apr. 28, 2000).

44 Securities Act Rules 502(c), 902(c)(3)(vi).

45 *See* "Research Reports" in Chapter 6 for a fuller discussion of Securities Act Rules 138 and 139.

46 *See* "Rule 144A Transactions – General Solicitation" earlier in this Chapter. Although JOBS Act Title II addresses only Rule 144A offerings, the SEC Staff provided informal guidance, consistent with the long-standing non-integration principles relating to concurrent US and non-US offerings, that general solicitation activities conducted in connection with a Rule 144A offering would similarly not be viewed as constituting directed selling efforts in the context of a concurrent Rule 144A/Regulation S offering. The presence of directed selling efforts, however, is still a concern in the context of a Regulation S-only offering and the presence of general solicitation is still a concern in private placements made in reliance on the safe harbor under Rule 506(b) under the Securities Act or the statutory exemption under Securities Act Section 4(a)(2).

47 FINRA was created in July 2007 through the consolidation of the former National Association of Securities Dealers, Inc. (NASD) and the regulatory, arbitration, and enforcement operations of the New York Stock Exchange (NYSE). In connection with its oversight function, FINRA has promulgated various rules that govern the conduct of its members. Those rules are intended to protect investors and the integrity of the securities markets.

48 *Interpretation: Statement of the Commission Regarding the Use of Internet Websites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore,* Release No. 33-7516, at Section IV.A.1 (Mar. 23, 1998).

49 *Id.* at Section IV.A.2.

50 "State securities regulation of covered securities generally is limited under Section 18(b) of the Securities Act to imposing notice filing requirements on offerings, requiring the filing of a consent to service of process, and assessing a filing fee." *Proposed Rule: Revisions of Limited Offering Exemptions in Regulation D*, Release No. 33-8828, n.45 (Aug. 3, 2007).

51 *See* FINRA Regulatory Notice 12-40 (Sept. 2012). Offering documents filed with FINRA under this rule will not be approved or commented upon by FINRA. All information filed pursuant to the requirements of Rule 5123 will receive confidential treatment by FINRA.

52 FINRA Rule 5122 (adopted by FINRA in 2008) requires member firms to file certain information with FINRA, imposes certain specific disclosure requirements, and contains certain restrictions on use of proceeds in connection with private placements conducted by member firms in their own or an affiliate's securities, subject to a number of exemptions similar to those contained in FINRA Rule 5123.

CHAPTER 3

Unregistered Resales of Regulation S and Privately Placed Securities

Resales of Securities

The US securities laws regulate both the initial sale of securities as well as the resales of those securities. These laws generally require that each sale of a security (whether in connection with the security's initial issuance or a subsequent purchase) be registered with the SEC or satisfy an available exemption from such registration. Since both Section 4(a)(2) and Regulation D apply only to initial sale transactions by issuers,[1] a purchaser wishing to resell securities without registering the resale transaction with the SEC must look elsewhere for an appropriate exemption. Typically, a purchaser that is not itself the issuer of the security, an affiliate of the issuer, an underwriter in respect of the security, or a broker-dealer will utilize the registration exemption provided by Section 4(a)(1) of the Securities Act. A broker-dealer no longer acting as an underwriter may rely on Section 4(a)(3) of the Securities Act for resales of securities. However, in circumstances in which the securities to be resold were acquired by the purchaser in a Regulation S transaction or a private placement, there may be a question as to whether the purchaser is acting in the capacity of an underwriter and therefore unable to rely on the Section 4(a)(1) exemption (or, for broker-dealers, the Section 4(a)(3) exemption). In these cases, the purchaser will generally seek to structure the resale transaction so that it will satisfy other potentially available exemptions such as those provided by Rule 144A (discussed above), the so-called "Section 4(1½) exemption," and Rule 144. In addition, a purchaser seeking to resell securities outside the United States may look to Rule 904 of Regulation S.

> PRACTICE POINT
>
> Rule 904 of Regulation S and Rule 144 provide a means to effect a non-registered resale transaction on a *public* basis.
>
> Rule 144A and Section 4(1½) provide a means to effect a non-registered resale transaction on a *private* basis.

Regulation S Safe Harbor for Offshore Resales

Rule 904 of Regulation S provides a safe harbor for certain offshore resales. Under Rule 904:

- resales by most non-affiliates and persons who are not distributors are subject only to the requirements that:
  - the offer or sale must be made in an "offshore transaction;" and
  - there must be no "directed selling efforts" in the United States by the seller or its affiliates;
- resales by officers and directors who are affiliates solely by virtue of their positions are subject only to the "offshore transaction" and no "directed selling efforts" requirements, provided no remuneration is paid other than customary broker's commissions; and
- for resales by dealers and persons receiving selling concessions, the following additional conditions apply if the securities being resold are of the type included within the Category 2 or Category 3 safe harbor and the resale is within the distribution compliance period imposed with respect to those securities:

- the seller and any person acting on behalf of the seller must not knowingly offer or sell the securities to a US person; and
- if the purchaser of the securities is also a securities professional, then the seller must deliver a confirmation or other notice stating that the securities may be offered and sold during the distribution compliance period only in accordance with Regulation S, pursuant to registration under the Securities Act, or an exemption from registration.

"Section 4(1½)" Resales

Section 4(1½) does not actually appear in the Securities Act and is instead the name given to a practice, developed by the private securities bar, that allows the resale of securities in accordance with procedures comparable to those used in connection with Section 4(a)(2) private placements.

Typical restrictions in a Section 4(1½) transaction include that resales may only be made:

- on a nonpublic basis;
- to sophisticated investors who could have participated in the original private placement and who are buying for investment and not with a view to distribution; and
- subject to limitations on subsequent resales (such as letters of representation from purchasers or appropriate "no registration" opinions of counsel).

Rule 144 Resales

Rule 144 provides a non-exclusive safe harbor under which non-affiliates of an issuer may resell "restricted securities" to the public without registration under the Securities Act. It also provides a non-exclusive safe harbor for public resales by affiliates of the issuer of restricted securities as well as unrestricted securities. Unrestricted securities held by an affiliate are sometimes referred to as "control securities."

Restricted securities include:

- securities acquired directly or indirectly from an issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving a public offering;
- securities acquired from the issuer that are subject to the resale limitations of Regulation D;
- securities acquired in a Rule 144A transaction; and
- equity securities of domestic US issuers acquired in Regulation S transactions.

An "affiliate" of an issuer for these purposes is a person that, directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the issuer.

It is important to note that Rule 144 treats resales by affiliates and non-affiliates differently:

- *Resales of restricted securities by a non-affiliate*: Non-affiliates must comply with either a six-month or one-year holding period, depending on whether the issuer is an Exchange Act reporting company and whether it is current in its filings. After one year, there are no further restrictions on resale.
- *Resales of restricted securities by an affiliate*: Like non-affiliate holders, affiliate holders of restricted securities must satisfy either a six-month or one-year holding period, depending on the Exchange Act reporting status of the issuer. In addition, after expiration of the relevant holding period, the following restrictions apply:

- *Volume limitations*: The amount of securities sold, together with all sales of restricted or other securities of the same class for the account of the affiliate within the preceding three months, must not exceed the greater of (1) 1% of the shares of the class outstanding; (2) the average weekly reported trading volume on US national securities exchanges during the prior four weeks; or (3) if the securities sold are debt securities, then 10% of the principal amount of the tranche attributable to the securities sold;
- *Manner of sale*: If the securities to be sold are equity securities, they must be resold in (1) unsolicited brokers' transactions; (2) transactions with a market maker; or (3) riskless principal transactions;
- *Notice of sale*: If more than 5,000 shares or $50,000 worth of securities are resold in any three-month period, the seller must file a notice on Form 144 with the SEC, which may be filed either electronically or on paper; and
- *Current public information*: If the issuer is an SEC reporting company, it must have filed all required SEC reports during the 12 months prior to the sale (other than current reports on Form 8-K); if the issuer is not a reporting company, it must have made public certain basic corporate information.

- *Resales of control securities by an affiliate*: There is no holding period applicable to the resale of control securities by an affiliate. But the remaining requirements of Rule 144 apply as if the affiliate were reselling restricted securities (volume limitations; manner of sale requirements; notice of sale requirements).

ENDNOTES

1 Securities Act Section 4(a)(2); Regulation D, Preliminary Note 4.

CHAPTER 4

SEC-Registered Offerings

Issues to Identify Before Registration

Any issuer considering a public offering in the US, a private offering with US registration rights or a listing in the US is strongly advised to consult with its auditors' SEC specialists well in advance of the first submission to the SEC to assure that required financial statements are available and complete. The availability of required financial statements often affects significantly the timing of an offering.

A first-time issuer must also compile significant amounts of non-accounting data about its business and markets, its strategy, and the regulatory environment in which it operates, and must distill this information into a clear and understandable prospectus and thoroughly check the disclosure for accuracy before submitting the registration statement to the SEC. First-time issuers will also become subject to Sarbanes-Oxley's wide-ranging requirements.

Prospective underwriters and counsel can assist the issuer in assembling this information and an assortment of disclosure documents from "comparable" issuers, but the process of preparing for a first-time registration often takes several months.

Issues to address in advance of any offering include the following:

- *Will you qualify as an EGC?* If so, you will benefit from the accommodations provided by Title I of the JOBS Act, which will make the entire IPO process easier. Most IPO issuers with less than $1.235 billion of revenue in their most recently ended fiscal year will qualify as an EGC and be entitled to cost-saving regulatory accommodations, which we discuss in more detail below.
- *Is the right audit team in place and are the auditors ready to go?* Have all required audits been conducted in accordance with the standards of the US Public Company Accounting Oversight Board (the PCAOB)? Public company auditors need to be registered with the PCAOB, and the audits need to be conducted in accordance with PCAOB standards even in the case of an issuer using local GAAP or IFRS (whether IASB IFRS or non-IASB IFRS).[1] Public company auditors must also meet the SEC's and the PCAOB's rigorous independence standards.[2] Private companies with smaller auditors sometimes find their existing auditors are not experienced in these matters or are not enthusiastic about the prospect of their audit being part of a public registration statement. Some private companies decide to switch to a larger accounting firm in order to gain from the experience the larger firm has amassed. Also, an auditor that is considered independent for a private company may not meet the independence test for public companies. Obviously, these decisions have timing and cost implications.
- *Do you have the right law firm in your corner?* In the United States, the issuer's law firm is generally in charge of assisting the issuer in addressing the many big picture and technical aspects of completing an IPO. A strong, experienced legal team can significantly reduce the burden of the IPO drill on management. This is important because the management team will still be obligated to run the business during the time-consuming IPO process. Also, life as a public company will involve new challenges that an experienced legal team can help navigate. As with the auditors, you will want to make sure your law firm is the right fit.
- *Are the financials ready for prime time?* If you prepare financial statements based on an accounting standard other than US GAAP or IASB IFRS, what are the significant differences between local GAAP/non-IASB IFRS and US GAAP? How long will it take to prepare a reconciliation to US GAAP?

- *Are you ready for life as a public company?* Do you have the corporate governance procedures and mechanisms in place to comply with Sarbanes-Oxley's requirements (for example, management certifications, internal control over financial reporting, disclosure controls and procedures, and the appropriate audit committee functions)? Note that a first-time issuer that is not already an SEC reporting company becomes subject to Sarbanes-Oxley upon the initial public filing of its registration statement, even before the SEC declares that registration statement effective. Will changes need to be made to ownership structures, shareholder agreements, employment arrangements, and the like? Will it be necessary to hire a treasurer, a general counsel, an investor relations officer, or other individuals with public company experience? Are you ready to start turning out annual and semi-annual statements on the timeline required of public companies? Will revisions be needed to bring executive compensation arrangements in line with public company practices and those of key public competitors?

- *Have you completed any significant acquisitions or dispositions during the prior full financial year or any subsequent interim period preceding the date of the offering?* Separate subsidiary financial statements and pro forma financial information may be required.

- *Will your securities be guaranteed by any company?* Guarantees in respect of a security are considered to be separate securities under the US federal securities laws that must be registered, sometimes with separate audited guarantor financial statements. If you are offering debt securities that will be secured by a pledge of the capital stock or inter-company debt of any related company, you may have to file separate financial statements for the company that issued the pledged securities.

- *Do you have a significant minority investment in any other entity or any 50/50 joint venture?* Separate financial statements may be required for such an entity and the issuer may not have access to these statements or to such entity's auditors.

- *Can material contracts be filed publicly?* The SEC requires material contracts to be publicly filed as exhibits. The definition of material contracts sweeps in many related-party agreements but excludes most ordinary-course agreements. You will, however, need to file ordinary-course contracts on which your business is "substantially dependent." You may be able to redact limited, commercially sensitive portions of filed contracts, but the need to publicly file the balance of those agreements can raise difficult business issues. Do you have any material contracts that contain commercially sensitive information, or that are subject to confidentiality agreements that would be violated if they were filed publicly? Are any third-party notices or consents required before the contracts can be filed? Note that under the SEC rules mandating electronic filing by all foreign private issuers, documents (including material contracts) generally have to be submitted in English. Does the issuer have any material contracts that must be translated into English?

- *Do you manage your business in separate segments?* If so, are your internal accounts enough to prepare financial statements that meet the SEC's "segment reporting" requirements?

- *Will there be any industry data?* The SEC requires issuers in certain types of industries (such as banking and oil and gas) to provide detailed and specific disclosure on various matters. Will the issuer be able to assemble and develop the required information? If so, you may need an expert's consent if you include or summarize an industry expert's report, valuation, or opinion in your F-1. This is separate from the consent you will need from your auditors for the inclusion of their audit report.

- *Are there "cheap stock" issues?* Have you granted stock options within the 12 months prior to filing an IPO registration statement? Was there a contemporaneous equity valuation performed at or near the time of grant? If there is a significant difference between the exercise price of those options and the expected IPO price, the grant may trigger compensation expense that could reduce net income and/or prompt the SEC to ask for a detailed explanation of the rapid change in the issuer's valuation.[3]

- *Do you have a communications plan in place?* The SEC's rules impose strict limitations on communications around a planned IPO. These rules can cause significant friction, especially for companies that are used to being transparent and have active PR programs. On the other hand, violations of the SEC's communications restrictions – often called "gun jumping" – can cause an offering to be delayed for weeks or even months. You will need to ensure you have a plan in place to prevent unauthorized public statements during the public offering process.
- *Is there a possibility that you will wish to pursue an unregistered transaction instead of the public offering?* Based on Securities Act Rule 152, an issuer is permitted to conduct a private placement 30 days after withdrawing a public offering. The rule gives general guidance that 30 days is an appropriate "quiet period" in advance of a private placement.
- *Will there be a concurrent private capital raise?* Is there a possibility that you will pursue an unregistered private placement concurrently with the IPO? If so, care must be taken to avoid taking steps that could potentially threaten the private placement or inadvertently cause offerees in the private offering to be excluded from participation in the IPO.

Available Registration Forms

The SEC has specific forms for the registration of securities under both the Securities Act and the Exchange Act. Forms not only contain their own disclosure requirements, but also specify certain items that must be disclosed under Securities Act Regulation S-K (for textual disclosure requirements) and under Securities Act Regulation S-X (which governs financial statements).

The central form for foreign private issuers is Form 20-F. Form 20-F sets out the required disclosure for US listings and annual reports by foreign private issuers. In addition, the registration forms for public securities offerings refer extensively to Form 20-F.

For both the Securities Act and the Exchange Act, the relevant forms typically prescribe broad categories of information, rather than specific disclosures. In the case of a Securities Act registration form, the registration statement includes a prospectus containing prescribed categories of financial and non-financial disclosure, as well as additional information not included in the prospectus, including exhibits (such as corporate documents and material contracts). The registration statement, prospectus, and annual report must contain a basic package of financial statements and other financial information to illustrate the financial condition and results of operations of the issuer.

For a foreign private issuer, the primary registration forms are:

SEC Registration Forms	Description
Securities Act Forms	
Form F-1	The form for first-time issuers and all other issuers who are not eligible for Form F-3.
Form F-3	A short form available for certain offerings by seasoned issuers. Issuers may incorporate by reference information contained in filings made under the Exchange Act, such as an annual report on Form 20-F.
Form F-4	The form for business combinations and exchange offers.
Form F-6	The form for American Depositary Shares (ADSs) evidenced by American Depositary Receipts (ADRs).
Form S-8	The form for registering securities issued to employees under an employment benefit plan, and interests in such plans.

SEC Registration Forms	Description
Exchange Act Forms	
Form 20-F	The form for registering outstanding securities that will be listed on the NYSE or Nasdaq, and for annual reports.
Form 8-A	A short form available for registering newly issued securities that will be listed on the NYSE or Nasdaq in connection with a concurrent public offering in the US. Form 8-A is used in conjunction with the applicable Securities Act registration form.

ADRs and ADSs

Many foreign private issuers that sell equity securities into the United States do so through the use of ADRs. ADRs are issued by a depositary, usually a large multinational bank, and represent a specified number of the issuer's underlying equity securities held by the depositary or its custodian. Although ADR holders have essentially the same ultimate rights as holders of the underlying securities and can, with limited exceptions, exchange their ADRs for the underlying securities at any time, ADRs are denominated in US dollars, and their terms are negotiated between the issuer and the depositary bank. The depositary typically receives fees from holders for transactions in the underlying shares, such as withdrawals from or deposits into the ADR facility, currency exchanges in connection with the payment of dividends, and ongoing annual depositary service fees.

The SEC considers ADRs to be separate securities from the underlying shares. This means that depositary banks, as the issuer of the ADRs, must separately register the issuance of ADRs with the SEC on Form F-6. In addition, an issuer wishing to conduct a public offering or seeking a listing in the US must always register the underlying shares on the applicable SEC form as discussed above.

Issuances of ADRs in connection with a US public offering by the issuer are known as "Level III" ADR programs; issuances of ADRs in connection with a US listing of existing shares in the US without a public offering are known as "Level II" ADR programs; and issuances of ADRs representing existing shares that are traded only over-the-counter in the United States are known as "Level I" ADR programs. ADR depositaries may establish a Level I ADR program to facilitate secondary trading in a foreign private issuer's previously issued shares either with the issuer's participation (a sponsored program) or without the issuer's participation (an unsponsored program).

NYSE and Nasdaq Listing Requirements

To be eligible for listing on the NYSE or on Nasdaq, a foreign private issuer must meet certain quantitative listing requirements and corporate governance standards. Once listed, foreign private issuers must meet certain requirements relating to ongoing shareholder communication and disclosure. The quantitative NYSE and Nasdaq listing criteria and corporate governance standards are summarized in Annexes A and B.

NYSE and Nasdaq adopted wide-ranging changes in corporate governance requirements for listed companies in the wake of Sarbanes-Oxley. Foreign private issuers may generally follow home-country practice in lieu of certain of the corporate governance requirements, although they must also disclose any significant ways in which their home-country practices differ from those followed by domestic US companies.[4]

Confidentiality

Foreign private issuers that are registering with the SEC for the first time may submit registration statements for review on a confidential basis.[5] Confidential submission offers a number of advantages: A foreign private

issuer that decides not to proceed with the IPO past this stage will not have made public competitively sensitive information, such as financial information or key supplier or customer contracts. A foreign private issuer may continue to confidentially submit the first draft of a registration statement for 12 months following the effective date of the initial registration statement.[6] Confidential submissions must be substantially complete when submitted to the SEC for review, just like a publicly filed registration statement. However, a confidentially submitted draft registration statement need not include the consent of auditors or other experts and does not need to be signed because a confidential submission does not constitute a "filing" under the Securities Act.[7] An issuer does not need to name any underwriters in its first confidential submission, but the SEC Staff typically will not continue reviewing a draft registration statement unless underwriters are named with the second submission. The registration statements remain confidential until the point of public filing.[8]

In almost all other circumstances, issuers are required to file registration statements and Exchange Act reports publicly. These documents – including any exhibits, such as material contracts – become available shortly after filing through the SEC's EDGAR database. In addition, the SEC makes public both its comment letters on issuer's registration statements and required Exchange Act reports, as well as issuers' responses to those comments, within 45 days of the end of the SEC's review process.[9]

Issuers often wish to preserve the confidentiality of certain portions of their response to SEC comments, as well as key terms of material contracts required to be filed as exhibits. An issuer may redact from those contracts information that is confidential, immaterial to investors, and proprietary such that disclosure would result in competitive harm.[10] The SEC Staff may, and in the case of an IPO is likely to, supplementally request an unredacted copy of the contract, and may also subsequently request a materiality and competitive harm analysis to substantiate the redactions. The Securities Act and the Exchange Act include rules detailing how confidential treatment may be obtained for information contained in other documents that are required to be filed with the SEC – such as responses to SEC comments and materials responsive to a Staff request for additional information.[11] The SEC Staff has historically been unwilling to grant broad-brush requests for confidential treatment, particularly of contractual terms, so issuers should redact precisely and avoid overly broad requests.

FINRA's Corporate Financing Rule and Related Requirements

FINRA Rule 5110 (also commonly referred to as the Corporate Financing Rule) generally applies to any public offering conducted in whole or in part in the United States in which a FINRA member firm participates as an underwriter, dealer, distributor, or in a similar capacity (the Participating Member[12]). Although most often Rule 5110 will come up in the context of an SEC-registered offering, the Rule also applies to public offerings that are not required to be SEC-registered, including, for example, public offerings by US banks (or US branches of foreign banks) conducted in accordance with the Securities Act Section 3(a)(2) exemption. Rule 5110, however, does not apply to offerings conducted in accordance with the private placement exemption from Securities Act registration under Section 4(a)(2) of the Securities Act, or pursuant to Regulation S or Rule 144A.

The purpose of Rule 5110 is to ensure that FINRA members do not participate in a public offering of securities in which the underwriting or other terms and arrangements relating to the distribution of securities are "unfair or unreasonable." In determining whether the compensation to be received by the Participating Members for the offering is "unfair or unreasonable," FINRA will look not only at the "spread" or underwriting discount to be received by the underwriters, but also at any other fees and arrangements or securities of the issuer that could be deemed to be "Underwriting Compensation"[13] received by (or payable to) the Participating Member within the period beginning 180 days prior to the date of the initial SEC confidential submission or public filing for a registered offering through the 60th day following the effectiveness date of the offering (this period is known as the Review Period).

In the case of an issuer's initial public offering of equity securities in the United States, as well as in respect of certain other public offerings, Rule 5110 requires that the underwriters for the offering file certain information with FINRA for review. With respect to documents, FINRA allows registration statements or other documents that have been filed with the SEC to be filed with FINRA solely by providing the relevant EDGAR identification or "accession" number, and provides that amendments to previously filed offering documents need to be filed only if they include changes that impact the underwriting terms and arrangements. The filing of industry-standard master forms of agreement is not required unless such forms are specifically requested by FINRA. Public offering filings will also need to include a representation as to whether any officer or director of the issuer or any beneficial owner of 10% or more of any class of the issuer's equity and "equity-linked securities,"[14] is an associated person or an affiliate of a Participating Member. The FINRA filing must be made no later than three business days after the SEC filing or confidential submission, as applicable. In addition, IPOs and other offerings that are not otherwise exempt from FINRA's filing requirements must receive FINRA's approval (in the form of a "no objections letter") before any securities may be offered or sold to investors.[15] This is the case even if the SEC has indicated it has no further comments and is ready to declare the registration statement effective.[16] As a result, it is of critical importance to determine early on in the process whether the offering will be subject to FINRA's review and approval process and to incorporate FINRA's filing and other requirements into the anticipated timeline for the offering.

If a participating FINRA member has a "conflict of interest" in connection with the offering (which may be the case, for example, if the member is an affiliate of the issuer or the member or its affiliates will be receiving 5% or more of the net proceeds from the offering to reduce or retire an outstanding credit facility or to redeem outstanding bonds or for any other purpose), FINRA Rule 5121 will also apply and may, in certain circumstances, require the participation in the offering of a "qualified independent underwriter," or QIU. Again, early identification of the potential application of this rule and the possible need to appoint a QIU will be key to ensuring that the offering is not unnecessarily delayed.

To assist in the determination of whether, and which, FINRA rules and requirements will be applicable to a particular offering, underwriters' counsel (typically in coordination with issuer's counsel) will send to the issuer, its officers, directors, and the beneficial holders of 10% or more of the issuer's equity and equity-linked securities a detailed questionnaire designed to elicit the required information. The issuer will also be asked to identify, and similar questionnaires will be sent to, the beneficial holders of any unregistered equity securities of the issuer that were acquired during the Review Period. In particular, the questionnaires are designed to identify (i) any Underwriting Compensation received or to be received by any of the Participating Members in connection with the public offering during the Review Period; and (ii) any association or affiliation of the issuer or any officer, director, 10% beneficial holder, or beneficial holder of recently acquired unregistered equity securities with any Participating Member in the offering. The information gathered in this process will be used to satisfy the requirements of Rules 5110 and 5121 and to make (if required) the associated FINRA filings, but the questionnaires themselves are not submitted to FINRA.

Although FINRA will accord confidential treatment to all documents and other information submitted to it for review under the Corporate Financing Rule,[17] note that certain information regarding items of underwriting compensation and other material relationships between the Participating Members and the issuer will, nonetheless, require disclosure in the offering document pursuant to the provisions of the FINRA rules, as well as Regulation S-K (S-K).

ENDNOTES

1 *See Financial Reporting Manual*, Sections 4110.1 (citing PCAOB Rule 2100), 4110.5, 4210.3).

2 For the initial registration by a foreign private issuer, the auditor must be independent under applicable SEC and PCAOB standards only for the most recent audited fiscal year as long as it is independent under home-country standards for all other audited periods. *See* S-X Rule 2-01(f)(5)(iii).

3 Latham & Watkins and The SEC Institute discuss the issue of "cheap stock" in *Cheap Stock: An IPO Survival Guide* (Aug. 12, 2010).

4 NYSE Manual §§ 303A.00, 303A.11; Nasdaq Rules 5615(a)(3), 5605(c), 5605(f), 5606, 5625, 5640. *See also* Nasdaq IM-5615-3.

5 A foreign private issuer undertaking its initial SEC registration has three alternatives for making a draft submission to the SEC for its IPO.
- A foreign private issuer that qualifies as an EGC may use the confidential submission procedure under Section 6(e) of the JOBS Act to the same extent and subject to the same requirements as an EGC that is not a foreign private issuer.
- A foreign private issuer that does not qualify as an EGC may use the confidential submission procedure under the expanded policy announced by the SEC Staff in June 2017. *See* Staff of the Division of Corporation Finance, *Draft Registration Statement Procedures Expanded*, (June 29, 2017) [*2017 Procedures*].
- A foreign private issuer that is already listed on a non-US stock exchange or that is concurrently listing on a non-US stock exchange in connection with its initial SEC registration may use the separate policy for dual-listed foreign private issuers. *See* Staff of the Division of Corporation Finance, *Non-Public Submissions from Foreign Private Issuers* (Dec. 8, 2011, updated May 30, 2012). [*2012 Procedures*]

6 *See 2017 Procedures.* The accommodation applies only to the first submission. Any response to Staff comments must be filed publicly, and, in any event, the public filing must be made at least 48 hours prior to going effective.

7 *See* SEC Division of Corporation Finance, *JOBS Act FAQs: Confidential Submission Process for Emerging Growth Companies* (Apr. 10, 2012), Question 7. In addition, a confidential submission does not constitute a filing for purposes of Sarbanes-Oxley.

8 Under the 2017 Procedures, any foreign private issuer that confidentially submits a draft registration statement must agree not to commence its IPO road show until at least 15 days after publicly filing the initial confidential submission and all confidentially submitted amendments. *See 2017 Procedures*; SEC Division of Corporation Finance Voluntary Submission of Draft Registration Statements – FAQs (June 30, 2017) *2017 Procedures – FAQs*, Question 3. Companies that proceed under the 2012 Procedures are not required to wait 15 days after their first public filing to begin their road show, which may be an important consideration in coordinating an offering in the home country. In the case of a follow-on offering, the accommodation applies only to the first draft submission. Any response to Staff comments must be filed publicly, and, in any event, the public filing must be made at least 48 hours prior to going effective. *See 2017 Procedures*.

9 *SEC Staff to Publicly Release Comment Letters and Responses* (June 24, 2005).

10 *See* Regulation S-K (S-K), Items 601(b)(2) and 601(b)(10)(iv). *See also* SEC Division of Corporation Finance, *New Rules and Procedures for Exhibits Containing Immaterial, Competitively Harmful Information* (Apr. 1, 2019). An issuer may also omit attachments and schedules to the contract that are not material and not otherwise disclosed in the contract itself or the disclosure documents. S-K, Item 601(a)(5).

11 Securities Act Rule 406 and Exchange Act Rule 24b-2. *See also* SEC Division of Corporation Finance, *Staff Legal Bulletin No. 1*.

12 The term "Participating Member" means any FINRA member that is participating in a public offering, any affiliate or associated person of the member and their immediate family members but does not include the issuer itself. The terms "participate," "participation" or "participating" for this purpose means involvement in the preparation of the offering document or other documents, involvement in the distribution of the offering, furnishing of customer or broker lists for solicitation, or providing advisory or consulting services to the issuer related to the offering. A broker dealer solely providing advisory or consulting services to the issuer as an independent financial adviser are excluded from the definition of "participating member."

13 "Underwriting Compensation" is defined as any payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering. In addition, underwriting compensation shall include finder's fees, underwriter's counsel fees, and securities. Amended Rule 5110 also includes expansive Supplementary Materials, which provide additional context and guidance as to what the term underwriting compensation is intended to encompass.

14 The term "equity-linked securities" means any security that are convertible or exchangeable into an equity security.

15 Certain offerings are not required to be reviewed and approved by FINRA under Rule 5110, but the participating FINRA members must nonetheless comply with the underwriting compensation limitations and other requirements of Rule 5110.

16 Typically, the SEC will not declare the registration statement effective until it has received an indication from FINRA that FINRA has no objection to the underwriting terms for the offering.

17 *See* FINRA Rule 5110(a)(4)(D).

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CHAPTER 5

SEC-Registered Offerings by EGCs Under the JOBS Act

The JOBS Act significantly modified the US securities laws in ways that make the IPO process more attractive to most companies considering an IPO. Title I of the JOBS Act created a new category of issuer, called an emerging growth company or EGC. EGCs benefit from a transition period, or on-ramp, from private to public company. During this period – which can last for up to five years – EGCs are exempt from certain costly requirements of being a public company. EGCs may choose all, some, or none of the on-ramp accommodations offered by Title I of the JOBS Act.[1]

EGC Status

You can take advantage of the JOBS Act Title I accommodations only if you are an EGC. In order to qualify as an EGC, a company must have annual revenue for its most recently completed fiscal year of less than $1.235 billion.[2] After the initial determination of EGC status, a company will remain an EGC until the earliest of:

- the last day of any fiscal year in which the company earns $1.235 billion or more in revenue;
- the date when the company qualifies as a "large accelerated filer," with at least $700 million in public equity float;[3]
- the last day of the fiscal year ending after the fifth anniversary of the IPO pricing date; or
- the date of issuance, in any three-year period, of more than $1.0 billion in non-convertible debt securities.

EGC status will ordinarily terminate on the last day of a fiscal year. However, the issuance in any three-year period of more than $1.0 billion in non-convertible debt securities would cause an issuer to lose its EGC status immediately. Note however, that EGC status will be extended during the registration process even if the registrant's revenues exceed $1.235 billion or the registrant issues in excess of $1.0 billion of debt securities during the registration process. Any confidential submission or public filing by an EGC will lock in EGC status through the earlier of (i) the IPO date or (ii) one year after the issuer would have otherwise lost EGC status.[4]

Subject to certain limitations, a company that was previously public may be eligible for EGC status.[5]

> PRACTICE POINT
>
> ***Scope of the EGC Lock-In***
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> An EGC that loses status during the registration process will get the benefit of all disclosure-related aspects of being an EGC (e.g., two years of financials rather than three). But the SEC Staff has taken the position that the lock-in does not extend to the relaxed rules on research.[6]

Elements of the IPO On-Ramp

As long as an issuer continues to qualify as an EGC, it benefits from a temporary transition period, or on-ramp, during which its regulatory requirements phase in gradually. This phased approach eases the cost of public company compliance by allowing the EGC additional time to comply with some of the more costly requirements that apply broadly to the largest public companies. As discussed above, the on-ramp period for any particular EGC will depend upon its revenue, public float, and issuance of debt securities but will not last beyond the last day of the fiscal year ending after the fifth anniversary of its IPO pricing date.

The on-ramp exemptions for EGCs include:

- *Section 404(b) of Sarbanes Oxley*. EGCs are exempt from the auditor attestation requirements of Section 404(b) relating to internal controls over financial reporting for as long as they qualify as EGCs.[7]
- *Executive compensation disclosure*. EGCs may use streamlined executive compensation disclosure and are exempt from the shareholder advisory votes on executive compensation required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. (Dodd-Frank) Foreign private issuers are subject to less stringent compensation disclosure requirements and thus this JOBS Act relief is less significant for them.
- *Extended phase-in for new US GAAP*. EGCs are not required to comply with new or revised financial accounting standards under US GAAP until those standards also apply to private companies.[8]
- *Certain PCAOB rules.* EGCs are exempt from any PCAOB rules that, if adopted, would mandate audit firm rotation and an expanded narrative, called auditor discussion and analysis, that would appear as part of any financial statement audit.[9] The PCAOB has adopted a new auditor reporting standard that will significantly change the standard form of audit report used in SEC filings. EGCs are exempt from this new standard.[10]

EGCs and the IPO Process

"Testing the Waters"

EGCs and their authorized persons (including underwriters), before or after confidentially submitting or publicly filing a registration statement, are allowed to meet with large heavyweight investors, called qualified institutional buyers or QIBs, and other institutional accredited investors, or IAIs, to gauge their interest in a contemplated offering.[11] These testing-the-waters, or TTW, meetings are discussed in the following Chapter.

Scaled Financial Disclosures

At the time of its IPO, an EGC can provide two, rather than three, years of audited financial statements.[12] After its IPO, an EGC must phase into full compliance by adding one additional year of financial statements in each future year until it presents the traditional three years of audited financial statements.[13] An EGC's MD&A may address only the years for which it provides audited financial statements and any subsequent interim period.[14] In our experience, some EGCs choose not to take advantage of the scaled financial disclosure accommodation because they prefer to show their performance trajectory over a longer period.

Research

The JOBS Act and subsequent FINRA rulemaking have effectively eliminated the quiet periods for pre-IPO and post-IPO research on EGCs and thus, in theory, would allow participating broker-dealers to publish research reports on an EGC before or immediately after the IPO pricing date. FINRA subsequently amended its rules to reduce the research blackout period for non-EGC IPOs to 10 days after an IPO in which the member has acted as an underwriter or dealer, and three days after a secondary offering in which the member has acted as a manager or co-manager, although other considerations under federal securities laws with respect to the distribution of research around the time of an offering continue to apply. Nonetheless, for both EGC and non-EGC IPOs, a 25-day research quiet period is still typically imposed on members of the underwriting syndicate. This syndicate-imposed research quiet period typically begins at the time an underwriter becomes a member of the syndicate and lasts until the 25th calendar day following the IPO effective date. This approach reflects the view of many industry participants that investors should be looking to the information provided in the prospectus during the prospectus delivery (or availability) period set forth in Securities Act Rule 174(d). It also provides the covering analysts with some time to prepare their first public research reports.

ENDNOTES

1 For a detailed discussion of the on-ramp accommodations introduced by Title I of the JOBS Act, *see* our Client Alerts *JOBS Act Establishes IPO On-Ramp* (Mar. 27, 2012) and *The JOBS Act After Two Weeks: The 50 Most Frequently Asked Questions* (Apr. 23, 2012). For a comprehensive analysis of trends in the IPO market that emerged during the first two years of the JOBS Act, *see* our report *The JOBS Act, Two Years Later: An Updated Look at the IPO Landscape* (Apr. 5, 2014).

2 *See* JOBS Act Sections 101(a) and (b) (adding new Securities Act Section 2(a)(19) and Exchange Act Section 3(a)(80)).

3 *See* S-K Items 308 (a) and (b). Under Exchange Act Rule 12b-2, a "large accelerated filer" is an issuer that, as of the end of its fiscal year:

- has an aggregate worldwide market value of voting and non-voting common equity held by non-affiliates (market capitalization) of $700 million or more (measured as of the last business day of the issuer's most recently completed second fiscal quarter);
- has been subject to SEC reporting under the Exchange Act for a period of at least 12 calendar months;
- has filed at least one annual report under the Exchange Act with the SEC; and
- is not eligible to be a "smaller reporting company" and had annual revenues of less than $100 million in the most recent fiscal year for which financial statements are available.

In addition, under Exchange Act Rule 12b-2, an "accelerated filer" is an issuer meeting the same conditions, except that it has a market capitalization of $75 million or more but less than $700 million (measured as of the last business day of its most recently completed second fiscal quarter). *See Final Rule: Accelerated Filer and Large Accelerated Filer Definitions*, Release No. 34-88365 (Mar. 12, 2020). *See also Final Rule: Smaller Reporting Company Definition*, Release No. 33-10513 (July 10, 2018).

4 Fixing America's Surface Transportation (FAST) Act, revising Securities Act Section 6(e)(1).

5 Restrictions include that the company was not taken private for the purpose of conducting an IPO as an EGC and did not have registration of a class of its securities revoked under Exchange Act Section 12(j). *See S*EC Division of Corporation Finance, *Jumpstart Our Business Startups Act Frequently Asked Questions: Generally Applicable Questions on Title I of the JOBS Act* (Sept. 28, 2014) (SEC Title I FAQs), Question 54.

6 *See* SEC Title I FAQs, Question 3.

7 *See* JOBS Act Section 103 (revising Sarbanes-Oxley Section 404(b)).

8 *See* JOBS Act Section 102(b)(1) (adding new Securities Act Section 7(a)(2)(B)). *See also* SEC Title I FAQs, Question 13. An EGC wishing to opt out of the extended phase-in for new or revised financial accounting standards under US GAAP must disclose this election in the first registration statement that is submitted to the SEC, regardless of whether it is a confidential submission or a public filing.

9 *See* JOBS Act Section 104 (revising Sarbanes-Oxley Section 103(a)(3)).

10 The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendment to PCAOB Standards, PCAOB Release No. 2017-001 (June 1, 2017), PCAOB Rulemaking Docket No. 034.

11 *See* JOBS Act Section 105(c) (adding new Securities Act Section 5(d)).

12 *See* JOBS Act Section 102(b)(1) (adding new Securities Act Section 7(a)(2)).

13 *See* JOBS Act Section 102(b)(2) (modifying Exchange Act Section 13(a)).

14 *See* JOBS Act Section 102(c) (modifying S-K, Item 303(a)).

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CHAPTER 6

Gun Jumping – Restrictions on Communications in Connection With Registered Securities Offerings

What Is "Gun Jumping"?

Gun jumping refers generally to violations of the communications restrictions under the Securities Act. Section 5 of the Securities Act divides the registration process into three distinct time periods:

- *Pre-filing or "quiet" period*. The pre-filing or quiet period begins when a company decides to make a public offering (usually by retaining an investment bank or banks to undertake the offering) and ends when the registration statement relating to the offering is first filed publicly with the SEC. During this period, Section 5(c) of the Securities Act prohibits any person from engaging in activity that could be construed as making an "offer" of the company's securities. Accordingly, other than TTW activities permitted by Section 5(d) of the Securities Act and Rule 163B of the Securities Act (discussed below), or absent an exemption from registration – such as the private placement exemption of Section 4(a)(2) or an exception from the definition of offer – nothing that would be considered to be an offer of securities is permitted during the pre-filing period.
- *Period between filing and effectiveness (also often called the "waiting period")*. The waiting period extends from the time that the registration statement is filed publicly with the SEC until the time that it is declared effective by the SEC. During this period, offers of the security are permitted by Section 5 if they are made properly (sales are not allowed until the effectiveness of the registration statement). Under Section 5(b)(1), no prospectus other than a prospectus meeting the requirements of Section 10 of the Securities Act may be used to make written offers. Because the term "prospectus" picks up nearly all forms of written offers (and many forms of oral communication, including TV broadcasts, blast voicemail messages, and the like), only certain types of oral offers and a carefully limited group of written offers may be made during the waiting period. A properly designed road show is one form of oral offer that satisfies the intricate requirements of Section 5. Issuers may also engage in TTW communications with QIBs and other IAIs during the waiting period.
- *Post-effective period.* After effectiveness of the registration statement (which occurs on the pricing date), underwriters, and other distribution participants may confirm sales of the securities by means of a final prospectus meeting the requirements of Section 10(a) of the Securities Act. In addition, underwriters will have an obligation to deliver a final prospectus during a period of time following effectiveness, even in connection with secondary market resales. Accordingly, until the later of (1) completion of the "distribution" of the securities (that is, when the securities have been sold to investors) or (2) expiration of the relevant prospectus-delivery period (typically 25 days), limitations on publicity by the issuer will remain in place.

Restrictions on Communications During the Quiet Period

During the quiet period, an issuer may not make offers or sales of the securities being registered, although issuers may participate in TTW meetings. The SEC has construed the term "offer" very broadly to include communications that do not refer to the proposed offering but which may nevertheless stimulate investor or dealer interest in the issuer or its securities. General statements about the issuer's rosy future prospects may well be considered to be offers. An issuer should generally not release publicly any forecasts, projections, or predictions relating to revenue, income, or earnings per share or concerning expected valuations, and should put in place procedures for review of public statements and press releases as soon as the offering process first gets underway.

> PRACTICE POINT
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> Prior to filing your registration statement, you should review your website to make sure the content is factually consistent with the statements in your registration statement and will not be considered to be an illegal offer of securities. Issuer websites are routinely reviewed by the SEC Staff during the registration process and could be construed to be an ongoing offer of securities. In addition, the Staff is looking to assess whether the issuer is presenting information about itself that is consistent, regardless of the media used.

Although an issuer may continue to advertise its products and services and issue press releases regarding factual business and financial developments in accordance with past practice,[1] the breadth of the SEC's definition of the term offer, coupled with the potentially significant problems flowing from gun jumping, make it advisable to tone down all public statements (or at least run them by counsel) during and immediately preceding the offering process. Meetings with, or publications targeted at, members of the investment community are particularly problematic during the quiet period.

As we discuss in more detail below, issuers and their authorized persons (including underwriters) may engage in oral or written communications with QIBs and other IAIs in TTW sessions that occur during (or before) the quiet period. In addition, the SEC has provided certain safe harbors from the prohibition on pre-filing offers that apply to all issuers (even non-EGCs). Under these safe harbors, an issuer may:

- conduct certain press activities outside the United States under Securities Act Rule 135e;
- take advantage of the Rule 163A safe harbor for communications that do not refer to the offering made more than 30 days prior to the filing of the registration statement;
- release a limited notice regarding the offering within the United States under Securities Act Rule 135;
- release certain factual and forward-looking information under Rule 168 or 169; and
- if it is a well-known seasoned issuer, or WKSI (defined below), make certain offers of securities under Securities Act Rule 163.

We discuss these safe harbors below.

Offshore Press Activity – Securities Act Rule 135e

Rule 135e provides a safe harbor from the definition of offer under Section 5 of the Securities Act for offshore press activity. This safe harbor is available for registered as well as unregistered transactions.

> PRACTICE POINT
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> Although Rule 135e does not limit the content of offshore press announcements, the SEC Staff frequently monitors offshore press activity by companies that are in the process of a public offering in the United States. Some caution is therefore warranted in relying on this Rule. Foreign private issuers should avoid making detailed discussions of a pending offering, particularly in the English-language press outside the United States.

The 30-Day Bright-Line Safe Harbor – Securities Act Rule 163A

Rule 163A provides all issuers (whether or not already public filers) with a non-exclusive safe harbor from Section 5(c)'s prohibition on pre-filing offers for certain communications made more than 30 days before

the public filing of a registration statement that might otherwise have been considered to be an offer under Section 2(a)(3). For an EGC that confidentially submits a draft registration statement for nonpublic review by the SEC, the date of the first public filing of the registration statement, not the date of the confidential submission, determines the availability of the Rule 163A safe harbor. Rule 163A is not available to prospective underwriters.

The requirements for Rule 163A include that:

- the communication cannot refer to the securities offering;
- the communications must be made by or on behalf of an issuer – in other words, the issuer will need to authorize or approve each Rule 163A communication (communications by an underwriter without the issuer's seal of approval will not come within the safe harbor); and
- the issuer must take "reasonable steps within its control" to prevent further distribution of the communicated information during the 30-day period before filing the registration statement (although the SEC has suggested that the issuer may maintain copies of previously published information on its website, if the information is appropriately dated, identified as historical material, and not referred to as part of the offering activities).[2]

Pre-Filing Public Announcements of a Planned Offering – Securities Act Rule 135

Rule 135 provides that an issuer will not be deemed to make an offer of securities under Section 5(c) as a result of a public announcement of a planned registered offering that includes only the bare-bones information permitted by the Rule. A Rule 135 notice can be released at any time, including before a registration statement is filed.

Under Rule 135, the announcement must contain a legend, and no more than the limited information enumerated in the Rule, which includes:

- the name of the issuer;
- the title, amount, and basic terms of the securities offered;
- the anticipated timing of the offering; and
- a brief statement of the manner and purpose of the offering, without naming the prospective underwriters for the offering.

Factual Business Communications by Reporting Companies – Securities Act Rule 168

Rule 168 is a non-exclusive safe harbor from Section 5(c)'s prohibition on pre-filing offers (and from Section 2(a)(10)'s definition of a "prospectus") that is available only to reporting issuers with a history of making similar public disclosures. It allows a reporting issuer (and certain widely traded, non-reporting foreign private issuers) to make continued regular release or dissemination of "factual business information" and "forward-looking information,"[3] but not information about an offering or information released as part of offering activities. Rule 168 is not available to underwriters. In addition, voluntary filers may not rely on the rule, and instead must look to Rule 169.[4]

Disclosure of Rule 168 information is permitted at any time, including before and after the filing of a registration statement, but only if:

- the issuer has previously released or disseminated Rule 168 information in the ordinary course of its business; and

- the timing, manner, and form in which the information is released is materially consistent with similar past disclosures.

For the information to be considered regularly released in the ordinary course of business, the method of releasing or disseminating the information, and not just the content, will be required to be consistent in material respects with prior practice.[5] Therefore, under Rule 168, the issuer will need to be able to show a record of releasing the particular type of information in the same particular manner, although the SEC has acknowledged that one prior release could establish a sufficient record.[6] The SEC has, however, cautioned that an issuer's release of "new types of financial information or projections just before or during a registered offering will likely prevent a conclusion" that the issuer regularly releases that information.[7]

Factual Business Communications by Non-Reporting Companies and Voluntary Filers – Securities Act Rule 169

Rule 169 provides a non-exclusive safe harbor from both Section 5(c)'s restriction on pre-filing offers and Section 2(a)(10)'s definition of a prospectus for companies that are not yet public. Under Rule 169, non-reporting issuers are permitted to continue to release factual business information, *but not forward-looking information*. Rule 169 is available only for communications intended for customers, suppliers, and other non-investors. The SEC has nonetheless made clear that the safe harbor will continue to be available if the information released happens to be received by a person who is both a customer and an investor.[8]

Pre-Filing Offers by WKSIs – Rule 163

Rule 163 creates a non-exclusive safe harbor for WKSIs from Section 5(c)'s prohibition on pre-filing offers. The exemption is not available to underwriters, although the SEC has proposed (but never adopted) broadening its scope to include certain underwriters and dealers authorized by an issuer to approach the market on the issuer's behalf.[9]

Under Rule 163, offers by or on behalf of a WKSI before the filing of a registration statement are free from the restraints of Section 5(c) if certain conditions are met. These include that any written offer must contain a prescribed legend and must be filed with the SEC promptly upon filing of the registration statement for the offering unless the communication has previously been filed with the SEC or is exempt from filing under the terms of Rule 433 (discussed below). If no registration statement is ever filed, however, a Rule 163 communication will not need to be filed.[10]

Definition of WKSI

The definition of WKSI[11] includes an issuer (and its majority-owned subsidiaries under certain circumstances) that:

- meets the registrant requirements of General Instruction I.A of Form S-3 or Form F-3, which include that the issuer:
  - has securities registered with the SEC under Section 12(b) of the Exchange Act, a class of equity securities registered under Section 12(g), or is required to file reports under Section 15(d);
  - has filed at least one annual report on Form 10-K or 20-F;
  - has filed on time all material required to be filed with the SEC during the 12 calendar months and any portion of a month immediately preceding the filing of the registration statement; and
  - has not had any material defaults under debt or long-term lease agreements since the end of the last fiscal year;

- as of a date within 60 days of the determination date,[12] has:
  - a worldwide market value of outstanding voting and nonvoting common equity[13] held by non-affiliates of at least $700 million; or
  - issued at least $1 billion in aggregate principal amount of non-convertible securities in transactions registered under the Securities Act, other than equity securities, in primary offerings for cash during the past three years; and
  - is not an ineligible issuer[14] or asset-backed issuer.

Restrictions on Communications During the Waiting Period

During the waiting period, which extends from the time that the registration statement is filed publicly with the SEC until the time that it is declared effective by the SEC, oral offers may be made but only certain types of written offers are permitted. The distinction between oral and written is not intuitive, and many forms of verbal communication, as well as TV broadcasts, blast voicemail messages, and the like, are considered written for these purposes. Issuers may continue TTW activities with QIBs and other IAIs during the waiting period through both written and oral communications.

During the waiting period, an issuer may continue to engage in activity that falls within one of the safe harbors discussed above. In addition, it may:

- publish a limited notice within the United States of its upcoming offering pursuant to the Securities Act Rule 134 safe harbor;
- circulate a preliminary prospectus (often referred to as a "red herring") that meets the requirements of Section 10 of the Securities Act, including a price range for the offering;
- conduct a road show and solicit "buy" orders; and
- under certain circumstances, use a free writing prospectus, or FWP.

Limited Post-Filing Communications – Securities Act Rule 134

Rule 134 provides that certain limited written communications related to a securities offering as to which a registration statement has been filed will be exempt from the restrictions applicable to written offers (because they will not be considered to be a prospectus). Rule 134 is only available once a preliminary prospectus that meets the requirements of Section 10 has been filed. IPO issuers may rely on Rule 134 before filing a price range prospectus, although the Rule does require a price range prospectus for certain specific statements, as discussed below.[15]

The information permitted by Rule 134 includes:

- certain basic factual information about the legal identity and business location of the issuer, including contact details for the issuer;
- the title and amounts of securities being offered;
- a brief description of the general type of business of the issuer, limited to information such as the general types of products it sells;
- the price of the security or the method for determining price (in the case of an IPO, this information cannot be provided until a price range prospectus has been filed);

- in the case of a fixed-income security, the final maturity, interest rate, or yield (in the case of an IPO, this information cannot be provided until a price range prospectus has been filed);
- anticipated use of proceeds, if then disclosed in the prospectus on file;
- the name, address, phone number, and email address of the sender of the communication, and whether or not it is participating in the offering;
- the names of all underwriters participating in the offering and their additional roles in the underwriting syndicate;
- the anticipated schedule for the offering, and a description of marketing events;
- a description of the procedures by which the underwriters will conduct the offering and information about procedures for opening accounts and submitting indications of interest, including in connection with directed share programs;
- in the case of rights offerings, the class of securities the holders of which will be entitled to subscribe, the subscription ratio, and certain additional information;
- certain additional information, including the names of selling security holders, the exchanges on which the securities will be listed, and the ticker symbols; and
- a required legend.

It is customary to have a Rule 134 press release on the first day of the road show, announcing the launch of the offering.

> PRACTICE POINT
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> Rule 134 is often relied on for the press release announcing the commencement of a registered offering, as well as the "tombstone" advertisement following the closing.

"Testing the Waters"

Issuers and their authorized persons (including underwriters), before or after confidentially submitting or publicly filing a registration statement, are allowed to meet with large heavyweight investors, called qualified institutional buyers or QIBs, and other institutional accredited investors, or IAIs, to gauge their interest in a contemplated offering.[16] These TTW meetings can include oral and written communications. The decision whether to test the waters and the timing of these meetings depends on the specific circumstances of each offering. In our experience, the majority of TTW meetings take place after confidential submission and before public filing, but we have also seen deals where TTW meetings occur prior to any submission or during the 15-day period prior to the launch of the road show.[17]

PRACTICE POINT

The deal team should consider how much detail to include in TTW materials, based on when testing the waters occurs and bearing in mind that the antifraud provisions of the federal securities laws apply to the content of these communications. As with traditional road show materials, TTW materials should also be consistent with the information contained in the registration statement. Market participants typically do not leave written TTW materials behind, although it is common to hand out flip books at these meetings and take them back when the meeting ends. The SEC Staff routinely asks to see all materials used in TTW meetings by issuing the following comment:

> *Please supplementally provide us with copies of all written communications, as defined in Rule 405 under the Securities Act, that you, or anyone authorized to do so on your behalf, present to potential investors in reliance on Section 5(d) of the Securities Act, whether or not they retain copies of the communications.*

These materials are not sent to the Staff through EDGAR but instead are provided in hard copies. The SEC provides a procedure for requesting that these materials be returned to the issuer.

Preliminary Prospectus (Red Herring)

A "red herring" or "red" is the colloquial term for a certain type of preliminary prospectus permitted by Section 10(b) of the Securities Act. A red herring can be used to make written offers and solicit customer orders but cannot be used to satisfy the prospectus delivery obligations that apply when orders are confirmed and securities are sold. This is because a red herring is a Section 10(b) prospectus (i.e., does not contain all of the information required by Section 10(a) of the Securities Act).

Securities Act Rule 430 provides that, in order to be a Section 10(b) prospectus, a red herring must include substantially all of the information required in a final prospectus, other than the final offering price and matters that depend on the offering price, such as offering proceeds and underwriting discounts.

In addition, S-K Item 501(b)(3) requires a preliminary prospectus used in an IPO to contain a "*bona fide* estimate" of the price range. The SEC Staff generally takes the position that a *bona fide* price range means a range no larger than $2 (for ranges below $10) or 20% of the high end of the range (for maximum prices above $10). If a filed prospectus does not yet include a *bona fide* price range or otherwise does not comply with Rule 430, it is known in the trade as a "pink herring" – i.e., a filed preliminary prospectus that is not quite a red because it does not yet meet the requirements of Section 10(b) and cannot be used to solicit customer orders.

A foreign private issuer that is already listed on a non-US stock exchange is sometimes permitted to avoid providing a price range but rather provides a recent share closing price on the non-US stock exchange, along with a US dollar convenience translation of that amount. Whether the Staff would permit this practice for a particular US IPO by a foreign private issuer, or even if permitted, whether it is appropriate from a marketing point of view, will depend on the facts and circumstances of the IPO, the nature of the non-US trading market, and several other factors.

PRACTICE POINT

Regulation S-K Item 501(b)(10) specifies the required "subject to completion" legend that must appear on the front cover of any preliminary prospectus. This legend is traditionally printed in red ink, and gave rise to the name "red herring."

Road Shows

Road shows are the duck-billed platypus of the securities world – the evolutionary missing link with traits of both oral and written offers. Securities Act Rule 433(h)(4) provides a formal definition of "road show" as an offer (other than a statutory prospectus) that "contains a presentation regarding an offering by one or more members of an issuer's management … and includes discussion of one or more of the issuer, such management and the securities being offered."

You can see why a traditional road show (an intensive series of in-person meetings with key members of the buy-side community over a multi-day period in multiple cities and, sometimes, in multiple countries) would be an oral offer. But what about the slide deck that is traditionally handed out and reviewed at road show meetings? And what if the road show is recorded and broadcast over the internet?

The explanatory note to Rule 433(d)(8) states:

> A communication that is provided or transmitted simultaneously with a road show and is provided or transmitted in a manner designed to make the communication available only as part of the road show and not separately is deemed to be part of the road show. Therefore, if the road show is not a written communication, such a simultaneous communication (even if it would otherwise be a graphic communication or other written communication) is also deemed not to be written.

As a result, road show slides and video clips are not considered to be written offers as long as copies are not left behind. Even handouts are not written offers so long as they are collected at the end of the presentation. If they are left behind, however, they become an FWP and are subject to a variety of detailed requirements spelled out in Securities Act Rules 164 and 433, which we discuss further below.

It has become customary to prepare a video recording of the road show for the benefit of retail investors. The video version will not need to be filed as an FWP so long as it is available on the internet to all comers and covers the same ground as the live road show.

> PRACTICE POINT
>
> It is customary to pass out copies of the slide deck at road show meetings, but all of these flip books are retrieved at the end of the meeting so the slides do not have to be treated as an FWP.

Free Writing Prospectuses (FWPs)

Overview

Under Securities Act Rule 405, an FWP is any written communication that constitutes an offer to sell or a solicitation of an offer to buy the securities that are the subject of a registered offering that is used *after* a registration statement has been filed. A confidential submission does not trigger the Rule's definition of an FWP, nor do TTW communications. A supplement to a statutory prospectus can be an FWP, as can press releases, emails, blast voicemails, and even press interviews.

The use of FWPs is governed by Securities Act Rules 164 and 433. Rule 164 provides that, once a registration statement has been filed, an issuer or an underwriter may use an FWP if, among other things, the issuer is an eligible issuer, the offering is an eligible offering, and the additional conditions of Rule 433 are met.[18] We discuss the key points of using FWPs below.

Why Are FWPs Permitted? – Securities Act Rule 164(a)

Recall that, under Section 5(b)(1), no prospectus other than a prospectus meeting the requirements of Section 10 may be used to make offers. Rule 164(a) provides that an FWP meeting the requirements of Rule 433 will be a Section 10(b) prospectus – that is, a prospectus that may be used to make offers after a registration statement has been filed. However, an FWP may not be used as a *final* prospectus to satisfy the prospectus delivery requirements associated with the delivery of securities after pricing.

Use of FWPs – Securities Act Rule 433(b)

Rule 433(b) distinguishes between the use of FWPs by certain seasoned issuers on the one hand, and IPO issuers or unseasoned public companies on the other.

WKSIs, issuers eligible to use Form S-3 or F-3, and certain majority-owned subsidiaries of the foregoing may generally use an FWP after filing a registration statement that includes a Section 10 prospectus.

Things work differently for IPO issuers, as well as certain unseasoned public companies.

- For an IPO issuer, the prospectus must contain a bona fide price range in order to qualify as a Section 10(b) prospectus that can be used to solicit customer orders during the road show. An IPO issuer cannot use an FWP until it has filed a price range prospectus. The requirement to have a price range prospectus does not apply, however, in the case of a media FWP that was not published in exchange for payment and was filed with a required legend within four business days of becoming aware of its appearance in the press (more on this below).
- A Section 10 prospectus must accompany or precede the FWP, unless either:
  - a statutory prospectus has already been provided and there is no material change from the most recent prospectus on file with the SEC; or
  - the FWP is a media FWP that was not published in exchange for payment and was timely filed with a legend.

Note that an electronic FWP emailed with the proper hyperlink will obviate the need for physical delivery of a prospectus.

What Can Be in an FWP? – Securities Act Rule 433(c)

An FWP may include information "the substance of which is not included in the registration statement." But this information must not conflict with either:

- information contained in the registration statement; or
- information in any of the issuer's Exchange Act reports that are incorporated by reference into the registration statement.

FWPs must also contain a prescribed legend, and may not include disclaimers of responsibility or liability that are impermissible in a statutory prospectus.[19] These include: disclaimers regarding accuracy, completeness, or reliance by investors; statements requiring investors to read the registration statement; language indicating that the FWP is not an offer; and, for filed FWPs, statements that the information is confidential.[20]

PRACTICE POINT

An FWP is often used when changes are made to an IPO that is already on the road. Typically, these changes are implemented in an amended registration statement filed with the SEC and a concurrent distribution of an FWP to prospective purchasers in the IPO. The FWP in this circumstance is typically a short summary of the changes included in the amended registration statement with the (important) changed pages attached. Circulating the FWP to prospective purchasers is a less cumbersome way to inform the market of deal changes than circulating an entire new preliminary prospectus.

Media FWPs – Securities Act Rule 433(f)

Rule 433(f) provides that any written offer that includes information provided, authorized, or approved by the issuer or any other offering participant that is prepared and disseminated by an unaffiliated media third party will be deemed to be an issuer FWP. Nevertheless, the requirements for prospectus delivery, legending, and filing on the date of first use that would otherwise apply to FWPs will not apply if:

- no payment is made or consideration given for the publication by the issuer or other offering participants; and
- the issuer or other offering participant files the media FWP with the required legend within four business days after the issuer or other offering participant becomes aware of publication or dissemination (but note that the FWP need not be filed if the substance of the written communication has previously been filed).

Any filing of a media FWP in these circumstances may include information that the issuer or offering participant believes is needed to correct information included in the media FWP. In addition, in lieu of filing the media communication as actually published, the issuer or offering participant may file a copy of the materials provided to the media, including transcripts of interviews.

PRACTICE POINT

A media FWP is how the SEC's rules deal with an article containing unfortunate quotes from an issuer or other offering participant that appears at an inopportune point in the offering process. If the article could be construed to be an "offer," then treating it as a media FWP is a good compromise solution – the offer will not violate Section 5, but the issuer will be required to accept Section 12 liability for the article's contents. It is usually advisable for issuers to refrain from giving media interviews immediately prior to or during the offering process.

When Must FWPs Be Filed? – Securities Act Rule 433(d)

The general rule is that an FWP must be filed with the SEC on the day the FWP is first used. If you miss the SEC's EDGAR filing cutoff for that day (5:30 p.m. Eastern Standard Time) you should still file the FWP as soon as you can.[21]

Issuers must generally file any issuer FWP, which is defined broadly to include an FWP prepared by or on behalf of the issuer or an FWP used or referred to by the issuer, as well as a description of the final terms of the securities in a pricing term sheet (whether contained in an issuer or an underwriter FWP). By contrast, an underwriter only needs to file an FWP that it distributes in a manner reasonably designed to lead to its "broad unrestricted dissemination." The SEC has explained that an FWP prepared by an underwriter that is only made available on a website restricted to the underwriter's customers or a subset of its customers will not require filing with the SEC, nor will an email sent by an underwriter to its customers, regardless of the number of customers involved.[22]

There are certain exceptions to the requirement to file an FWP. These include:

- an FWP does not need to be filed if it does not contain substantive "changes from or additions" to a previously filed FWP;
- an issuer does not need to file issuer information contained in an underwriter FWP if that information is already included in a previously filed statutory prospectus or FWP relating to the offering; and
- an FWP that is a preliminary term sheet does not need to be filed (recall that an FWP that is a final pricing term sheet must be filed by the issuer within two days of the later of establishing the terms or the date of first use).

Certain Failures to File and Failures to Include the Required Legend – Securities Act Rule 164

Failure to comply with the conditions of Rule 433 will potentially result in a violation of Section 5(b)(1) of the Securities Act. This has serious consequences, including a potential right of rescission under Section 12(a)(1).

Rule 164 provides some welcome relief from this harsh result in the case of certain "immaterial or unintentional" deviations from the requirements of Rule 433. In particular:

- a failure to file or a delay in filing an FWP will not be a violation so long as a good faith and reasonable effort was made to comply with the filing requirement and the FWP is filed as soon as practicable after the discovery of the failure to file;
- a failure to include the required legend will not be a violation, so long as: (1) a good faith and reasonable effort was made to comply with the legending requirement; (2) the FWP is amended to include the required legend as soon as practicable after the discovery of the omitted or incorrect legend; and (3) if the FWP was transmitted without the required legend, it is subsequently retransmitted with the legend by substantially the same means as, and directed to substantially the same purchasers to whom, the original FWP was sent; and
- a failure to comply with the record retention requirements of Rule 433 will not be a violation so long as a good faith and reasonable effort is made to comply with these record retention requirements.

Restrictions on Communications After Effectiveness of the Registration Statement; Prospectus Delivery

Some communications restrictions continue after the offering. After effectiveness of the registration statement, underwriters (and other dealers) will have an obligation to deliver (or make available in accordance with the "access equals delivery" protocol) a final prospectus during a period of time following effectiveness, even in connection with secondary market resales. That period is 25 calendar days in the case of an IPO that will be listed on a US exchange.[23] For a number of reasons, including that the prospectus being made available needs to continue to be accurate[24] until the expiration of the 25-day prospectus delivery period, certain limitations on other communications by the issuer during this period will remain in place. Once the 25-day prospectus delivery period has expired, Securities Act-related limitations on communications in connection with the offering can generally be eliminated.

Concurrent Private Offerings

Given that the registration process can take many months, an issuer may want, or need, to pursue a private offering that is not registered with the SEC on the same schedule as the offering. Concurrent public and private offerings are permitted, but need to be properly structured and conducted. There are two main areas of concern: making sure that activities in the public offering do not cause the private offering to run afoul of

Section 4(a)(2)'s restrictions on general solicitation; and preserving the potential for offerees in the private placement to participate in the public offering.

There are two ways to avoid tripping over the ban on general solicitation in private offerings. First, if the private offering purchasers are all QIBs, then it will not matter that the registration statement has been filed. In the *Black Box* and *Squadron Ellenoff* no-action letters, the SEC Staff laid out a limited policy exception to allow concurrent private offerings to QIBs and two or three additional large institutional accredited investors even though there was an ongoing public offering.[25] We call this the "who" exception. Alternatively, it is possible to structure a good private placement to investors who are not QIBs if they were attracted to the private offering by a means other than the registration statement, for example, as a result of a substantive pre-existing relationship with the issuer.[26] We call this the "how" exception.

The other issue that comes up in the context of concurrent public and private offerings is that potential private investors may expect information that is not typically part of the IPO disclosure package, particularly projections. Once a private investor has received projections from the issuer or placement agent in connection with the private offering, you will have to think carefully whether it will be wise to include that investor in the public offering. In most cases of concurrent public and private offerings, it can prove difficult to keep both the public and private options open as to the same institutional investor, unless that investor has received only the information included in the IPO disclosure. Otherwise, you and your banks will at some point need to decide which investors are exclusively private side and which are exclusively public side.

> PRACTICE POINT
>
> Concurrent public and private offerings are permissible, but you will want to be very thoughtful about who participates in which offering process, how they are solicited, and what disclosure they are provided.

Research Reports

Securities Act Rules 137, 138, and 139 set out circumstances under which a broker-dealer may publish research contemporaneously with a registered offering without running afoul of US restrictions on publicity. These safe harbors are *not* available to issuers. In addition, compliance with these rules does not obviate the need for broker-dealers to comply with other research-related requirements, such as those promulgated by FINRA.

In addition, the JOBS Act extends the principles underlying existing Securities Act Rule 139 to provide broker-dealers with an exclusion from the definition of offer in Securities Act Section 2(a)(3) for certain research reports relating to EGCs.[27]

> PRACTICE POINT
>
> Practices in this area continue to develop. Although we have not seen the emergence of pre-deal research on EGC IPOs by participating broker-dealers, analysts now routinely publish research reports on newly public EGCs as much as 15 days earlier than under prior law for IPOs and during some previously blacked-out periods immediately following EGC secondary offerings.

Definition of Research Report

For purposes of Rules 137, 138, and 139, a "research report" is defined as a written communication that includes information, opinions, or recommendations with respect to securities or an issuer, or an analysis of securities or an issuer, whether or not it provides information reasonably sufficient for an investment decision.[28] The term "written communication" includes a wide variety of electronic communication, such as

emails and websites. According to the SEC, the definition of research report is intended to encompass all types of research reports, whether issuer-specific or industry compendiums separately identifying the issuer.[29] In addition, the definition does not (and the related safe harbors do not) cover oral communications, which accordingly may be offers subject to Securities Act Section 12(a)(2) liability.[30]

Publication of Research by Non-Participating Broker-Dealers – Rule 137

Rule 137 provides that a broker-dealer that is not a participant in a registered offering but publishes or distributes research will not be deemed to offer securities in a distribution and, therefore, will not fall within the statutory definition of "underwriter" set forth in Section 2(a)(11) of the Securities Act.

Rule 137 applies to public companies as well as non-reporting issuers such as voluntary filers. It is available only to broker-dealers that are not participating in the registered offering of the issuer's securities and have not received compensation for participating in the securities distribution. Rule 137 also requires that the broker-dealer publish or distribute the research report in the regular course of its business.

Publication of Research by an Underwriter on Other Securities of an Issuer – Rule 138

Rule 138 provides that an underwriter participating in a distribution of securities by an issuer that is Form S-3 or F-3 eligible (or, in the case of a foreign private issuer only, meets certain conditions of Form F-3) is not deemed to make an offer of those securities if it publishes or distributes research that is confined to a different type of security of that same issuer. For example, Rule 138 allows publication of research with respect to debt securities by an underwriter when participating in a distribution of the issuer's common stock, and vice versa.

Rule 138:

- covers research reports on reporting issuers that are current in their Exchange Act reporting (i.e., it does not cover voluntary filers); and
- includes a requirement that the broker or dealer publish research reports on the types of securities in question in the regular course of its business.

The SEC has explained that the underwriter need not have a history of publishing research reports about the particular issuer or its securities, although it expressed concerns about situations in which an underwriter "begins publishing research about a different type of security around the time of a public offering of an issuer's security and does not have a history of publishing research on those types of securities."[31]

Publication of Research About the Securities Being Offered by an Underwriter – Rule 139

Rule 139 provides that an underwriter participating in a distribution of securities by certain seasoned issuers can publish ongoing research about the issuer and its securities without being deemed to offer those securities by way of its research reports.[32] Rule 139 research can take the form of issuer-specific reports, or more general reports covering an industry sector. Rule 139 covers Form S-3 or F-3 eligible issuers that are current in their Exchange Act reporting for issuer-specific research reports; all Exchange Act reporting companies for industry research reports; and certain foreign private issuers for both types of reports. The Rule does not, however, cover voluntary filers.

- *Issuer-specific reports*: To qualify for the Rule 139(a)(1) issuer-specific research report safe harbor, the report must be published by the underwriter in the regular course of its business. That publication may not represent the initiation of publication of research about the issuer or its securities (or re-initiation of publication following discontinuation). However, the SEC has explained that this requirement will be deemed satisfied if the underwriter has previously published research on the issuer or its securities at least once or has published one such report following discontinuing coverage.[33] The concept of discontinuation of coverage is not defined in Rule 139.

- *Industry reports*: To satisfy the Rule 139(a)(2) industry research report safe harbor, the underwriter must publish research in the regular course of its business and, at the time of the publication of the industry research report, must include similar information about the issuer or its securities in similar reports.[34]

> PRACTICE POINT
>
> Rule 139 no longer contains the prior requirement that the broker-dealer not make a recommendation in the report more favorable than that contained in previous reports, and in fact the broker-dealer need not have included any recommendation in its prior reports.[35]

ENDNOTES

1 *See Guidelines for the Release of Information by Issuers Whose Securities Are in Registration*, Release No. 33-5180 (Aug. 16, 1971).

2 *Securities Offering Reform Release*, pp. 76-77.

3 Under Rule 168, "factual business information" means:
- factual information about the issuer, its business, or financial developments, or other aspects of its business;
- advertisements of, or other information about, the issuer's products or services; and
- dividend notices.

"Forward-looking information" means:
- projections of an issuer's revenues, income or loss, earnings or loss per share, capital expenditures, dividends, capital structure, or other financial items;
- statements about management's plans and objectives for future operations, including plans or objectives relating to the products or services of the issuer;
- statements about the issuer's future economic performance, including statements generally contemplated by the issuer's MD&A; and
- assumptions underlying or relating to the foregoing.

4 *Securities Offering Reform Release*, n.81.

5 *Id*. at 63.

6 *Id*. at 64.

7 *Id*. at 64.

8 *Id*. at n.147.

9 *See Proposed Rule: Revisions to Rule 163*, Release No. 33-9098 (Dec. 18, 2009).

10 *See Securities Offering Reform Release*, p. 82.

11 Securities Act Rule 405, definition of "Well-Known Seasoned Issuer," para. (1).

12 *Id*. para. (2). For purposes of determining whether an issuer qualifies as a WKSI, the determination date is the later of: (i) the time of filing of the issuer's most recent shelf registration statement; (ii) the time of the most recent amendment to its shelf registration statement for purposes of satisfying Section 10(a)(3); or (iii) the date of filing the issuer's most recent annual report on Form 10-K or 20-F (if it has not filed a shelf registration statement for the prior 16 months).

13 The SEC interprets "common equity" for these purposes to include a class of participating voting or non-voting preferred stock of a foreign issuer where the issuance of the preferred stock results from requirements of the applicable non-US jurisdiction and where the class of preferred stock has liquidation or dividend preferences and other terms that cause it to be the "substantial economic equivalent" of a class of common stock. *See Securities Offering Reform Release*, pp. 26-27.

14 An "ineligible issuer" includes issuers that: (1) are not current in their Exchange Act reporting obligations (other than certain enumerated Form 8-K filings); (2) are blank check companies, shell companies, penny stock issuers, or limited partnerships offering other than through a firm commitment underwriting; (3) have filed for bankruptcy within the past three years, although ineligibility will terminate if an issuer has filed an annual report with audited financial statements subsequent to its emergence from bankruptcy; (4) within the past three years, have been convicted of any felony or misdemeanor under certain provisions of the Exchange Act; (5) within the past three years, were made the subject of any judicial or administrative decree or order arising out of a government action that prohibits certain conduct or activities regarding (including future violations of) the US federal securities laws, requires them to cease and desist from violating the antifraud provisions of the US federal securities laws or determines that they have violated those antifraud provisions; or (6) have had any registration statement subject to a refusal order or stop order within the past three years. *See* Securities Act Rule 405, definition of "Ineligible Issuer."

15 *See Securities Offering Reform Release* at n.185.

16 *See* JOBS Act Section 105(c) (adding new Securities Act Section 5(d)) and Securities Act Rule 163B (expanding the ability to engage in TTW to all issuers, including EGCs). EGCs might prefer to conduct TTW under Rule 163B, which – unlike Section 5(d) – allows the issuer and its representative to rely on a reasonable belief that an investor is a QIB or an IAI without having to verify that status.

17 The application of Exchange Act Rule 15c2-8(e) to TTW activities was clarified by the SEC in FAQs issued by the Division of Trading and Markets on August 22, 2013. See SEC Division of Trading and Markets, *Jumpstart Our Business Startups Act Frequently Asked Questions About Research Analysts and Underwriters* (Research FAQs). As discussed in the response to Question 1 of the Research FAQs, it should be possible for TTW activities to take place in a manner consistent with the requirements of Rule 15c2-8(e) (which generally has been interpreted to require the availability of a price range prospectus prior to soliciting orders for the registered securities). In particular, the answer to Question 1 states that an underwriter should generally be able to seek non-binding indications of interest from prospective investors (including as to the number of shares they may seek to purchase at various price ranges) so long as the underwriters are not soliciting actual orders and the investors are not otherwise asked to commit to purchase any particular securities.

[18] Ineligible issuers include blank check companies and shell companies, while ineligible offerings include business combinations. *See* Rules 164(e), (f), and (g).

[19] *Securities Offering Reform Release*, pp. 111-112.

[20] *Id*.

[21] *See* C&DI, Securities Act Rules, Question 232.02.

[22] *Securities Offering Reform Release*, n.267.

[23] Securities Act Rule 174(d).

[24] *See SEC v. Manor Nursing Centers*, 458 F.2d 1082, 1095-1096 (2d Cir. 1972).

[25] *See* Division of Corporation Finance no-action letters to *Black Box Incorporated* (June 26, 1990) and *Squadron Ellenoff, Pleasant & Lehrer* (Feb. 28, 1992). The SEC stated in 2007 guidance that the *Black Box* and *Squadron Ellenoff* no-action letters remain valid. *See Revisions of Limited Offering Exemptions in Regulation D*, Release No. 33-8828 (Aug. 3, 2007) (*2007 Regulation D Release*), n.126.

[26] *See* Securities Act Rule 152(a)(1)(ii); *See also Final Rule: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*, Release No. 33-10884 (Nov. 2, 2020), at p. 30 "New Rule 152(a)(1)(ii) codifies and expands the Commission's 2007 guidance that the existence of a pre-existing substantive relationship between the issuer, or its agent, and a prospective investor may be one means by which an investor may become interested in, or become aware of, a private placement conducted while a registration statement for a public offering is on file with the Commission that may be consistent with Section 4(a)(2)." *See 2007 Regulation D Release*, pp. 55-56; *see also* C&DI 139.25 (discussing the SEC's 2007 guidance).

[27] *See* JOBS Act Section 105(a) (revising Securities Act Section 2(a)(3)).

[28] Securities Act Rules 137(e), 138(d), 139(d). Note that this definition of "research report" is not the same as the definition set forth in Regulation AC or the FINRA rules.

[29] *Securities Offering Reform Release*, p. 158.

[30] *Id*. at 160.

[31] *Id*. at 164.

[32] On October 6, 2017, the Fair Access to Investment Research Act (the FAIR Act) was signed into law. The FAIR Act required the SEC to amend Rule 139 to cover certain investment fund research reports. On November 30, 2018, in response to the FAIR Act's mandate, the SEC adopted Rule 139b under the Securities Act to establish a non-exclusive safe harbor for broker-dealers that participate in offerings by certain funds to publish or distribute research reports on such funds without those research reports being deemed offers to sell the fund's securities. Rule 139b went into effect on January 14, 2019.

[33] *Securities Offering Reform Release*, p. 167.

[33] Given that, at the time of the publication of an industry research report, the report must include similar information about the issuer or its securities in similar reports, the Rule 139 industry report safe harbor also effectively requires that the industry report not represent the initiation of research coverage on the issuer or its securities.

[34] *Securities Offering Reform Release*, p. 168.

CHAPTER 7

Issuer Financial Statements

Background to Financial Statement Requirements

Public securities offerings registered with the SEC under the Securities Act require the filing of a registration statement with the SEC and the distribution of a prospectus in connection with the offering. The registration statement and prospectus must contain certain financial statements and other financial information regarding the issuer's financial condition and results of operations. The financial statement requirements for registration statements of foreign private issuers are found in Items 8, 17, and 18 of Form 20-F, and in Regulation S-X (S-X).

> PRACTICE POINT
>
> Compliance with the SEC's financial information requirements is usually the most difficult challenge for foreign private issuers seeking to access the US public markets. The requirements are technical and SEC-experienced members of the issuer's audit team must be involved at the earliest possible stage.
>
> Financial statements contained in the offering circular for many types of unregistered offerings (such as Rule 144A transactions) will typically track the financial statement requirements for a public prospectus closely, although market practice may permit deviations in certain circumstances. We discuss practice in the Rule 144A market below under "Special Considerations in Rule 144A Transactions."

What Financial Statements Must Be Included in Public Offerings?

The following tables summarize the scope of the basic financial statement requirements for all registered offerings.[1] Note that much of the basic information can be incorporated by reference for issuers eligible to use Form F-3,[2] and for certain issuers filing a registration statement on Form F-1.[3]

> PRACTICE POINT
>
> Although an issuer may be eligible for incorporation by reference, it should nonetheless consult its underwriters before electing to incorporate all required financial information. For marketing purposes, it is often desirable to provide the financial information directly in the printed offering document.

The Basic Requirements for Public Offerings

Annual Audited Financial Statements	Consolidated annual audited financial statements of the issuer consisting of:[4] • balance sheet; • statements of comprehensive income (or a statement of net income if there was no other comprehensive income); • statement of changes in equity;

Annual Audited Financial Statements

- statement of cash flows;
- related notes and schedules required by the system of accounting under which the financial statements were prepared; and
- if not included in the primary financial statements, a note analyzing the changes in each caption of shareholders' equity presented in the balance sheet.

Audited financial statements included in a registration statement (or annual report) must be prepared in accordance with:

- US GAAP;
- IASB IFRS; or
- local GAAP/non-IASB IFRS reconciled to US GAAP, as described below.[5]

Audited financial statements must cover each of the latest three fiscal years,[6] with certain exceptions:

- if the issuer has been in existence less than the required three years, financial information covering the issuer's predecessor entities (if any) may need to be provided;[7]
- if a jurisdiction outside the United States does not require a balance sheet for the earliest year of the three-year period, that balance sheet may be omitted;[8]
- in an initial registration statement, if the financial statements are presented in accordance with US GAAP (rather than reconciled to US GAAP), the earliest of the three years of financial statements may be omitted if that information has not previously been included in a filing made under the Securities Act or the Exchange Act.[9] This accommodation does not apply to financial statements presented in accordance with IASB IFRS unless the issuer is applying IASB IFRS for the first time;[10] and
- in an EGC IPO registration statement, as discussed below.

Under certain circumstances, audited financial statements may cover nine to 12 months rather than a full fiscal year for one of the required years.[11]

Audited financial statements must be accompanied by an audit report covering each of the audited periods.[12]

Audited financial statements for an issuer must be accompanied by an audit report issued by independent public accountants. The accountants must be registered with the Public Company Accounting Oversight Board (the PCAOB) under standards promulgated by the PCAOB[13] and meet SEC and PCAOB standards for independence.[14] The SEC Staff will not object if the audit report states that the audit was also conducted in accordance with home-country applicable professional standards.[15]

Interim Unaudited Financial Statements	If a registration statement becomes effective more than nine months after the end of the last audited fiscal year, the issuer must provide consolidated interim financial statements.[16] Those financial statements: • may be unaudited but must be prepared in accordance with US GAAP or IASB IFRS,[17] or local GAAP/non-IASB IFRS if reconciled to US GAAP;[18] • must cover at least the first six months of the fiscal year; • should include a balance sheet, statement of comprehensive income, statement of cash flows, statement of changes in equity, and selected note disclosures; • may be in condensed form, as long as they contain the major line items from the latest audited financial statements and include the major components of assets, liabilities, and equity (in the case of the balance sheet), income and expenses (in the case of the statement of comprehensive income), and the major subtotals of cash flows (in the case of the statement of cash flows); and • should include comparative interim statements for the same period in the prior fiscal year, except that the requirement for comparative balance sheet information may be met by presenting the year-end balance sheet.[19]
EGC Offerings	An EGC may conduct its initial public equity offering using two years, rather than three years, of audited financial statements.[20] After its IPO, an EGC phases into full compliance by adding one additional year of financial statements in each future year until it presents the traditional three years of audited financial statements.[21] The required MD&A would cover only the years for which audited financial statements are provided.[22]
Acquired Business Financial Information and Pro Forma Financial Information	Depending on the size of the acquisition and its significance to the issuer (which is measured in various ways – not all of them intuitive), audited financial statements for the most recent one or two fiscal years of the acquired business must be included, plus appropriate unaudited interim financial statements. These requirements are found in S-X Rule 3-05 and S-X Rule 3-14 (which applies to acquisitions of real estate operations). We discuss S-X Rule 3-05 and S-X Rule 3-14 in more detail below. Under S-X Article 11, when acquired business financial statements are included in a registration statement (and in certain other instances), pro forma financial information must also be included, covering the most recently completed fiscal year and the most recent interim period. We discuss S-X Article 11 in more detail on the following page.
Statement of Capitalization and Indebtedness	A registration statement must include a statement of capitalization and indebtedness.[23] Although the rules require the capitalization table to be as of a date no earlier than 60 days prior to the date of the registration statement,[24] the SEC Staff will not object if a foreign private issuer presents the statement as of the same date as the most recent balance sheet required in the registration statement.[25] If, however, there have been or will be significant changes in capitalization (for example, securities issuances including the proposed IPO), those changes should be reflected in “as adjusted” columns or notes to the table.[26]

What Financial Statements Must Be Included to Begin SEC Review?

Normally, a registration statement must include – as of the date of filing – all of the financial statements listed in the tables above. However, foreign private issuers that are EGCs and registering with the SEC for the first time may submit draft registration statements for *confidential* review, which is protected from disclosure under the Freedom of Information Act (FOIA).[27] Foreign private issuers that are not EGCs may also submit draft registration statements for *nonpublic* review, which affords more limited protection from FOIA.[28]

During this review process, financial statements may become "stale" (i.e., are too old and must be updated, as described below). Consequently, a foreign private issuer that is an EGC may omit from its confidential submissions submissions (and, though less common in practice, from its public filings) annual and interim financial data that it reasonably believes will not be required *at the time of the offering*.[29]

A foreign private issuer that is not an EGC may also omit from its nonpublic submissions the annual and interim financial data it reasonably believes will not be required *at the time the issuer files publicly*.[30]

In addition, an EGC or a non-EGC may omit from its confidential or nonpublic submissions the financial statements of an acquired business required by S-X Rule 3-05 or S-X Rule 3-14 that the issuer reasonably believes will not be required *at the time of the offering*.[31]

When Does Financial Information Go "Stale"?

Understanding the timing requirements for the provision of financial statements is almost as critical as understanding the scope of the financial information required. The determination of when financial statements go stale is sure to come up at the all-hands meeting, and planning to have the necessary financial information prepared on time is an essential part of the offering process. Among other considerations, the SEC Staff has a policy against commencing review of a filing unless the financial statements are not stale on the filing date.[32]

The following tables summarize financial statement staleness requirements, measured by the number of days between the effective date of the registration statement (or, by analogy, the pricing date of a Rule 144A offering if the transaction is intended to mirror SEC requirements) and the date of the financial statements in the filing.[33] For any of the time frames noted below, if the last day before the financial statements go stale is a Saturday, Sunday, or US federal holiday, Securities Act Rule 417 allows the filing to be made on the next business day, thereby effectively postponing the staleness date.

Staleness of Annual Audited Financial Statements	The last year of audited financial statements cannot be more than 15 months old at the time of the offering or listing, subject to the two exceptions listed below.[34] This means that an issuer with a December 31 fiscal year-end must have its registration statement "go effective" before **March 31**, or else annual audited financial statements for the year just ended must be included. In the case of a registration statement relating to an IPO, the audited financial statements must be as of a date not older than 12 months prior to the time the document is filed.[35] In other words, an IPO issuer with a **December 31** fiscal year-end cannot file a registration statement after **January 1** without including audited financial statements for the year just ended (or audited financial statements as of an interim date less than 12 months prior to the filing). However, if the issuer is already public in another jurisdiction, the 12-month rule does not apply.[36] In addition, an issuer may comply with the 15-month rule in an IPO where it is able to represent that it is not required to comply with this requirement in any other jurisdiction outside the United States and that complying with the requirement is impracticable or would involve undue hardship.[37]

Staleness of Annual Audited Financial Statements	In the case of a registration statement relating to an offering of securities (i) upon the exercise of outstanding rights granted *pro rata* to all existing security holders of the applicable class, (ii) pursuant to a dividend or interest reinvestment plan, or (iii) upon the conversion of outstanding convertible securities or upon the exercise of outstanding transferable warrants, the financial statements may be up to 18 months old at the time of the offering.[38] This means that an issuer with a **December 31** fiscal year-end must have its registration statement for these types of transactions go effective before **June 30**, or else annual audited financial statements for the year just ended must be included.
Staleness of Interim Unaudited Financial Statements	If a registration statement becomes effective more than nine months after the end of the last audited fiscal year (e.g., **September 30**, in the case of an issuer with a **December 31** fiscal year-end) the issuer must provide unaudited interim financial statements either in accordance with, or reconciled to, US GAAP, or in accordance with IASB IFRS, in either case covering at least the first six months of the year. In addition, if an issuer publishes interim financial statements that are more current than those required, it must include the more current information in its registration statement.[39] For example, if an issuer with a fiscal year ending **December 31** publishes first quarter information and does a securities offering in July, it must include the first quarter information in its registration statement. Likewise, if an issuer had already included six months' information in connection with an offering in November and then published third quarter information, it must include the third quarter information. The more current interim financial information (the first quarter information in the example above) generally need not be reconciled to US GAAP. However, except for financial information prepared in accordance IASB IFRS, a narrative explanation of differences in accounting principles should be provided, and material new reconciling items should be quantified.[40]

MD&A

Registration statements for foreign private issuers must contain or incorporate by reference an "Operating and Financial Review and Prospects," which contains essentially the same information as the MD&A (so we will refer to this as the MD&A).[41]

The purpose of the MD&A is to provide investors with management's explanation of factors that have materially affected the issuer's historical financial condition and results of operations, and an assessment of known trends and uncertainties that management anticipates will have a material effect in the future. A well-written MD&A will allow investors to view the issuer from management's perspective. It will identify and discuss the key metrics and any other statistical data that management uses to evaluate the business' performance and financial health, or that management believes will enhance an investor's understanding of its financial condition, cash flows, and results of operations. The analysis should cover all separate segments and other subdivisions, such as product lines and geographic regions of the issuer. An FPI should also refer to the reconciliation to US GAAP and discuss any aspects of US GAAP not covered in the reconciliation that it believes are necessary to understanding the financial statements as a whole.[42]

The MD&A line-item requirements cover the following topics:

Operating results. A discussion of significant factors materially affecting the issuers' income from operations, including material changes in net sales or revenue and reason for the changes (such as new products or services, or changes in prices or amounts); foreign currency fluctuations; the impact of hyperinflation, if any, during the period; and governmental policies.[43]

Liquidity and capital resources. A comprehensive discussion of the issuer's ability to generate and obtain adequate amounts of cash to meet its requirements and its plans for cash in both the next 12 months and a separate discussion of its long-term needs.[44]

Research and development, patents, and licenses, etc. A description of the issuer's research and development policies for the last three years.[45]

Trend information. The issuer must identify known trends, uncertainties, demands, commitments, or events that are reasonably likely to have a material effect on its net sales or revenues, income from continuing operations, profitability, liquidity or capital resources, or that would cause reported financial information not necessarily to be indicative of future operating results or financial condition.[46]

Critical accounting estimates. Issuers that do not prepare financial statements in accordance with IFRS IASB must provide information about accounting estimates or assumptions that are uncertain and reasonably likely to have a material impact on financial condition or operating performance.[47] The discussion should include qualitative and quantitative information necessary to understand the estimation uncertainty and the impact the critical accounting estimate has had or is reasonably likely to have to the extent the information is material and reasonably available.[48]

In addition, MD&A sections often incorporate a comprehensive analysis of the issuer's future prospects, typically presented under a subheading such as "Outlook." Some issuers even provide specific guidance for upcoming quarters or the current/following fiscal year. Drafting the MD&A section requires close collaboration among the issuer's financial team, its accountants, and legal counsel and can be a time-consuming process.

The SEC has published several interpretive releases with guidance on preparing the MD&A, most recently in 2020, when it streamlined the rules and moved toward a more principles-based approach.[49]

Using IFRS Without Reconciliation

A foreign private issuer may generally file financial statements prepared in accordance with IASB IFRS without reconciliation to US GAAP.[50] In order to take advantage of this:

- the accounting policy note must state compliance with IASB IFRS and the auditor's report must opine on compliance with IASB IFRS, although the issuer may state, and the auditor may opine on, compliance with both IASB IFRS and home-country standards (such as EU IFRS) if there is no difference;[51] and
- published interim financial information must also be prepared using IASB IFRS (and if the effective date of the registration statement or post-effective amendment is more than nine months after the end of the fiscal year, the issuer must explicitly state compliance with International Accounting Standard (IAS) 34).[52]

Note that reconciliation to IASB IFRS in lieu of full compliance with IASB IFRS is not permitted. In addition, foreign private issuers that voluntarily file on domestic US forms (such as Form 10-K) may file financial statements under IASB IFRS, but should prominently disclose that the company meets the foreign private issuer test and is voluntarily filing on domestic forms.[53]

Reconciliation to US GAAP

Annual Audited and Interim Unaudited Financial Statements

Annual audited and interim unaudited financial statements in a registration statement may be prepared using either US GAAP, IASB IFRS, or local GAAP.[54] If local GAAP or non-IASB IFRS is used in the preparation of the financial statements, the consolidated financial statements (both annual and interim) must include a reconciliation to US GAAP.[55]

Reconciliation comprises both disclosure of the material variations between local GAAP/non-IASB IFRS, on the one hand, and US GAAP, on the other hand, as well as a numerical quantification of those variations.[56] In the case of registered offerings, the reconciliation must meet Item 18 of Form 20-F (discussed in more detail below).

A foreign private issuer registering for the first time must reconcile only the two most recently completed fiscal years (and any interim period).[57]

Items that frequently require discussion and quantification as a result of the reconciliation requirements include stock compensation, restructuring charges, impairments, deferred or capitalized costs, investments, foreign currency translation, deferred taxes, pensions, derivatives, consolidation, asset retirement obligations, research and development, and revenue recognition.

MD&A

A foreign private issuer's MD&A disclosure should focus on its primary financial statements, whether those statements are prepared in accordance with US GAAP, local GAAP, IASB IFRS, or non-IASB IFRS.[58] To the extent those statements are prepared under local GAAP or non-IASB IFRS, a discussion should be included of the reconciliation to US GAAP and any differences between local GAAP/non-IASB IFRS and US GAAP not otherwise discussed in the reconciliation and needed for an understanding of the financial statements as a whole.[59]

Audit Reports

Audited financial statements must be accompanied by an audit report, covering each of the audited periods.[60] The SEC will generally not accept a disclaimer of an opinion or an audit report containing a qualification.[61]

Note that the audit report must state that the audit has been conducted in compliance with PCAOB standards, although the SEC Staff will not object if the audit report states that the audit was also conducted in accordance with home-country generally accepted auditing standards or International Standards on Auditing.[62] In addition, an accounting firm (US or non-US) that prepares or issues any audit report with respect to any issuer, or plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer, must be registered with the PCAOB.[63]

The auditor's report must also address critical audit matters and information about the auditor's tenure in serving as the issuer's independent accounting firm and independence. Issuers that are EGCs are not subject to the critical audit matters requirement, but still must include auditor tenure information.[64]

The Holding Foreign Companies Accountable Act (HFCAA) requires the SEC, on an annual basis, to identify all registrants that have retained a registered public accounting firm to issue an audit report, where that firm has a branch or office located in a foreign jurisdiction that the PCAOB has determined it is unable to inspect or investigate completely because of a position taken by an authority in that jurisdiction (Commission-Identified Issuers (CII)).[65]

Once the SEC provisionally identifies issuers on its website,[66] a listed issuer has 15 business days to notify the SEC that it believes it has been incorrectly identified and to provide evidence supporting its claim. Thereafter, absent notification of a dispute by the issuer and a subsequent favorable determination by the SEC, the SEC will treat the issuer as conclusively identified, subjecting it to the HFCAA.[67]

In its next annual report following identification, a CII that is also a "foreign issuer"[68] must disclose:[69]

- the PCAOB-identified accounting firm that has prepared an audit report for the issuer during the period covered by the form;
- the percentage of the issuer's shares by governmental entities in the foreign jurisdiction in which the issuer is incorporated or otherwise organized;
- whether governmental entities in the applicable foreign jurisdiction have a controlling financial interest with respect to the issuer;
- the name of each official of the Chinese Communist Party (CCP) who is a member of the board of directors of the issuer (or its operating entity; and
- whether the articles of incorporation of the issuer (or equivalent organizing document) contains any charter of the CCP, including the text of any such charter.

After a CII has had two consecutive non-inspection years (i.e., filing financial statements audited by a PCAOB-identified accounting firm) the SEC will publish an order prohibiting the trading of an identified issuer's securities on a US stock exchange and the US over-the-counter market, with effect on the fourth business day after publication.

On December 15, 2022, the PCAOB issued a determination vacating its 2021 determinations that the positions taken by authorities in mainland China and Hong Kong prevented it from inspecting and investigating registered public accounting firms headquartered in those jurisdictions. As a result, the SEC announced that it would not provisionally or conclusively identify an issuer as a CII if it files an annual report with an audit report issued by a registered public accounting firm headquartered in either jurisdiction on or after December 15, 2022, until such time as the PCAOB issues a new determination.

The SEC will continue to include any CII on the provisional or conclusive list if it filed an annual report with an audit report issued by a registered public accounting firm headquartered in mainland China and Hong Kong prior to the PCAOB's decision to vacate its 2021 determination. Additionally, each CII that is on the conclusive list must comply with the HFCAA's submission and disclosure requirements for the year that it is identified.[70]

Currency Translation; Exchange Rates

Foreign private issuers may state amounts in their financial statements in any currency they deem appropriate (the reporting currency),[71] although (except for companies operating in a hyperinflationary environment) operations should generally be measured using the currency of the primary economic environment to measure transactions.[72] The reporting currency must be prominently disclosed on the face of the financial statements.[73] The issuer must also disclose if dividends will be paid in a different currency as well as any material exchange restrictions or controls relating to the reporting currency, the currency of the issuer's domicile, or the currency in which dividends will be paid.[74]

If the reporting currency is not the US dollar, US dollar-equivalent financial statements or "convenience translations" are not permitted to be included, except that an issuer may present a translation of the most recent fiscal year and any subsequent interim period.[75] The exchange rate used for any convenience translations should be as of the most recent balance sheet date included in the registration statement, except where the exchange rate of the most recent practicable date would yield a materially different result.[76]

Recent and Probable Acquisitions

In addition to financial statements of the issuer, registration statements generally require inclusion of audited financial statements for a significant acquisition of a "business" that has taken place 75 days or more before the offering.[77] In the case of an acquisition that exceeds 50% on any of the significance tests discussed below, the audited financial statements must be included in the registration statement as soon as the acquisition becomes "probable."[78] These requirements can be found in S-X Rule 3-05 and S-X Rule 3-14 (which applies only to acquisitions of real estate operations). In addition, where a material acquisition has occurred, or is probable, pro forma financial information complying with S-X Article 11 for the most recent fiscal year and the most recent interim period will generally also be required in the registration statement.

What Is a "Business"?

The SEC defines the term "business" to include an operating entity or business unit, but excludes machinery and other assets that do not generate a distinct profit or loss stream.[79] It is important to note that the definition of a business under US GAAP (and potentially other GAAPs) differs from the SEC's definition. Accordingly, an acquisition that is a business under US GAAP may not be one for SEC purposes, and vice versa.

What Is "Probable"?

Evaluating whether a given transaction is probable involves looking at the facts and circumstances. The SEC Staff has taken the general view that an acquisition becomes probable at least upon the signing of a letter of intent,[80] and has also stated that an acquisition is probable "whenever a registrant's financial statements alone would not provide investors with adequate financial information with which to make an investment decision."[81] In practice, unless there were significant conditions relating to a proposed acquisition, an issuer would not want to be in the position of arguing and disclosing that an important acquisition is not probable.

Significance Tests

Whether financial statements for recent and probable acquisitions must be included in the filing also depends upon the "significance" of the acquisition. Significance of an acquired business is evaluated under S-X Rule 3-05 or S-X Rule 3-14 based upon three tests (which in turn are derived from S-X Rule 1-02(w)):

- **Investment Test** – the amount of the issuer's investment in the acquired business (generally, the aggregate value of the acquisition) compared to:
  - the aggregate worldwide market value of the issuer's voting and non-voting common equity, or
  - the issuer's total assets if it does not have publicly traded equity securities.[82]
- **Asset Test** – the issuer's share of the consolidated total assets of the acquired business compared to the issuer's consolidated total assets, in each case after intercompany eliminations.[83]
- **Income Test** – includes two components, both of which must be tested where applicable:
  - *Net income component* – the issuer's share of "pre-tax income"[84] from continuing operations of the acquired business compared to the issuer's pre-tax income from continuing operations.[85]
  - *Revenue component* – where the issuer and the acquired business have material annual revenue for the last two fiscal years, the issuer's (and its other subsidiaries') share of the consolidated total revenues of the acquired business compared to the issuer's consolidated total revenues for its most recent fiscal year, in each case after intercompany eliminations.[86]

– *Note*: When testing significance, both components of the test must exceed the applicable threshold. When determining the number of periods for which financial statements must be presented, the issuer uses the lower of the two components.[87]

Each of these tests should compare the issuer's and the acquired business' most recent annual financial statements (which need only be audited for the issuer).[88] Worldwide market value should be determined using the average of the last five trading days of the month before the acquisition was agreed or announced (whichever is earlier).[89] In addition, any issuer – including an IPO issuer – may use pro forma financial information to measure significance for acquisitions consummated in the most recent fiscal year, so long as it has filed the required S-X Rule 3-05 financial statements and S-X Article 11 pro forma financial information for the acquired businesses.[90] (In the case of an IPO issuer, the relevant disclosure would be made in its IPO registration statement.) Once an issuer uses pro forma financial information to measure significance, it will need to continue to use pro forma financials until the next Form 20-F annual report.[91] This approach can be useful where the pro forma information produces a larger "denominator" for testing significance.

Acquisitions of related businesses are treated as a single acquisition for purposes of the significance tests. Businesses are considered "related" if they are owned by a common seller or under common management, or where the acquisition of one business is conditioned upon the acquisition of each other business or a single common event.[92]

Generally if the acquired business exceeds 20% of any of the three significance tests, then one year of audited financial statements is required, as well as the most recently completed interim period that would be required under S-X Rules 3-01 and 3-02.[93] If the acquired business exceeds 40% of any of the three tests, then two years of audited financial statements and the appropriate interim periods are required.[94]

Summary of Financial Statement Requirements

The following table summarizes the general rules for an acquisition that occurred more than 75 days before the offering. The issuer must, when both the net income and revenue components of the Income Test are applicable, use the lower of the two to determine the number of periods required.[95]

Acquisition Scenario	Reporting Requirement
Individual acquisition at or below the 20% significance level.	No requirement to include audited or interim financial statements.
Individual acquisition (or multiple acquisitions of "related businesses," as described above) in excess of the 20% significance level, but not above the 40% level.	Audited financial statements for the most recent fiscal year of the acquired business must be included. Unaudited interim financial statements for the most recently completed interim period may need to be included, depending on the time of year that the offering takes place.
Individual acquisition (or multiple acquisitions of "related businesses," as described above) in excess of the 40% significance level.	Audited financial statements for the two most recent fiscal years of the acquired business must be included. Unaudited interim financial statements may need to be included, depending on the time of year that the offering takes place.

Acquisition Scenario	Reporting Requirement

Multiple acquisitions of unrelated businesses aggregating more than 50% significance that are:
• less than 20% significance level
• greater than 20% and less than 50% significance level and:
  • have not yet been consummated or
  • have been consummated but for which financial statements are not yet required because of the 75-day grace period.[96]
	Audited financial statements for the most recent fiscal year will be required for any acquired business that exceeds the 20% significance level and for the most recent two fiscal years for any business that exceeds the 40% significance level. The unaudited interim financial statements that are required for individual acquisitions may need to be included, depending on the time of year that the offering takes place.

Note that:

- The permitted age of financial statements of an acquired or soon-to-be-acquired business is generally determined by looking to the "staleness" rules that apply to its financial statements (rather than the staleness rules applicable to the financial statements of the acquiring company).[97] In other words, you need to determine whether the acquired company is, for example, a large accelerated filer, an accelerated filer, or an initial filer, and then analyze the dates on which its financial statements go stale.[98]
- Below the 50% significance level, no audited financial statements are required in the offering document for probable acquisitions or for completed acquisitions consummated up to 74 days before the date of the offering.[99] The commitment committees of some financing sources may, however, require at least a one-year audit of the acquired company in this situation together with historical pro forma financial information, even if the 74-day grace period has not yet expired.
- When a "foreign business"[100] is acquired, the financial statements of the acquired business may be in accordance with US GAAP, IASB IFRS, or another local GAAP. No US GAAP reconciliation is required for the inclusion of financial statements of an acquired foreign business where that business uses IASB IFRS or when the acquired business is below the 30% level for all significance tests.[101] At or above 30%, if the acquired business qualifies as a foreign business, or does not qualify as a foreign business but would qualify as a foreign private issuer if it were a registrant, the financial statements for the annual and interim periods required to be presented may be prepared in IASB IFRS without reconciliation to US GAAP or in local GAAP reconciled to either (i) US GAAP or (ii) IASB IFRS provided the acquiror is itself a foreign private issuer that prepares its financial statements in accordance with IASB IFRS.[102] Any reconciliation need only meet the requirements of Item 17, not Item 18, of Form 20-F.[103]
- Except in very limited circumstances, if the acquired company is not already an SEC-reporting company, its financial statements need not be audited by a PCAOB-registered firm, and the audit report need not refer to PCAOB standards.[104] However, the audit must be conducted in accordance with US generally accepted auditing standards.
- The amounts used for these calculations must be determined on the basis of US GAAP (for issuers that file their financial statements in accordance with or provide a reconciliation to US GAAP) or IASB IFRS (for foreign private issuers that file their financial statements in accordance with IASB IFRS) rather than local GAAP or non-IASB IFRS.[105]

Exceptions to the Financial Statement Requirements for Acquired Businesses

There are a number of exceptions to the requirement to provide separate financial statements of acquired businesses.

Exceptions to the Requirement to Provide Financial Statements of Acquired Businesses	Separate financial statements for an acquired business do not need to be presented once the operating results of the acquired business have been included in the issuer's audited consolidated financial statements for at least nine months for an acquired business that exceeds the 20% level of significance and one fiscal year for an acquired business that exceeds the 40% level.[106] A single audited period of nine, 10, or 11 months may count as a year for an acquired business in certain circumstances.[107]

S-X Rule 3-14; Real Estate Operations

The acquisition or probable acquisition of real estate operations is subject to S-X Rule 3-14. "Real estate operations" means a business that generates substantially all of its revenues through the leasing of real property, such as a REIT.[108] In comparison, where real estate is merely incidental to the service provided by a business, as for example in the case of many hotels, the regular S-X Rule 3-05 requirements would apply.

S-X Rule 3-14(a) requires that audited financial statements be provided for the most recent fiscal year and most recently completed interim period for any acquisition or probable acquisition that would exceed 20% significance using the Investment Test, discussed above.[109] S-X Rule 3-14(c) also permits certain variations from the typical form of statement of comprehensive income, provided certain additional textual disclosure is made.[110] In a registration statement, issuers using S-X Rule 3-14 should also consider individually insignificant acquisitions (i.e., those amounting to less than a 20% significance level individually) if, as a group, they exceed the 20% significance level.

MD&A for Acquisitions

Whenever historical financial statements of an acquired business (or probable acquisition) are included in the offering document, the issuer will need to consider whether a separate MD&A section discussing those financial statements is appropriate. Although there is no specific line item requiring that a second MD&A be included, it is not uncommon for issuers to interpret Securities Act Rule 408[111] to require a full discussion and analysis of the financial statements of an acquired business (or probable acquisition), particularly where it is necessary to make the required statements not misleading.

Pro Forma Financial Information

As noted above, where a material acquisition has occurred, or is probable, that would trigger the need for acquired business financial statements under S-X Rule 3-05, pro forma financial information complying with S-X Article 11 must also be included. Pro forma financial information will also be required for multiple acquisitions that in the aggregate exceed the 50% level of significance of (i) individually insignificant businesses (i.e., below the 20% significance level), and (ii) acquisitions of individually significant businesses between the 20% and 50% significance level that have either not have been consummated or for which financial statements are not yet required due to the 75-day grace period.[112] Pro forma financial information is intended to illustrate the continuing impact of a transaction by showing how the specific transaction might have affected historical financial statements had it occurred at the beginning of the issuer's most recently completed fiscal year or the earliest period presented.

In particular, S-X Article 11 requires:[113]

- a pro forma condensed balance sheet[114] as of the end of the most recent period for which a consolidated balance sheet of the issuer is required, unless the transaction is already reflected in that balance sheet;[115] and
- a pro forma condensed statement of comprehensive income[116] for the issuer's most recently completed fiscal year and the most recent interim period, unless the historical statement of comprehensive income reflects the transaction for the entire period.[117]

S-X Article 11 also requires pro forma financial information in a number of other situations, such as:

- certain dispositions at a greater than 20% significance level (measured under the tests summarized above) that are not fully reflected in the financial statements of the issuer included in the prospectus;[118]
- acquisition of certain investments accounted for under the equity method;[119] and
- other events or transactions for which disclosure of pro forma financial information would be material to investors.[120]

S-X Article 11 provides extensive specific requirements for the content of pro forma financial information, including those set out in the following table.[121]

Pro Forma Financial Information – Certain Key Content Requirements

Pro Forma Financial Information – Key Content Requirements – S-X Rule 11-02	**Required Adjustments** *Transaction Accounting Adjustments* – reflect the application of US GAAP or IASB IFRS to the transaction, linking the effects of the acquired business to the issuer's audited historical financial statements and must include: • Total consideration transferred or received, including its components and how they were measured. • If any consideration is contingent, the basis for determining the amount(s) and an undiscounted estimate of the range of outcomes or an explanation of why a range cannot be estimated. • If the initial accounting is incomplete, a prominent statement to that effect, and a description of the required information, including uncertainties affecting the pro forma financial information, an estimate of when the accounting will be finalized, and other information regarding the magnitude of the potential adjustments. *Autonomous Entity Adjustments* – reflect the operations and financial position of the acquiror (i.e., the issuer) as an autonomous entity when it was previously part of another entity and must include: • A description of each adjustment and any material uncertainties, the calculation of the adjustment, and qualitative information about the adjustment necessary to give a fair and balanced presentation. *Transaction Accounting and Autonomous Entity Adjustments* – must be included in the calculation of the historical and pro forma per share data presented on the face of the pro forma condensed statement of comprehensive income.

Pro Forma Financial Information – Key Content Requirements – S-X Rule 11-02

Pro Forma Financial Information – must include revenues, expenses, gains and losses, and related tax effects that will not recur in the income of the issuer beyond 12 months after the transaction.

Optional Adjustments

Management's Adjustments – permit the issuer to include forward-looking information[122] that depicts the synergies and dis-synergies identified by management and provides insight to investors into the potential effects of the acquisition and management's post-acquisition plans.

The following conditions must be met:

- There is a reasonable basis for each such adjustment;
- Adjustments that reduce expenses may not exceed the amount of the related expense historically incurred during the pro forma period presented;
- The pro forma financial information includes a statement that, in the opinion of management, it reflects all Management's Adjustments necessary to a fair statement of the pro forma financial information presented; and
- When synergies are presented, any related dis-synergies must also be presented.
- Additional Form of Presentation requirements include:
  - The explanatory notes must include disclosure of the basis for and material limitations of each Management's Adjustment, including any material assumptions or uncertainties of such adjustment, an explanation of the method of the calculation of the adjustment, if material, and the estimated period for achieving the synergies and dis-synergies of such adjustment.
  - Management's Adjustments must be presented in the explanatory notes in the form of reconciliations of pro forma net income from continuing operations attributable to the controlling interest and the related pro forma earnings per share data to such amounts after giving effect to the adjustments.
  - Management's Adjustments included (or incorporated by reference) should be as of the most recent practicable date prior to the applicable effective date, mail date, qualified date, or filing date.

If Management's Adjustments will change the number of shares or potential common shares, the change must be reflected within Management's Adjustments in accordance with US GAAP or IASB IFRS, as applicable, as if the shares were outstanding as of the beginning of the period presented.

Periods to Be Presented

Pro forma condensed statements of comprehensive income should be presented using the issuer's fiscal year end.[123] If the most recent fiscal year end of the acquired company differs from that of the issuer by more than one fiscal quarter, the acquired company's statement of comprehensive income must be brought up to within one fiscal quarter of the issuer's most recent fiscal year end (if practicable).[124]

PRACTICE POINT

Even if pro forma financial information for an acquired business is not required to be included in the prospectus, the underwriters may nevertheless request that pro forma financial information be included in the disclosure document. This situation arises where the underwriters want to show the expected higher "run rate" operating results of the combined companies for marketing reasons even though there is no specific requirement to do so.

Guarantor Financial Statements

A guarantee of a security (such as a guarantee of a debt or preferred equity security) is itself a security that must be registered under the Securities Act, absent an applicable exemption.[125] As a result, the general rule is that guarantors, as "issuers" of the guarantee, are required to present the same financial statements as the issuer of the guaranteed securities.[126] Fortunately, S-X Rules 3-10(a) and 13-01 provide an alternative disclosure regime (the Alternative Disclosures) that does not generally require extensive financial information about subsidiary issuers, subsidiary guarantors, and subsidiary non-guarantors. The Alternative Disclosures permit disclosure of summarized financial information about consolidated subsidiary issuers and guarantors, together with material non-financial disclosure about the guarantee, the issuer, and the guarantors. The effort required to provide the Alternative Disclosures is less burdensome and expensive than producing the separate audited financial statements for every subsidiary issuer or guarantor that would otherwise be required.

Eligibility for Alternative Disclosures

In order to substitute Alternative Disclosures for audited financial statements of individual subsidiary issuers or guarantors, the offering must meet the following conditions:[127]

- The issuer or guarantor must be a consolidated subsidiary of the parent company.
- The parent company must have filed consolidated financial statements and either is or will become an Exchange Act reporting company as a result of the offering.
- The guaranteed security must be debt or "debt-like."[128]
- The parent company must either:
  - issue or co-issue the security jointly and severally with one or more of its consolidated subsidiaries or
  - fully and unconditionally guarantee the security which is issued by or co-issued with one or more of its consolidated subsidiaries.

Requirements for Alternative Disclosures

The Alternative Disclosures will consist of, to the extent material, qualitative narrative disclosure and summarized financial information, along with an exhibit listing all subsidiary issuers and guarantors. Financial and non-financial disclosures must also include any additional information that would be material to an investor to evaluate the sufficiency of the guarantee and to make the financial information not misleading.[129] The Alternative Disclosures may be located in the MD&A or in the notes to the financial statements.[130] The obligation to provide Alternative Disclosures ends when the issuers and guarantors no longer have an Exchange Act reporting obligation with respect to the securities, even though the securities themselves remain outstanding.[131]

Narrative Disclosures should provide a description of:

- The issuers and guarantors (the Obligor Group).[132]

- The terms and conditions of the guarantees and how payments to holders may be affected by the composition of and relationships among the issuers, guarantors, and non-obligor subsidiaries.[133]
- Other factors that may affect payments to holders of the guaranteed securities, including restrictions on dividends, guarantee enforceability, or the rights of a non-controlling interest holder.[134]

Summarized Financial Information must be presented for the Obligor Group covering the parent company's[135] most recently completed financial year and year-to-date interim period.[136] The summarized financial information may be presented on a combined basis after eliminating intercompany balances and transactions and excluding investments by obligors in non-obligors.[137] If any financial or non-financial disclosure does not apply to the combined Obligor Group, summarized financial information for the affected obligors should be presented separately.[138] Narrative disclosure may be substituted for separately presented summarized financial information where it can be easily explained and understood.[139]

The registration statement for the offering must include pre-acquisition summarized financial information for any "significant" business (and/or its subsidiaries) that has been acquired by the parent company since the last balance sheet date where that business or subsidiary will be a member of the Obligor Group.[140]

The parent company may omit summarized financial information if the parent determines such information would not be material to investors.[141] S-X Rule 13-01(a)(4) lists four non-exclusive examples that permit omission of the summarized financial information, if the conditions are met and the omission disclosed.

- The financial information of the combined Obligor Group is not materially different than the corresponding information in the parent company's consolidated financial statements.[142]
- The combined Obligor Group, excluding investments in subsidiaries that are non-obligors, has no material assets, liabilities, or results of operations.[143]
- The issuer is a finance subsidiary[144] of the parent company, the parent company has fully and unconditionally guaranteed the security, and no other subsidiary of the parent company guarantees the security.[145]
- The issuer is a finance subsidiary that co-issued the security, jointly and severally, with the parent company, and no other subsidiary of the parent company guarantees the security.[146]

Subsidiary Obligor Exhibit must be provided under S-K Item 601 listing each subsidiary member of the Obligor Group and its role as issuer or guarantor in relation to the securities.[147]

Note that the amounts used for these calculations must be determined on the basis of US GAAP or IASB IFRS rather than local GAAP/non-IASB IFRS.

Secured Offerings

Where the securities of one or more of an issuer's affiliates have been pledged as collateral for securities being offered, S-X Rule 13-02 requires, to the extent material, substantially the same summarized financial information and non-financial disclosure for each affiliate as would be required under S-X Rule 13-01 for a subsidiary issuer or guarantor.[148] The affiliate disclosure is subject to the same requirement to include any financial and narrative information that would be material to investors to evaluate the pledge of securities and to make the financial and non-financial information not misleading.[149] This information may be located outside the financial statements[150] and is required only as long as the issuer maintains an Exchange Act reporting obligation with respect to the securities.[151]

Investments Accounted for Under the Equity Method

S-X Rule 3-09 generally requires the inclusion of separate audited financial statements for significant investments that are accounted for under the equity method.[152] S-X Rule 3-09 applies whether the investee is held by an issuer, a subsidiary, or another investee.[153] Note that if the investee is not already an SEC-reporting company, its financial statements need not be audited by a PCAOB-registered firm, and the audit report need not refer to PCAOB standards (although in some circumstances, such as when the principal auditor of the issuer is making reference in its report to the investee auditor's report, the audit must be carried out in accordance with PCAOB standards).[154]

For investees, significance is evaluated under S-X Rule 1-02(w) based on the following two tests:[155]

- whether the amount of the issuer's (and its other subsidiaries') investment in and advances to the investee exceeds 20% of the total assets of the issuer and its subsidiaries on a consolidated basis as of the end of the most recently completed fiscal year (Test 1);[156] and
- whether both (where applicable) the equity of the issuer (and its other subsidiaries) in: (i) the pre-tax income from continuing operations and (ii) the consolidated total revenues from continuing operations (after intercompany eliminations) of the equity investee exceeds 20% of such income and revenue of the issuer and its subsidiaries on a consolidated basis for the most recently completed fiscal year (Test 2).[157] The revenue component of Test 2 applies only when both the issuer and its consolidated subsidiaries and the equity investee had material revenue in each of the two most recently completed fiscal years.

If either of the above tests is met, separate financial statements of the investee must be filed.[158] Insofar as practicable, those financial statements must be as of the same dates and for the same periods as the required audited annual financial statements of the issuer, but need only be audited for those fiscal years in which either Test 1 or Test 2 is met at or above the 20% level.[159] An EGC may include two years of investee financial statements in its initial registration statement, irrespective of whether it presents two or three years of its own financial statements.[160] Note that the amounts used for these calculations must be determined on the basis of US GAAP or IASB IFRS rather than local GAAP/non-IASB IFRS.[161]

US GAAP permits the use of the "fair value option" for certain investments that would otherwise be accounted for under the equity method. If an issuer elects the fair value option, Test 2 above is altered to compare the change in fair value of the investee (as reflected in the issuer's financial statements) to the issuer's consolidated pre-tax income for the most recently completed fiscal year.

For equity investees that meet any of the three S-X Rule 1-02(w) criteria at the greater than 10% but not more than the 20% significance level, S-X Rule 4-08(g) requires the presentation of summary financial information as described by S-X Rule 1-02(bb).[162]

Financial statements of equity investees that are presented under local GAAP or non-IASB IFRS to comply with S-X Rule 3-09 do not have to be reconciled to US GAAP unless either of the Test 1 or Test 2 criteria is greater than 30% (calculated on a US GAAP basis).[163] That reconciliation may be done under the less comprehensive requirements of Item 17 of Form 20-F rather than Item 18.[164] A description of the differences in accounting methods is required regardless of the significance levels.[165] Equity investees using IASB IFRS do not need to include a reconciliation.[166]

Summary financial information for a foreign business provided under S-X Rule 4-08(g) must be presented under the same GAAP used by the issuer. For example, a US company would report summarized information for a foreign investee under US GAAP no matter what basis of accounting is used by the foreign investee to prepare its own financial statements.[167]

Segment Reporting

In addition to all the consolidated financial information required to be included in an offering document, a company (including a company that has a single reportable segment) is required to provide segment disclosures by reportable segment in annual and interim financial statements. S-K Item 303 requires certain financial reporting and textual disclosure in the MD&A for each relevant, reportable segment or other subdivision of the business if the discussion would be necessary to understanding the business.[168] FASB Accounting Standards Codification 280, "Segment Reporting" (ASC 280), provides detailed guidance for when a component of an enterprise constitutes an operating segment, and how discrete financial information of a reportable segment must be reported. IASB IFRS Accounting Standards for segment reporting (IFRS 8, Operating Segments) have similar reporting requirements as ASC 280. However, differences exist between the two standards.

Generally, under both ASC 280 and IFRS 8, a component of an enterprise is an operating segment if it has three characteristics:

- it engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise);
- its operating results are regularly reviewed by the enterprise's chief operating decision maker (CODM)[169] to make decisions about resources to be allocated to the segment and assess its performance; and
- discrete financial information is available for the component.

The aim of segment reporting is to align public financial reporting with a company's internal reporting in order to permit financial analysts and the public to see the overall enterprise the same way management sees it. A 'management approach" is used to identify operating segments, meaning that an entity's operating segments are largely based on how management organizes and operates the business.[170] Once an entity identifies its operating segments, it may aggregate operating segments that meet certain criteria. The purpose of aggregation is to treat operating segments with similar economic characteristics as a single operating segment. Whether an issuer can aggregate operating segments into a single operating segment is highly fact-specific and depends on factors such as economic similarity, the similarity of the products or services sold, the nature of the production process, customer type, distribution methods, and the regulatory environment for the business. The determination is very subjective and is often the subject of much discussion with the company's accountants and, through the SEC comment process, with the SEC Staff.

Each operating segment is analyzed to determine whether it is a reportable segment. If two or more operating segments have been aggregated, they are analyzed as a single operating segment.

Under both ASCS 280 and IFRSS 8, an operating segment is a reportable segment if it meets any of the following thresholds:

- its reported **revenue** (including both sales to external customers and inter-segment sales) is 10% or more of the combined revenue (internal and external) of all operating segments;
- the absolute amount of its reported **profit or loss** is 10% or more of the greater, in absolute amount, of (i) the combined profit of all operating segments that did not report a loss or (ii) the combined loss of all operating segments that did report a loss; or
- its **assets** are 10% or more of the combined assets of all operating segments.[171]

Note that, for purposes of applying the 10% significance criteria, an issuer should use the basis of accounting used for internal management reporting.

Under both ASC 280 and IFRS 8, a company must provide disclosures by reportable segment in its annual and interim financial statements. To determine which information to disclose, a company generally needs to assess which information is regularly provided to or regularly reviewed by the CODM. This assessment may require judgment.

These disclosures include general information, profit or loss and asset measures for each reportable segment,[172] additional quantitative and qualitative information about profit or loss and assets (e.g., external and intersegment revenues, interest revenue and expense, depreciation and amortization), and reconciliations of specified segment amounts to the corresponding consolidated balances. Additional information such as equity method investments and capital expenditures may be required.

ASC 280 requires a company to disclose significant segment expenses. It also permits a company to report more than one profit or loss measure that is used by the CODM to assess performance and allocate resources, as long as one of the reported measures is the measure most consistent with US GAAP.[173] IFRS 8 does not explicitly require the disclosure of significant segment expenses, and the SEC Staff has taken the position that IFRS 8 permits a company to disclose only a single measure of segment profit or loss.

Financial disclosure relating to operating segments may be part of a discussion in the MD&A if the company concludes such information is necessary to understand the business. The effect of these requirements is to force disclosure of profitability by segment, which many issuers are reluctant to do for competitive reasons.

> PRACTICE POINT
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> The identification and reporting of financial information for operating segments will be critical in the offering process, as the time to prepare such information, the effect on textual disclosure, and the impact on enterprise valuation may all be significant. The need for segment reporting is always considered carefully when a company is issuing securities for the first time. However, the issue should be revisited whenever the company has entered into new business lines or if management has begun to analyze its business in a new way that may impact the original segment analysis. Because the guidance of ASC 280 (and IFRS 8) is complex and its application very fact-specific, it is important to begin an early dialogue with the independent auditors when there may be segment reporting issues.

Supplemental Schedules for Certain Transactions

S-X Rule 5-04 requires a number of supplemental schedules for particular industries and circumstances.[174] Each schedule contains additional financial information that must be audited and provided, typically including:

- *Schedule I – Condensed Financial Information of Registrant (known as "parent-only" financial statements)*: requires the presentation of condensed non-consolidated balance sheets, statements of comprehensive income, and cash flows, as of the same dates and for the same periods as the audited consolidated financial statements. This requirement applies if the restricted net assets of subsidiaries exceed 25% of the issuer's consolidated net assets as of the end of the most recently completed fiscal year. "Restricted net assets" refer to the issuer's proportionate share of net assets of consolidated subsidiaries (after eliminating intercompany transactions) that, as of the end of the most recent fiscal year, may not be transferred to the parent company in the form of loans, advances, or cash dividends without obtaining consent from a third party. This third party may include lenders, regulatory agencies, foreign governments, or other relevant entities.[175]
- *Schedule II – Valuation and Qualifying Accounts*: requires an analysis of each valuation and qualifying account (e.g., allowance for doubtful accounts, allowance for obsolescence).

- *Schedule III – Real Estate and Accumulated Depreciation*: requires real estate operating and investment companies to disclose certain financial details regarding each of their properties.
- *Schedule IV – Mortgage Loans on Real Estate*: requires real estate operating and investment companies to disclose details of each mortgage loan that accounts for 3% or more of the carrying value of all of the issuer's mortgages.
- *Schedule V – Supplemental Information Concerning Property-Casualty Insurance Operations*: requires disclosure as to liabilities on property-casualty insurance claims if the issuer, its subsidiaries, or 50%-or-less-owned, equity-basis investees have such liabilities. However, the schedule may be omitted if reserves for unpaid property-casualty claims and claims adjustment expenses did not, in the aggregate, exceed 50% of common stockholders' equity of the issuer and its consolidated subsidiaries as of the beginning of the fiscal year.

Note that issuers in specific industries may have schedule requirements that vary from those listed above. In addition, an issuer may provide the schedule information separately or in the notes to the audited financial statements.

Industry Guides

S-K Item 801 sets out three industry "guides" requiring enhanced disclosure of financial and operational metrics for issuers in certain industries:[176]

- *Guide 4 – Prospectuses Relating to Interests in Oil and Gas Programs*: requires enhanced disclosure relating to the offering terms and participation in costs and revenues among investors and others, as well as a 10-year financial summary of any drilling programs by the issuer and its associates, including recovery on investment for investors in those programs.
- *Guide 5 – Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships*: requires a summary of the financial performance of any other real estate investment programs sponsored by the general partner and its affiliates.
- *Guide 6 – Disclosure Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*: requires disclosure of details of reserves and historical claim data if reserves for unpaid property-casualty claims and claim adjustment expenses of the issuer, its consolidated and unconsolidated subsidiaries, and equity investees exceed 50% of the common stockholders' equity of the issuer and its consolidated subsidiaries.

In recent years, the SEC has rescinded the following industry guides and moved the disclosure requirements into subparts of S-K.

- *S-K Item 1200*: requires enhanced disclosure of oil and gas reserves (including from non-traditional sources), the company's progress in converting proved undeveloped reserves into proved developed reserves, technologies used in establishing reserves, the company's internal controls over reserves estimates, and disclosure based on geographic area (as defined). Required disclosure also includes information regarding proved undeveloped reserves; oil and gas production; drilling and other exploratory and development activities; present activities; delivery commitments; and oil and gas properties, wells, operations, and acreage. Disclosure of probable and possible reserves and oil and gas reserves' sensitivity to price is optional under S-K Item 1200.[177]
- *S-K Item 1300*: requires disclosure of mineral resources and reserves that have been determined on the company's properties. The company must provide summary disclosure about its properties in the aggregate along with detailed disclosure about individually material properties, including location of the property,

history of previous operations, and a description of the present condition of and operations on the property. The company must also disclose material exploration results and related exploration activity and exploration targets, if the disclosure is accompanied by specified cautionary and explanatory statements. The disclosure must be based on and accurately reflect information and supporting documentation prepared by a mining expert—or "qualified person,"[178] including a dated and signed technical report summary, which identifies and summarizes the information reviewed and conclusions reached about the mineral resources or mineral reserves determined to be on each material property. The technical report summary must be filed as an exhibit when disclosing mineral reserves or mineral resources for the first time or when there is a material change in the mineral reserves or mineral resources from the last technical report summary filed for the property.[179]

- *S-K Item 1400:* requires disclosure by bank holding companies about the following for each annual period presented and any additional interim period if a material change in the information or trend evidenced thereby has occurred: distribution of assets, liabilities and stockholders' equity, the related interest income and expense, and interest rates and interest differential; weighted average yield of investments in debt securities by maturity; maturity analysis of the loan portfolio including the amounts that have predetermined interest rates and floating or adjustable interest rates; certain credit ratios and the factors that explain material changes in the ratios, or the related components during the periods presented; the allowance for credit losses by loan category; and bank deposits including average amounts and rate paid and amounts that are uninsured.[180]

> PRACTICE POINT
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> Compiling the information required by these industry guides and S-K Items may be a significant undertaking, and the issuer's financial and operating management should consult with its professional advisors early in the process if an industry guide applies to the offering.

Quantitative and Qualitative Disclosure About Market Risk

Item 11 of Form 20-F sets out various specific requirements for quantitative and qualitative disclosure about market risk sensitive instruments (such as derivatives). This disclosure can be significant for companies with substantial trading portfolios or that engage in extensive hedging.

Reconciliation to US GAAP – Item 18 Versus Item 17

Form 20-F provides two levels of financial statement disclosure: Item 17 and Item 18.[181] Item 18 requires a more thorough adaptation of the issuer's financial statements to US GAAP and the requirements of S-X than does Item 17.[182] The distinction between Items 17 and 18 is based on a classification of the requirements of US GAAP and S-X into those that specify the methods of measuring the amounts shown on the face of the financial statements, and those prescribing disclosures which explain, modify, or supplement the accounting measurements.[183] Disclosures that are required by US GAAP but not local GAAP or IFRS need not be furnished for Item 17[184] (although they might need to be disclosed under MD&A).

Securities Act registration statements, Exchange Act annual reports on Form 20-F and Exchange Act registration statements for secondary listings or spin-offs must generally comply with Item 18.[185] Item 17 is available in certain specific circumstances, including required financial statements of significant acquired foreign businesses,[186] significant equity method investees,[187] entities whose securities are pledged as collateral,[188] and guarantors.[189]

Additional Financial Information That Is Typically Included

In addition to the formal requirements of Form 20-F and S-X, it is customary to include additional operational and other metrics in the offering document to help investors understand the issuer's business. The three most common examples are described below.

Other Financial Data

A page of summary financial data is always included in the summary box in the offering document. This key marketing page often supplements the summary financial information with additional operational and other metrics. These additional metrics will vary with the type of issuer and its industry, and will be selected based on the criteria that management and the investment community monitor to evaluate performance or liquidity. Typical examples include comparable store sales data for a retailer, capital expenditures for a manufacturer, and subscriber numbers for a cable television company.

Recent Financial Results

If a significant amount of time has passed since the most recent financial statements included in the offering document, it may be appropriate to include a summary of recent financial results in the summary box. Examples of "recent results" disclosures are most common after a quarter or half year (depending on how frequently the issuer reports) is completed but before financial statements concerning that quarter/half year have become available. The issuer and the underwriters will want to tell investors as soon as possible about any positive improvement in operating trends, while if the recent results are negative, recent results disclosure may be advisable to avoid any negative surprises for investors when the full quarterly/half yearly numbers become available.

Recent Developments

To the extent material, the likely consequences of material recent developments may also be disclosed in the summary box or the MD&A. For example, it is customary to discuss a material recent or pending and probable acquisition in the MD&A section of the offering document, whether or not audited financial statements of the acquired or to-be-acquired business are required to be presented. This practice will often result in a discussion of the impact of the pending or recently completed transaction on margins, debt levels, etc., in a section of the MD&A labeled "Overview," "Impact of the Acquisition," or a similar title. The textual disclosure may also include a discussion of any special charges or anticipated synergies expected to result from the acquisition or other pending event.

Non-GAAP Financial Measures

Many issuers choose to disclose measures of financial performance or liquidity that, while derived from GAAP figures presented in a company's financial statements, are not themselves calculated in accordance with GAAP. EBITDA is perhaps the best-known (and most widely used) non-GAAP financial measure.

The SEC's rules (adopted in response to Section 401(b) of Sarbanes Oxley) limit the use of non-GAAP financial measures in various ways. First, Regulation G applies to any public disclosure of non-GAAP financial measures.[190] Second, Item 10(e) of S-K layers on additional requirements for disclosures in Securities Act and Exchange Act filings (and earnings releases furnished to the SEC under Item 2.02 of Form 8-K).[191]

Regulation G

A non-GAAP financial measure under Regulation G is defined broadly as a numerical measure of financial performance that excludes (or includes) amounts that are otherwise included in (or excluded from) the comparable measure calculated and presented in the financial statements under GAAP.[192]

For purposes of Regulation G, "GAAP" generally means US GAAP. However, in the case of a foreign private issuer whose primary financial statements are prepared in IFRS or local GAAP, "GAAP" means the accounting principles under which the financial statements were prepared, unless the measure in question is derived from US GAAP (in which case GAAP means US GAAP).[193]

The term "non-GAAP financial measure" carves out certain items including:

- operating measures and ratios or statistical measures calculated using financial measures determined in accordance with (1) GAAP (e.g., GAAP sales per square foot and operating margin calculated by dividing GAAP revenues into GAAP operating income) or (2) measures that are not themselves non-GAAP financial measures;[194] or
- financial measures required to be disclosed by GAAP, SEC rules, or an applicable system of regulation of a government, governmental authority, or a self-regulatory organization (e.g., segment measures required by ASC 280 or IFRS 8).[195]

Under Regulation G, if a public company discloses a non-GAAP financial measure, it must:[196]

- present the most directly comparable financial measure calculated in accordance with GAAP; and
- quantitatively reconcile the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure.[197]

In addition, Regulation G contains an antifraud prohibition – that is, an issuer may not make any non-GAAP financial measure public if the measure contains a material misstatement or omission.[198]

A foreign private issuer need not comply with Regulation G with respect to a specific non-GAAP financial measure if:[199]

- its securities are listed or quoted outside the United States;
- the non-GAAP financial measure being used is not derived from or based on a measure calculated and presented in accordance with US GAAP; and
- the disclosure is made outside the United States.

S-K Item 10(e)

For purposes of Item 10(e), the term "non-GAAP financial measures" has the same meaning as under Regulation G.[200] Under Item 10(e), if a public company includes a non-GAAP financial measure in an SEC filing it must also include:[201]

- a presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;
- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure;
- a statement why management believes the non-GAAP financial measure provides useful information for investors; and
- to the extent material, a statement of the additional purposes for which management uses the non-GAAP financial measure.

Furthermore, Item 10(e) prohibits in SEC filings, among other things:[202]

- non-GAAP measures of liquidity that exclude items requiring cash settlement, other than EBIT and EBITDA;

- non-GAAP measures of performance that eliminate or smooth items characterized as non-recurring, unusual, or infrequent when it is reasonably likely that a similar charge or gain will recur within two years, or there was a similar charge or gain within the prior two years;
- the presentation of non-GAAP financial measures on the face of the financial statements, in the accompanying notes, or on the face of any pro forma financial information required to be disclosed by Article 11 of S-X; and
- using a name for non-GAAP financial measures that is the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

Item 10(e) contains an exemption from these prohibitions for a foreign private issuer if the non-GAAP financial measure relates to the local GAAP used in the issuer's primary financial statements, is required or expressly permitted by the standard-setter that establishes the local GAAP and is included in the issuer's annual report for its home jurisdiction.[203]

The SEC Staff monitors the use of non-GAAP financial measures and has issued several interpretations of SEC rules. The guidance covers various areas, such as ensuring equal or greater prominence for GAAP measures, appropriate presentation of per-share measures, handling of forward-looking non-GAAP financial measures without reconciliation, exclusion of recurring items, consistency in the inclusion or exclusion of gains or charges in non-GAAP measures over time, tailored recognition and measurement methods for specific financial statement line items (e.g., revenue), accurate labeling and clear descriptions of non-GAAP measures, and the recognition that disclosure alone may not be sufficient to address misleading non-GAAP measures.[204]

Interactive Data

The SEC has adopted rules that require foreign private issuers that prepare their financial statements in accordance with US GAAP or IASB IFRS to supplement their filed financial statements with financial statements formatted in eXtensible Business Reporting Language (XBRL). XBRL is a form of electronic communication whose main feature includes interactive electronic tagging of both financial and non-financial data. All operating company filers (including foreign private issuers) are required to embed XBRL data directly into the body of an SEC filing, rather than tag the information in a separate exhibit.[205]

A previously non-reporting company is not required to include XBRL financial statements in its initial Securities Act registration statement (i.e., an IPO on Form F-1 or an initial exchange offer on Form F-4) or its initial Exchange Act registration statement (i.e., Form 20-F).[206] Once having provided its first XBRL financial statements, the company would include XBRL financial statements in a subsequent Securities Act registration statement, but only if it includes a price or price range (and not if it merely incorporates financial statements by reference).[207] This means, for example, that XBRL financial statements are not needed in a base registration statement for a shelf offering.

There is a narrow exception to the XBRL rules relevant to foreign private issuers: the rules only apply to foreign private issuers that prepare their financial statements in accordance with US GAAP or IASB IFRS – i.e., they do not apply to foreign private issuers that prepare their financial statements in accordance with local GAAP.[208] However, there are only a very small number of foreign private issuers that use local GAAP in their SEC filings, so this exception is of limited use.

Special Considerations in Rule 144A Transactions

The disclosure document in a Rule 144A offering is typically modeled after a public offering prospectus. This holds true for financial statement requirements as well — although the line item disclosure rules of the Securities Act do not strictly apply to private offerings under Rule 144A, it has become standard practice to follow these rules as if they applied to Rule 144A offerings, with only limited exceptions. In many situations,

the commitment committees of the major financing sources will insist on including financial disclosure in the Rule 144A offering circular that is in all material respects consistent with the financial statement requirements that would apply to a registration statement filed with the SEC. Rule 144A offerings are typically sold to buyers who expect levels of disclosure substantially equivalent to what they would receive in a public deal. Additionally, in the case of a Rule 144A offering with registration rights, the Rule 144A circular will be followed by a registered exchange offer prospectus, and the buyers of the offered securities will thereby receive full Securities Act disclosure after the closing. Therefore, Rule 144A offering circulars typically follow the public offering rules described above in all material respects.

Foreign private issuers tend to take a flexible approach to financial statements in unregistered transactions depending on a variety of factors, including the type of transaction, local market practice, deal size, underwriter practice, investor expectations, and other marketing issues. It is not uncommon however, for a working group on a Rule 144A deal to decide to dispense with a particular financial statement requirement if the group determines that that particular item will not materially alter the total mix of information provided, or if there is another way to disclose the item that the S-X requirement is targeting.

After all, Rule 144A(d)(4)'s information requirement is very modest and calls only for "the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available)." A more flexible approach can also be justified by the fact that the liability standards of Sections 11 and 12 of the Securities Act do not apply to Rule 144A deals. Although Rule 10b-5 does apply to Rule 144A offerings, it is more difficult for disgruntled purchasers to demonstrate the requisite *scienter* required to establish a valid 10b-5 claim.[209] As a result, it is not uncommon to provide only two years of audited financial statements in a Rule 144A transaction where a registration statement would require three years. This is true for the issuer and for material acquired businesses. We have seen this decision taken in a number of deals, particularly where the issuer is already in its third or fourth fiscal quarter, since the third year of audited financial statements will likely be completed in the natural course before the exchange offer registration statement is required to be filed. Other working groups have elected to exclude some of the finer elements of the financial information requirements where they have determined that such additional information would not materially alter the total mix of information presented. Although the industry custom is to follow the public offering rules as if they applied to the Rule 144A deal, there is no requirement in Rule 144A to do so, and some working groups will conclude that not every detail of the information called for in a registration statement is required to present 144A investors with full and fair disclosure.

> PRACTICE POINT
>
> As the full impact of Sarbanes-Oxley has made itself felt upon issuer's accessing the US capital markets, "144A-for-life" debt financings have become typical. These transactions are identical to regular Rule 144A offerings, except that they do not offer bond investors any registration rights, and they do not require the bond issuers to become or remain voluntary filers of Exchange Act reports. Because these offerings will not be followed by a registered exchange offer prospectus that is fully compliant with S-X, some deal teams are concluding that "144A-for-life" disclosure documents can more freely dispense with non-core S-X requirements than would be the case in a traditional Rule 144A offering with registration rights.

ENDNOTES

1 We do not cover financial statements in M&A transactions. When securities are registered on Form S-4 or F-4 in connection with a stock-for-stock acquisition, different requirements may apply.

2 Generally, Form F-3 may be used by an issuer to sell securities (provided that the issuer has at least $75 million of common equity outstanding held by non-affiliates) if the issuer has been subject to the Exchange Act reporting requirements and timely filed all Exchange Act reports for the 12 months prior to registration, and neither the issuer nor its subsidiaries have had any material defaults on a payment related to a dividend, sinking fund, indebtedness, or rentals under long-term leases. *See* Form F-3, General Instructions.

3 In particular, Form F-1 allows an issuer to incorporate information by reference from its previously filed Exchange Act reports if the issuer:

- is required to file Exchange Act reports;
- has filed all required reports and other materials under the Exchange Act during the prior 12 months (or for such shorter period that the issuer was required to file such reports and materials);
- has filed an annual report for its most recently completed fiscal year;
- is not, and during the past three years neither the issuer nor any of its predecessors was, a blank check issuer, shell company, or penny stock issuer; and
- makes its Exchange Act reports readily available on its website (including by way of hyperlink to the reports).

See Form F-1, General Instructions.

4 *See* Form 20-F and Item 8.A.1.

5 *See id*. at Items 17(c), 18.

6 *See* Form 20-F, Item 8.A.2.

7 *See* Form 20-F, Instruction 1 to Item 8. *See* also S-X Rule 3-02(a) (noting if the issuer has been in existence less than the prescribed number of years, it is sufficient to provide statements of comprehensive income for the life of the issuer and its predecessors); *Financial Reporting Manual*, Section 6220.5 (a foreign private issuer that has been in existence less than a year must include an audited balance sheet that is not more than nine months old; if the issuer has commenced operations, it must include audited statements of income, stockholders' equity, and cash flows for the period from the date of inception to the date of the audited balance sheet). Financial information of a registrant's predecessor is required for all periods prior to the registrant's existence, with no lapse in audited periods or omission of other information required about the registrant. *Financial Reporting Manual*, Section 1170. The term *predecessor* is defined broadly. *See* Securities Act Rule 405.

8 *See* Form 20-F, Instruction 1 to Item 8.A.2.

9 *See id*. at Instruction 3 to Item 8.A.2; *see also Financial Reporting Manual*, Section 6410.2.

10 *See* Form 20-F, General Instruction G(a); *see also Financial Reporting Manual*, Section 6340.1.

11 *See* S-X Rule 3-06. Under this rule, the SEC will accept financial statements for periods of not less than nine, 21, and 33 consecutive months as substantial compliance with the requirement to provide financial statements for one, two, and three years, respectively. In particular, whenever audited financial statements are required for a period of one, two, or three years, a single audited period of nine to 12 months may count as a year if:

- the issuer has changed its fiscal year during the period;
- the issuer has made a significant business acquisition for which financial statements are required under S-X Rule 3-05 and the financial statements covering the interim period pertain to the business being acquired; or
- the SEC grants permission to do so under S-X Rule 3-13, provided that financial statements are filed that cover the full fiscal year or years for all other years in the time period.

See id. Note that historically the SEC Staff has been reluctant to grant this relief. *See Financial Reporting Manual*, Note to Section 1140.8 (issuer must show unusual circumstances). On June 29, 2017, the SEC Staff signaled that it might be willing to grant permission if an issuer is able to argue that the information is not necessary for investor protection. *See* Staff of the Division of Corporation Finance, *Draft Registration Statement Procedures Expanded* (June 29, 2017, updated Aug. 17, 2017) [*2017 Procedures*]:

> While an issuer should take all steps to ensure that a draft registration statement is substantially complete when submitted, we will not delay processing if an issuer reasonably believes omitted financial information will not be required at the time the registration statement is publicly filed. In addition, we will consider an issuer's specific facts and circumstances in connection with any request made under Rule 3-13 of Regulation S-X.

See 2017 Procedures

12 *See* Form 20-F, Item 8.A.1., Item 8.A.3.

13 *See Financial Reporting Manual*, Section 4110.5 (accounting firm must be PCAOB registered and auditor's report must refer to PCAOB standards); Section 4110.1 (citing PCAOB Rule 2100, which requires each firm to register with the PCAOB that prepares or issues any audit report with respect to any issuer, or plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer).

14 *See Financial Reporting Manual*, Section 4130.1 (audit reports that refer to PCAOB standards must comply with both the SEC's and PCAOB's independence rules). For the initial SEC registration by a foreign private issuer, the auditor must be independent under applicable SEC and PCAOB standards only for the most recent audited fiscal year as long as it is independent under home-country standards for all other audited periods. *See* S-X Rule 2-01(f)(5)(iii).

15 *See Financial Reporting Manual*, Section 6820.2; *see also* Form 20-F, General Instruction E(c)(2) (entities other than the issuer included in the filing must be audited in accordance with applicable professional standards).

16 *See* Form 20-F, Item 8.A.5.

17 *See IFRS Reconciliation Release*, Section III.A.2. For pre-effective registration statements and post-effective amendments with annual financial statements less than nine months old, published interim financial statements need not be reconciled to US GAAP if audited annual financial statements included or incorporated by reference for all required periods are prepared in accordance with IASB IFRS. For pre-effective registration statements and post-effective amendments with annual financial statements more than nine months old, reconciliation is not required for an interim period where the issuer complies with and explicitly states compliance with IAS 34, and audited annual financial statements are prepared in accordance with IASB IFRS. *See Financial Reporting Manual*, Section 6330.

18 *See* Form 20-F at Items 17(c) and 18; *see also Final Rule: First-Time Application of International Financial Reporting Standards*, Release No. 8567 (Apr. 12, 2005) [*First-Time Application of IFRS Release*] (discussing the applicable exceptions).

19 *See* generally Form 20-F, Item 8.A.5.

20 *See* JOBS Act Section 102(b)(1) (adding new Securities Act Section 7(a)(2)).

21 *See* JOBS Act Section 102(b)(2) (modifying Exchange Act Section 13(a)).

22 *See* JOBS Act Section 102(b)(3) (modifying Regulation S-K, Item 303(a)).

23 *See* Form 20-F, Item 3.B.

24 *See id.*

25 SEC Division of Corporation Finance, *International Reporting and Disclosure Issues*, Section III.B.f (Nov. 1, 2004).

26 *See id.*

27 JOBS Act, Section 106(a), adding Securities Act Section 6(e)(1). The confidential submission is automatically exempt from disclosure under the Freedom of Information Act (FOIA). JOBS Act, Section 106(a), adding Securities Act Section 6(e)(2).

28 *See* 2017 Procedures. Prior to the end of the twelfth month following the effective date of the initial registration statement, these issuers may also submit the first draft of a follow-on registration statement for nonpublic review. *Id*.
A foreign private issuer may choose instead to use the procedures adopted in 2011 for foreign private issuers, which are limited to a foreign private issuer that is filing with the SEC for the first time that:

- qualifies as an emerging growth company under the JOBS Act (which would be treated as a confidential submission as described above);
- is listed or is concurrently listing its securities on a non-US securities exchange – i.e., a foreign private issuer that is not solely listing in the United States;
- is being privatized by a foreign government; or
- can "demonstrate that the public filing of an initial registration statement would conflict with the law of an applicable foreign jurisdiction."

See Staff of the Division of Corporation Finance, *Non-Public Submissions from Foreign Private Issuers* (Dec. 8, 2011, updated May 30, 2012) [*2012 Procedures*].

Nonpublic submissions are not automatically exempt from FOIA, and issuers are advised to request confidential treatment under SEC Rule 83. 2017 Procedures, at n.1. Making a Rule 83 request does not guarantee that the information will be protected from public disclosure; the issuer simply puts the SEC on notice that it wants the information kept confidential. The SEC will resolve whether to honor a confidentiality request only when disclosure of the information is requested under FOIA. *See Confidential Treatment Procedures Under the Freedom of Information Act*, 17 C.F.R. 200.83.

29 FAST Act Section 71003, adding new JOBS Act Sections 102(d)(1) and (2); FAST Act Compliance and Disclosure Interpretations (C&DIs), Question 1. *See also* Securities Act Forms C&DIs, Question 101.04 (Aug. 17, 2017).

30 *See* 2017 Procedures; SEC Division of Corporation Finance, Voluntary Submission of Draft Registration Statements - FAQs (June 30, 2017), Question 7. *See also* Securities Act Forms C&DIs, Question 101.05 (Aug. 17, 2017). A non-EGC must publicly file its registration statement and all previous nonpublic submissions at least 15 days before commencing any road show or, absent a road show, 15 days prior to effectiveness. 2017 Procedures. The 15-day requirement does not apply to submissions made under the 2012 Procedures by a non-EGC or by an EGC that has chosen not to take advantage of any of the accommodations available to an EGC under the JOBS Act. However, the public filing must be made prior to the start of the road show. *See* 2012 Procedures; *see also* Staff of the Division of Corporation Finance, *Jumpstart Our Business Startups Act Frequently Asked Questions Generally Applicable Questions on Title I of the JOBS Act* (Apr. 16, 2012, updated May 3, 2012 Sept. 28, 2012, and Dec. 15, 2015) [*JOBS Act Title I FAQs*], Question 9. In the case of a follow-on offering, the public filing must be made at least 48 hours prior to effectiveness. 2017 Procedures.

31 FAST Act C&DIs, Question 2 (Dec. 15, 2015). The SEC Staff has signaled a more flexible approach in reviewing requests to omit financial information under S-X Rule 3-13, based on an issuer's specific circumstances. *See* 2017 Procedures.

32 *See Financial Reporting Manual*, Section 1210. Section 1210 was updated in October 2020 to clarify that the SEC Staff will "not delay processing if an issuer reasonably believes omitted financial information will not be required at the time the registration statement is publicly filed." *See also* 2017 Procedures ("While an issuer should take all steps to ensure that a draft registration statement is substantially complete when submitted, we will not delay processing if an issuer reasonably believes omitted financial information will not be required at the time the registration statement is publicly filed.").

33 *See* Form 20-F, Instruction 1 to Item 8.A.4. The rules regarding the age or "staleness" of the required financial statements for foreign private issuers vary a great deal from those applicable to US domestic issuers. Generally speaking, the financial statements for US domestic issuers go "stale" at a much faster rate.

34 *See* Form 20-F, Item 8.A.4.

35 *See* Form 20-F, Item 8.A.4. (requiring IPO issuers to provide audited financial statements "as of a date not older than 12 months at the time the document is filed" and noting that the audited financial statements in such cases "may cover a period of less than a full year").

36 *See Financial Reporting Manual*, Section 6220.3.

37 *See* Form 20-F, Instruction 2 to Item 8.A.4; *see also Financial Reporting Manual*, Section 6220.3.

38 *See* Form 20-F, Instruction 2 to Item 8; *see also Financial Reporting Manual*, Section 6220.2.

39 *See* Form 20-F, Item 8.A.5. This requirement applies to any publication of financial information that includes, at a minimum, revenue and income information, even if that information is not published as part of a complete set of financial statements. *See* Form 20-F, Instruction 3 to Item 8.A.5.

40 *See Financial Reporting Manual*, Section 6220.6.

41 *See* Form 20-F, Item 5. The MD&A requirements for US issuers are set out in S-K Item 303.

42 *See* Instruction 10 to S-K Item 303(b).

43 *See* Form 20-F, Item 5.A. *See also* Instruction 9 to S-K Item 303(b).

44 *See* Form 20-F, Item 5.B.

45 *See* Form 20-F, Item 5.C.

46 *See* Form 20-F, Item 5.D.

47 *See* Form 20-F, Instruction 5 to Item 5 ("In responding to this Item 5, an issuer need not repeat information contained in financial statements that comply with IFRS as issued by the IASB."). *See also Final Rule: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information*, Release No. 33-10890 (Nov. 19, 2020), at n.243 ("These proposed [critical accounting estimate] requirements are similar to those found in IFRS."); n.344 ("Certain IFRS standards require some disclosures that substantially overlap with the requirements of Item 5.E. [Critical Accounting Estimates] of Form 20-F.")

48 *See* Form 20-F, Item 5.E.

49 *See Final Rule: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information*, Release No. 33-10890 (Nov. 19, 2020); *Commission Guidance on Management's Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-10751(Jan. 30, 2020); *Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis*, Release No. 33-9144 (Sept. 17, 2010); *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8350 (Dec. 19, 2003); *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8056 (Jan. 22, 2002); and *SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, Release No. 33-6835 (May 18, 1989).

50 *See IFRS Reconciliation Release; Financial Reporting Manual*, Section 6310.1.

51 *See* Form 20-F, Item 17(c); *Financial Reporting Manual*, Section 6310.2.

52 *See* Form 20-F, Instructions 3 and 4 to Item 8.A.5; *Financial Reporting Manual*, Sections 6330.1 and 6330.2.

53 *See Financial Reporting Manual*, Section 6120.6.

54 *See* Form 20-F, Item 17(c).

55 *See IFRS Reconciliation Release*.

56 *See* Form 20-F, Item 17(c).

57 *See Financial Reporting Manual*, Section 6410.2.

58 *See* Form 20-F, Instruction 2 to Item 5. *See also* Instruction 9 to S-K Item 303(b).

59 *See id.*

60 *See* Form 20-F, Item 8.A.1; Item 8.A.3. (noting audit reports must cover each period of required disclosure).

61 *See* Form 20-F, Instruction to Item 8.A.3. *See also* SAB 103, Topic 1.E.2 (financial statements on which the auditors' opinions are qualified because of a limitation on the scope of the audit do not meet the requirements of S-X Rule 2-02(b); financial statements for which the auditors' opinions contain qualifications relating to the acceptability of accounting principles used or the completeness of disclosures made are also unacceptable); *Financial Reporting Manual*, Section 4220 (discussing qualified audit reports generally).

62 *See Financial Reporting Manual*, Section 6820.2; *see also* Form 20-F, General Instruction E(c).

63 *See Financial Reporting Manual*, Section 4110.1 (citing PCAOB Rule 2100).

64 AS 3101. The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendment to PCAOB Standards, Note to 05(b).

65 *See* Pub. L. 116-222, 134 Stat. 1063 (Dec. 18, 2020), adding Section 104(i) to Sarbanes-Oxley; *see also Final Rule: Holding Foreign Companies Accountable Act Disclosure*, Release No. 34-93701 (Dec. 2, 2021) [HFCAA Release]. For a list of PCAOB-identified accounting firms *see* Public Company Accounting Oversight Board, *HFCAA Determination Report Issued Pursuant to 15 USC § 7214(i)(2)(A) and PCAOB Rule 6100, Board Determinations Under the Holding Foreign Companies Accountable Act* (Dec. 16, 2021), available at https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/international/documents/104-hfcaa-2021-001.pdf.

66 Available at https://www.sec.gov/hfcaa.

67 *See* HFCAA Release, at 21-21. "If the Commission agrees with the registrant's analysis, the Commission will notify the registrant and will remove the registrant from the provisional identification list…. [I]f the Commission does not agree…, the determination that the registrant is a Commission-Identified Issuer will be conclusive. .If the registrant does not contact the Commission to dispute the provisional identification, the determination that the registrant is a Commission-Identified Issuer will be conclusive 15 business days after the provisional identification."

68 *See* Exchange Act Rule 3b-4. A "foreign issuer" means any issuer that is a foreign government, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country.

69 *See* Section 3 of the HFCAA.

70 *See* Holding Foreign Companies Accountable Act – PCAOB Determination Update (last updated Feb. 1, 2023), at https://www.sec.gov/hfcaa. *See also Staff Statement on the Holding Foreign Companies Accountable Act and the Consolidated Appropriations Act, 2023*, Division of Corporation Finance and Division of Trading and Markets (Apr. 6, 2023), at https://www.sec.gov/corpfin/announcement/statement-hfcaa-040623.

71 *See* S-X Rule 3-20(a).

72 *See Financial Reporting Manual*, Section 6610.1.

73 *See* S-X Rule 3-20(b).

74 *See id.; see also* S-K Item 301, Instruction 5.C (noting if equity securities are being registered, a five-year summary of dividends per share stated in both the currency in which the financial statements are denominated and US dollars must be included, based on the exchange rates at each respective payment date).

75 *See* S-X Rule 3-20(b) (providing that "[i]f the reporting currency is not the US dollar, dollar-equivalent financial statements or convenience translations shall not be presented, except a translation may be presented of the most recent fiscal year and any subsequent interim period presented using the exchange rate as of the most recent balance sheet included in the filing, except that a rate as of the most recent practicable date shall be used if materially different").

76 *See id.*; *see also Financial Reporting Manual*, Section 6600 (discussing reporting currency generally).

77 Disclosure requirements for Investment companies (including business development companies) that were formerly included in S-X Rule 3-05, have been moved to new Rule 6-11, which covers financial reporting in the event of a fund acquisition.

78 *See* Form F-1, Item 4(b); *see also* Form F-3, Item 5(b)(1)(i). This requirement does not apply to annual reports. See Form 10-K, Item 8(a). *See generally* S-X Rule 3-05(b)(4). Also, when securities are registered on Form S-4 or F-4 in connection with a stock-for-stock acquisition, somewhat different requirements apply for the financial statements of the company being acquired. Finally, in the case of a takedown from an already effective shelf registration statement, management must determine whether a consummated or probable acquisition of one or more businesses constitutes a fundamental change that would trigger a requirement to file a post-effective amendment including the financial statements of those businesses. *See Financial Report Manual* Section 2930.12.

79 *See* S-X Rule 11-01(d). The question whether an acquisition is of a "business" should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity's operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances to consider in evaluating whether an acquisition of a lesser component of an entity constitutes a business are:

- whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or
- whether any of the following attributes remain with the component after the transaction: (i) physical facilities, (ii) employee base, (iii) market distribution system, (iv) sales force, (v) customer base, (vi) operating rights, (vii) production techniques, or (viii) trade names.

See id.

80 However, a different conclusion may be reached depending upon the customary practice for an industry or a particular issuer. For example, an issuer may be submitting a letter of intent as one of many parties in a bidding process, or a roll-up entity may routinely sign letters of intent to further its due diligence investigations of multiple potential targets, but with the acquisition of only a minority of those companies becoming probable.

81 *See Financial Reporting Manual*, Section 2905.4.

82 S-X Rule 1-02(w)(1)(i)(A).

83 S-X Rule 1-02(w)(1)(ii).

84 By "pre-tax income" we mean the income from continuing operations. *See* S-X Rule 1-02(w)(1)(iii)(A)(1). Absolute values should be used for the net income component.

85 S-X Rule 1-02(w)(1)(iii)(A)(1).

86 S-X Rule 1-02(w)(1)(iii)(A)(2).

87 *See* S-X Rule 3-05(b)(2).

88 S-X Rule 1-02(w)(1).

89 S-X Rule 1-02(w)(1)(i)(A)(3).

90 *See* S-X Rule 3-05(b)(3) referring to Rule 11-01(b)(3) and (4). The tests may not be made by "annualizing" data, and may only include Transaction Accounting Adjustments.

91 *See* S-X Rule 3-05(b)(3) referring to Rule 11-01(b)(3) and (4).

92 *See* S-X Rule 3-05(a)(3) (governing whether businesses are "related"); S-X Rule 11-01(d) (governing whether an acquisition involves a "business").

93 *See* S-X Rule 3-05(b)(2)(ii). A comparative interim period for the prior year is not required when only one year of audited Rule 3-05 Financial Statements is required.

94 *See* S-X Rule 3-05(b)(2)(iii).

95 See S-X Rule 3-05(b)(2).

96 *See* S-X Rule 3-05(b)(2)(iv). *See also Final Rule: Amendments to Financial Disclosures About Acquired and Disposed Businesses*, Release No. 33-10786 (May 20, 2020), p.79. "Individually insignificant businesses" include any: (a) acquisition consummated after the acquiror's audited balance sheet date whose significance does not exceed 20%; (b) probable acquisition whose significance does not exceed 50%; and (c) consummated acquisition whose significance exceeds 20%, but does not exceed 50%, for which financial statements are not yet required because of the 75-day grace period.

97 *See* S-X Rule 3-05(a)(1) (financial statements of acquired businesses must be prepared and audited in accordance with S-X).

98 Although the staleness date for an acquired company's financial statements is determined based on the status of the acquired company (e.g., as an accelerated or non-accelerated filer), an interesting wrinkle may emerge where the acquiring company is on a faster track than the acquired company. In that fact pattern, the separate requirement to include pro forma financial information under Article 11 of S-X can effectively accelerate the need for the acquired company's financial information. The acquiring company will need to produce financial statements for the acquired business if the acquiring company wants to go to market with "last twelve months" pro forma financials after the date on which its own year-end financials are due but before the due date for the acquired company's financials.

99 *See* S-X Rule 3-05(b)(4)(i). The date of an offering will be deemed to be the date of the final prospectus or prospectus supplement filed pursuant to Rule 424(b). *See id.* By analogy, the pricing date would be the date of an offering in a Rule 144A transaction.

100 "Foreign business" is defined in S-X Rule 1-02(l) as a business that is majority owned by persons who are not citizens or residents of the United States and is not organized under US law, and either:
- more than 50% of its assets are located outside the United States; or
- the majority of its executive officers or directors are not US citizens or residents.

In determining the majority ownership of a business, the SEC Staff will consider the ultimate parent entity that would consolidate the business under US GAAP (or IFRS for IASB IFRS issuers) and the parent's controlling shareholders. *See Financial Reporting Manual*, Section 6110.4. The implication of this is that a non-US subsidiary of a US company would likely not be considered a "foreign business."

101 *See* S-X Rule 3-05(c) (financial statements of an acquired foreign business can meet Item 17 of Form 20-F); Form 20-F, Item 17(c)(2)(v) (financial statements of an acquired business may omit reconciliation below the 30% significance level.

102 *See* S-X Rule 3-05(d).

103 *See* S-X Rule 3-05(c) Accommodations in Item 17(c)(2) that would be inconsistent with IASB IFRS may not be applied, but IFRS 1 *First Time Adoption of International Financial Reporting Standards* may be applied.

104 *See Financial Reporting Manual*, Section 4110.5.

105 *See* S-X Rule 1-02(w).

106 S-X Rule 3-05(b)(4)(iii).

107 *See* S-X Rule 3-06.

108 *See* S-X Rule 3-14(a)(2)(i). (defining a real estate business as a "business that generates substantially all of its revenues through the leasing of real property").

109 *See* S-X Rule 3-14(b)(2). Where the acquiror does not have publicly traded securities, the acquiror's investment in the real estate operation should include any debt secured by the real property that is assumed by the acquiror in connections with the acquisition compared to the acquiror's total assets. Significance for blind pool offerings must be computed by comparing the issuer's investments in the real estate operations or other acquired business to the sum of its total assets as of the date of the acquisition and the proceeds (net of commissions) in good faith expected to be raised in the registered offering over the next 12 months. After the distribution period for the offering ends and until the next Form 10-K is filed, significance is based on the issuer's total assets as of the date of acquisition or disposition, except that for acquisitions total assets must exclude the acquired real estate operations. After that next Form 10-K is filed, the issuer can determine significance using total assets as of the end of the most recently completed fiscal year included in the Form 10-K. *See* S-X Rule 11-01(b)(4).

110 *See* S-X Rule 3-14(c). The additional disclosure includes: (i) material factors considered by the issuer in assessing the property, including sources of revenue (including, but not limited to, competition in the rental market, comparative rents, occupancy rates) and expense (including, but not limited to, utility rates, *ad valorem* tax rates, maintenance expenses, and capital improvements anticipated), and (ii) an indication that, after reasonable inquiry, the issuer is not aware of any material factors relating to the property other than those discussed in (i) that would cause the reported financial information not to be necessarily indicative of future operating results. *See* S-X Rule 3-14(f).

111 Securities Act Rule 408 states that, "In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

112 *See* S-X Rule 3-05(b)(iv)(A) and S-X Rule 3-14(b)(2)(i)(C)(1).

113 *See* S-X Rule 11-01(a)(1) (noting pro forma financial information required for a "significant" business acquisition); S-X Rule 11-01(b)(1) (noting a "significant" acquisition means an acquisition above the 20% significance level); S-X Rule 11-01(c) (noting no pro forma financial information is needed if separate financial statements of the acquired business are not included and the aggregate impact of the acquisition of these multiple businesses does not exceed the 50% significance level).

114 *See* S-X Rule 11-02(a)(1).

115 *See* S-X Rule 11-02(c)(1). The pro forma condensed balance sheet should be prepared as if the transaction had occurred on the date of the latest historical balance sheet.

116 *See* S-X Rule 11-02(a)(1).

117 *See* S-X Rule 11-02(c)(2)(i). The pro forma condensed statements of comprehensive income should be prepared as if the transaction had taken place at the beginning of the latest fiscal year included in the filing.

118 *See* S-X Rule 11-01(a)(4). A "significant" disposition for these purposes is one where the business would be a "significant subsidiary" under S-X Rule 1-02(w) at the 20% significance level. *See* S-X Rule 11-01(b)(2).

119 *See* S-X Rule 11-01(a)(1) and *Financial Reporting Manual*, Section 3110.1.

120 *See* S-X Rule 11-01(a)(8).

121 *See general*ly S-X Rule 11-02.

122 This information is expressly protected by the safe harbor provisions for forward-looking information of Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act. *See Acquired Business Financial Disclosures Release*, p. 115. *See also*, S-X Rule 11-01 Instruction to paragraph (a)(7).

123 *See* S-X Rule 11-02(c)(3).

124 *See id.* This updating could be accomplished by adding subsequent interim period results to the most recent fiscal year-end information and deducting the comparable preceding year interim period results.

125 *See* Section 2(a)(1) of the Securities Act.

126 *See* S-X Rule 3-10(a). In the case of a foreign private issuer, these would be the financial statements required by Item 8.A of Form 20-F. Note that S-X Rule 3-10 typically does not apply to credit enhancements that are not guarantees. However, in certain cases the financial condition of the party providing the credit enhancement could be material to investors and subject to disclosure. *See Final Rule: Financial Statements and Periodic Reports for Related Issuers and Guarantors*, Release No. 33-7878 at n.50 (Aug. 15, 2000).

127 S-X Rule 3-10(a).

128 S-X Rule 3-10(b)(2) defines a security as "debt" or "debt-like" if: "(i) The issuer has a contractual obligation to pay a fixed sum at a fixed time; and (ii) Where the obligation to make such payments is cumulative, a set amount of interest must be paid."

129 S-X Rule 13-01(a)(6)-(7). In some situations, this may require the parent company to include separate summarized financial information for the issuers and guarantors to which that additional information applies. For instance, where a subsidiary guarantee is not full and unconditional and the guarantor is not wholly owned by the parent company, the parent may be required to disclose separate summarized financial information for the guarantor, as well as additional information about the terms of the guarantee and the rights of minority interests in the subsidiary.

130 S-X Rule 13-01(b). The parent company may decide to include the Alternative Disclosures in the notes to the consolidated financial statements, which would then subject the information to audit and with possible delay and expense. If not included in the consolidated financial statements or in the MD&A, the parent company must include the disclosures in its prospectus immediately following "Risk Factors" or, if there are no risk factors, immediately following pricing information.

131 S-X Rule 13-01(a). For instance, if there were fewer than 300 holders of record of the subject securities, the reporting obligation would be automatically suspended after the first annual report on Form 10-K following the issuance. See Exchange Act Section 15(d)(1).

132 S-X Rule 13-01(a)(1).

133 S-X Rule 13-01(a)(2).

134 S-X Rule 13-01(a)(3).

135 *See* S-X Rule 3-10(b)(1) the "'parent company' is the entity that (i) Is an issuer or guarantor of the guaranteed security; (ii) Is, or as a result of the subject Securities Act registration statement will be, an Exchange Act reporting company; and (iii) consolidates each subsidiary issuer and/or subsidiary guarantor of the guaranteed security in its consolidated financial statements.

136 S-X Rule 13-01(a)(4)(v).

137 S-X Rule 13-01(a)(4), referring to the definition of "summarized financial information" in S-X Rule 1-02(bb), required for other note disclosures (e.g., equity investees). There is no requirement to present cash flow information, but the required disclosures include current and non-current assets, preferred stock, non-controlling interests, net sales or gross revenues, income/loss from continuing operations, and net income/loss.

138 S-X Rule 13-01(a)(4)(iv).

139 S-X Rule 13-01(a)(4)(iv).

140 S-X Rule 13-01(a)(5). An acquired business is significant for these purposes if it exceeds 20% on any of the Asset, Investment, or Income Tests discussed above in "Recent and Probable Acquisitions."

141 S-X Rule 13-01(a)(4)(vi).

142 S-X Rule 13-01(a)(4)(vi)(A).

143 S-X Rule 13-01(a)(4)(vi)(B).

144 S-X Rule 13-01(a)(4)(vi) defines a "finance subsidiary" as a "a subsidiary that has no assets or operations other than those related to the issuance, administration and repayment of the security being registered and any other securities guaranteed by its parent company."

145 S-X Rule 13-01(a)(4)(vi)(C).

146 S-X Rule 13-01(a)(4)(vi)(D).

147 S-K Item 601(b)(22).

148 S-X Rule 3-16 will continue to apply to any secured offering registered before January 4, 2021 where the registrant has not been providing S-X Rule 3-16 financial statements. This extension of the S-X Rule 3-16 regime for the remaining term of securities that meet these criteria is designed to ensure that collateral release provisions in the related indentures are not unintentionally triggered and holders' rights impaired.

149 S-X Rule 13-02(a)(6)-(7).

150 S-X Rule 13-02(b).

151 S-X Rule 13-02(a).

152 *See* ASC 323, *Investments – Equity Method and Joint Venture*; *see also Financial Reporting Manual*, Section 5210.

153 *See* SAB 103, Topic 6.K.4.

154 *See Financial Reporting Manual*, Section 4110.5.

155 *See* S-X Rule 3-09(a).

156 Note this test is derived from S-X Rule 1-02(w)(1)(i).

157 Note this test is derived from S-X Rule 1-02(w)(1)(iii).

158 *See* S-X Rule 3-09(a).

159 *See* S-X Rule 3-09(b).

160 *The Center for Audit Quality SEC Regulations Committee Highlights* (Mar. 19, 2013) (EGC may include only two years of financial statements of the Rule 3-09 investee, even in situations where an EGC voluntarily provides a third year of financial statements).

161 *See* Note to paragraph (w) of S-X Rule 1-02(w).); *see also Financial Reporting Manual*, Section 6350.2.

162 *See generally* S-X Rule 4-08(g).

163 *See* Form 20-F, Item 17(c)(vi).

164 *See* S-X Rule 3-09(d).

165 *See* Form 20-F, Item 17(c).

166 *See id.*

167 *See Financial Reporting Manual*, Note to Section 6410.6.

168 *See* S-K Item 303(a).

169 ASC 280 uses the term "chief operating decision maker" to identify a function rather than a specific person; the "chief operating decision maker" could be the CEO, CFO, or a group of senior managers, depending upon the circumstances. IFRS 8 ("Operating Segments") uses similar language: "The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others."

170 In practice, there is a great variety of ways in which management may view its business and there is no one right answer within a given industry.

171 *See* ASC 280 10-50-12 and IFRS 8.13 (quantitative thresholds).

172 Under ASC 280, the details provided in reporting a "measure of profit or loss" depend upon the information that is actually reviewed by the chief operating decision maker and may include revenues from external versus internal customers, interest revenue and expenses, depreciation and amortization, and unusual items, among others.

173 Voluntary measures of segment profit or loss that are not consistent with US GAAP must comply with the SEC non-GAAP rules and regulations (Regulation G and S-K Item 10(e)).

174 *See generally* S-X Rule 5-04(c).

175 Where restrictions on the amount of funds that may be loaned or advanced differ from the amount restricted as to transfer in the form of cash dividends, the amount least restrictive to the subsidiary may be used. Redeemable preferred stocks and non-controlling interests are deducted in computing net assets for purposes of this test. *See* S-X Rules 5-04 and 1-02(dd).

176 *See generally* S-K Item 801.

177 *See Interpretive Release: Modernization of Oil and Gas Reporting*, Release No. 33-8995 (Dec. 31, 2008).

178 The rules define a "qualified person" to mean:
- a mineral industry professional with at least five years of relevant experience in the type of mineralization and type of deposit under consideration and in the specific type of activity that person is undertaking on behalf of the company; and
- an eligible member or licensee in good standing of a recognized professional organization at the time the technical report is prepared.

179 *See Final Rule: Modernization of Property Disclosures for Mining Registrants*, Release No. 33-10570 (Oct. 31, 2018).

180 *See* Final Rule: Update of Statistical Disclosures for Bank and Savings and Loan Registrants, Release No. 33-10835 (Sept. 11, 2020).

181 *See Financial Reporting Manual*, Section 6510 (Item 17), Section 6520 (Item 18).

182 *Compare* Form 20-F, Item 17(b) (financial statement must disclose information "substantially similar" to financial statements complying with US GAAP and S-X) *with id*. at Item 18 (an issuer must provide all Item 17 information plus all other information required by US GAAP and S-X unless those requirements do not apply to foreign private issuers, subject to certain exceptions).

183 *See* SAB 103, Topic 1.D.1.

184 *See id*.

185 *See* Form 20-F, General Instruction E(c)(2).

186 *See* S-X Rule 3-05.

187 *See* S-X Rule 3-09.

188 *See* S-X Rule 3-16.

189 *See* S-X Rule 3-10 and S-X Rule 13-01.

190 *See* Regulation G, Rule 100(a).

191 *See* Form 8-K, Item 2.02, Instruction 2 (requirements of S-K Item 10(e)(1)(i) apply to Item 2.02 disclosures).

192 *See* Regulation G, Rule 101(a)(1).

193 *See id.* at Rule 101(b).

194 *See id.* at Rule 101(a)(2).

195 *See id.* at Rule 101(a)(3).

196 *See id.* at Rule 100(a).

197 *See id.* at Rule 100(a)(2). In the case of forward-looking, non-GAAP measures, a quantitative reconciliation need only be provided to the extent available without unreasonable efforts. *Id.*

198 *See id.* at Rule 100(b).

199 *See id.* at Rule 100(c).

200 *See* S-K, Items 10(e)(2), 10(e)(4), and 10(e)(5).

201 *See id.* at Item 10(e)(1)(i), including in an earnings release furnished under Form 8-K Item 2.02.

202 *See id.* at Item 10(e)(1)(ii), but not in an earnings release furnished under Form 8-K Item 2.02.

203 *See id.* at Item 10, Note to Paragraph (e).

204 *See generally* Non-GAAP Financial Measures C&DIs (last updated Dec. 22, 2022).

205 *See Final Rule: Inline XBRL Filing of Tagged Data*, Release No. 33-10514 (June 28, 2018). In addition, any electronic filer that is required to submit interactive data files in Inline XBRL format must also tag all of the information required on the cover page of Forms 10-K, 10-Q, 8-K, 20-F, and 40-F. The requirement applies to Forms 20-F and 40-F only if they are being used as annual reports and not as registration statements. See Final Rule: FAST Act Modernization and Simplification of Regulation S-K, Release 33-10618 (Mar. 20, 2019) (adding new Rule 406 to Regulation S-T, new Item 601(b)(104) to S-K, new paragraph 104 to the "Instructions as to Exhibits" of Form 20-F, and new paragraph B.17 to the "General Instructions" of Form 40-F).

206 *See* S-K Item 601(b)(101)(i).

207 *See Id.*

208 *Final Rule: Interactive Data to Improve Financial Reporting*, Release No. 33-9002, p. 1 (Jan. 30, 2009).

209 Under the relevant Rule 10b-5 case law, a plaintiff must show more than a simple misstatement or omission. A showing of *scienter* or recklessness is also required to establish liability.

CHAPTER 8

Equity Derivatives

Derivatives are financial instruments whose value derives from that of something else. Equity derivatives, as distinguished from other types of derivatives such as credit derivatives or foreign currency derivatives, derive their value from underlying equity securities. In other words, the value of an equity derivative is linked to the value of the underlying security or securities. Equity derivatives, as described in this Chapter, also encompass a variety of transaction formats. Those formats include (i) over-the-counter transactions executed on ISDA documentation "platform," like accelerated share repurchases, various swaps, forwards, and options, to capital markets instruments, for example, mandatory and optional convertible and exchangeable securities, and (ii) M&A and financing transactions, like margin loans, other types of equity-based financings, and certain derivative products used in structured acquisition trades.

Equity derivatives mainly allow parties to acquire or dispose of economic exposure by transferring the risks and benefits of owning the underlying equity securities. Equity derivatives are thus commonly used as a means of obtaining a synthetic position in an underlying security without having to own it. The synthetic position can be *long*, meaning that the derivative has a direct relationship to the value of the underlying security, and therefore replicates the economics of an investment in the underlying security. The synthetic position can also be *short*, meaning that the derivative has an inverse relationship to the value of the underlying security, and therefore replicates the economics of a sale in the underlying security.

The practice of managing uncertainty by balancing long positions against short positions is commonly known as *hedging*. Hedging allows investors to tailor their payoffs to their desired risk profile. Hedging also allows banks or dealers to be in the business of buying and selling derivatives (and collecting the associated fees) without taking a particular directional view with regard to the value of the underlying security.

An increasing number of issuers, both US and foreign, have chosen to use equity derivatives linked to their own stock to facilitate capital-raising transactions, to minimize potential dilution to their equity, and to optimize their capital structure. Derivatives or derivative-related issues play a role in a number of transactions that seem fairly ordinary, whether in capital markets products or financing transactions.

Examples of Corporate Equity Derivatives Transactions

Structured Share Repurchases

An issuer with listed shares can repurchase its own shares in an open-market share repurchase program or through the use of equity derivatives.[1] A common type of derivative used by issuers is an accelerated share repurchase, or ASR. Many variants of the structure exist, but in a typical ASR an issuer will give to a dealer an up-front cash payment (reflecting the then-current market price of the shares plus a commission) in exchange for the immediate delivery of an agreed number of shares that the dealer has borrowed from the market. During the term of the transaction the dealer will buy shares from the open market and return them to its stock lenders to close out its open positions. If at the end of the transaction, the price of the shares (determined pursuant to a method specified in the agreement) is greater than the initial price at which the dealer sold the shares to the issuer, the issuer will pay the difference (either in cash or by delivering shares) to the dealer. If the price is lower than the initial price, the dealer will deliver additional shares to the issuer.

An issuer may choose to enter into an ASR for a variety of reasons, such as:

- the issuer believes that its stock is undervalued;

- the repurchase and reduction in the number of shares outstanding generally will immediately positively impact earnings per share because relevant accounting rules may allow the issuer to immediately recognize the full number of shares as having been retired on the ASR's trade date; or
- it needs the shares for other purposes, for example, to satisfy its obligations under its employee stock option plans.

ASRs are also beneficial in that they allow issuers to effectively repurchase their shares at an average price, thereby lessening the impact of price volatility.

Convertible/Exchangeable Bond Hedge Transactions

Convertible bonds are a type of a debt instrument that, subject to satisfaction of any specified conditions or the occurrence of any specified contingencies, the holder may convert into shares of the issuer at a specified conversion price and conversion rate. Because this embedded call option, an equity derivative in its own right, may itself have value to the holder of the bond, convertible bonds typically pay lower interest than straight corporate debt. From the point of view of the issuer, the ideal convertible bond would have low coupon payments, to minimize cost of financing, and a high conversion price, so as to minimize the potential dilutive impact upon conversion. However, a high conversion price often negatively impacts the marketability of the bond. A high conversion price also means the option is farther out of the money and would have less value. Investors would therefore want to be compensated for this with a higher coupon. To solve this problem, the issuer might enter into a call spread transaction to synthetically raise the conversion price of the bond and also potentially offer certain tax advantages.

In a call spread transaction, an issuer buys a call option (bond hedge) from a dealer that matches the terms of the embedded call option in the convertible bond. When and if the holders of the convertible debt exercise their options, the issuer can look to the dealer to provide the deliverable shares. The issuer has therefore hedged its obligation under the equity portion of the convertible bonds. To offset the cost of the call option purchased from the dealer, the issuer can sell a call (warrant) to the dealer with a higher strike price and longer maturity than the bond hedge. With the equity portion of the convertible debt and the bond hedge canceling each other out, the issuer's payoff would now resemble that of issuing convertible debt at the terms of the sold warrant. The dealer will hedge the equity risk by entering into cash-settled total return swaps (TRS) or purchasing the underlying shares, and then it will dynamically adjust its hedge positions for the term of the call spread.

Margin Loans

Margin loans are an attractive instrument for borrowers who want to monetize a large equity position. It allows them to raise funds upfront and participate in share price appreciation while still retaining voting control of the stock collateral.

The classic margin loan is the purchase of stock on margin in a margin account. The discussion here instead focuses on corporate margin loans on large equity stakes. In such a margin loan, a borrower receives financing from a bank and pledges stock to secure its obligations. During the term of the transaction, cash margin is posted or released depending on the value of the stock collateral. The borrower is also responsible for interest payments on the loan. Meanwhile, the bank will pass along any dividends and other collateral proceeds or the dividends will be kept in a collateral account as cash collateral. At the settlement of the loan, the borrower repays the full amount of the loan, and the bank releases the equity collateral. If the borrower defaults under the loan, the lender will foreclose on and liquidate the stock collateral and apply the liquidation proceeds to satisfy the borrower's obligations under the loan.

It is important to note that, unlike standard financing transactions, margin lenders only secondarily focus on the borrower's credit quality. The primary risk emphasis of margin loans is on the "quality" of pledged collateral,

particularly its trading characteristics – liquidity, free float, volatility, essentially factors that are relevant to lender's ability to promptly exit the position by disposing of collateral in public securities markets. For similar reasons, any legal restrictions, whether under applicable securities and other laws, or any contractual limits on the secured party's ability to dispose of that collateral, are also a crucial element of structuring and executing a margin loan. It is also the reason that margin loans are effectively marketed and structured by bankers who are usually equities and equity derivatives specialists rather than finance experts.

Equity Swaps

Equity swaps, also known as delta one swaps, provide full economic exposure to an underlying equity security without actually owning it. There are two basic types of equity swaps, a TRS and a price return swap. The difference is that in a TRS the payoff for the long party includes any returns, such as dividends, from the underlying equity security, whereas such amounts are not included in a price return swap. In a typical transaction, the long party will post cash collateral equal to a fraction of the notional amount of the swap. During the term of the transaction, the collateral is either increased or released depending on the price of the underlying security. Meanwhile, the long party will also pay floating amounts representing the financing cost of the underlying security. On the other side of the transaction, the short party (e.g., a dealer) will usually buy the actual equity security from the market to neutralize its short exposure under the swap. At settlement, if the equity price is below the predetermined swap price, the long party will pay the dealer the difference between the swap price and the stock price. If the stock price is above the swap price, then the dealer pays the long party the difference between the stock price and the swap price. Importantly, in cash-settled TRSs where there is no express or implied agreement between the parties with respect to voting rights or disposition of the dealer's hedge, there is no transfer of any type of legal ownership. As a result, the long party will not have any sort of voting rights with respect to the underlying security.

An issuer might wish to enter into an equity swap for a variety of reasons. Since the position of the long party is economically equivalent to that of a party that has borrowed from the dealer to finance the acquisition of the shares, the TRS gives the long party the ability to take leveraged exposure to the shares without an up-front cash payment and without the limitations imposed by the margin regulations discussed below. Another reason is to hedge against short exposure under its own employee stock options plan. By entering into the swap as the long party, the issuer can neutralize its equity price risk under the options.

Variable Share Forwards and Collars

Variable share forwards and collars with embedded financing are examples of hedging and monetization transactions. In a typical transaction, a holder of securities enters into a forward agreement for delivery of those securities at a future date. A number of shares for final delivery are often subject to variance depending on the price of the underlying security at the time of settlement. The transaction is accompanied by the dealer prepaying the value of the future deliverable and by the counterparty pledging the maximum number of shares underlying the transaction. The dealer can hedge its exposure to the forward or the collar by entering into a corresponding short position in the underlying securities and dynamically managing that position throughout the term of the transaction.

As an economic matter, the security holder entering into this transaction hedges its exposure to the underlying security and, to the extent it receives financing from the dealer, it monetizes its equity position. If the counterparty accepts a degree of variability in its delivery obligation, it may also retain a portion of the upside in the underlying securities. That variability may also convey certain tax and/or accounting benefits to the holder. The bank's position in the transaction, assuming its comfort with the collateral position, leaves the bank with little, if any, credit risk to the counterparty, even with the financing component. The bank's upside exposure to the value of the shares is secured with the collateral consisting of identical shares and its downside exposure is protected by its short position.

Synthetic Acquisition Structures

Derivatives are often used in order for a counterparty to acquire exposure to the underlying equity securities in lieu of directly acquiring such securities. These transactions often are in a form of forwards, swaps, options, or any combination of these. They also differ depending on the type of settlement, that is, some are cash-settled only, so they convey just economic exposure to the underlying shares, while some allow for physical settlement, thus allowing a counterparty to acquire the underlying securities at expiration or at any time during the term of the transaction. Some of these structures also provide for an ability to acquire relevant exposure on an accelerated basis by sourcing the shares in the stock loan market.

Unlike in hedging transactions, acquisition structures provide a counterparty with a *long* position to the underlying asset and necessitate an acquisition of a long hedge position by the dealer. In that sense, these transactions are often viewed and analyzed as akin to the acquisition of the underlying securities. They are effected, however, to utilize different benefits of financial engineering – they may embed financing, provide price protection and expediency in establishing the position. Also, because they are in different forms and often convey different economic positions than purchasing securities outright, corresponding legal analysis is more nuanced.

Common Regulatory Issues

Derivatives relating to equity securities raise issues under securities laws and commodities laws that differ from those raised by other kinds of derivatives. To complicate matters, because of the complex allocation of jurisdiction between the SEC and the Commodity Futures Trading Commission, or CFTC, the distinction between different types of derivatives has a greater regulatory significance than with other derivatives. To the extent that equity derivatives are deemed securities or transactions in securities, they are subject to the same rules and regulations as more traditional securities products under the Securities Act and the Exchange Act. This section summarizes and analyzes certain major regulatory issues that commonly appear in this practice area.

Registration Under the Securities Act

US securities registration issues are relevant in the context of certain derivatives transactions, as well as in connection with related hedging activities. If an issuer, or a shareholder that is an affiliate of the issuer, or a holder of restricted securities, enters into an equity derivative transaction with a dealer that results in the dealer having an economic long position, and the dealer sells shares into the US public market to hedge the transaction, the issue arises as to whether these sales by the dealer should be subject to the same registration requirement as sales made directly by the issuer or shareholder. As a result, most hedging transactions are structured in a manner complying with relevant registration requirements or applicable exemptions. Importantly, in addition to domestic exemptions like Rule 144 and Rule 144A, transactions in securities of foreign private issuers may provide greater latitude because the parties may avail themselves of certain jurisdictional exemptions, particularly under Regulation S. Similarly, the key to structuring and execution of equity-based financing transactions, like margin loans, is the analysis around the secured party's ability to access resale public markets. In that sense, understanding the relevant elements of applicable resale exemptions – like Rule 144, private placement resales, and even Regulation S secondary sales – is essential to these deals.

Insider Trading Rules and Rule 10b5-1 Safe Harbor

Equity derivatives transactions are subject to the same general fraud and insider trading prohibitions as securities transactions. For example, entering into or terminating a swap transaction while in possession of material nonpublic information could subject both the issuer and the dealer to liability under the antifraud

rules. Similarly, if a dealer is involved in dynamic hedging, whereby it is buying and selling the issuer's stock throughout the term of the transaction, it could face liability if it was in possession of material nonpublic information about the issuer, regardless of whether it actually used such information. As an aside, margin loans also entail elements of this analysis, as lenders want to be comfortable that they will be able to access public markets in the event of foreclosure without any concerns about insider trading liability. To address these problems, parties typically choose to document equity derivative transactions as plans meeting the requirements of the affirmative defense provided by Exchange Act Rule 10b5-1.[2] The transaction documentation will also usually include representations by the party that it is not in possession of material nonpublic information and that if it does come into possession of such information, it will not disclose such information to the dealer.

Market Manipulation

Section 9 of the Exchange Act prohibits transactions intended to create, or that actually create, "a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security." Generally, if any person is purchasing or selling securities in the market, especially if an issuer is purchasing its own shares, it should take care to do so in a manner that is not deemed manipulative within the meaning of Section 9. Correspondingly, if a party enters into an equity derivative transaction with a dealer that results in the dealer having an economic short position under the transaction and the dealer buys shares to hedge the transaction, the issue arises as to whether those purchases by the dealer raise the same manipulation concerns as purchases made directly by the issuer.

Exchange Act Section 13 Reporting Requirements

Just like in the context of an acquisition of a physical position in equity securities, an equity derivative transaction might implicate reporting requirements under Section 13 of the Exchange Act and related rules.[3] Those rules (as well as Section 16 and related rules that are not applicable to equity securities of foreign private issuers) contain a number of requirements governing the reporting of derivative positions in underlying securities subject to the same regime. The issue arises whether the position should be reported under Section 13, and also whether the transaction or related agreements would result in the bank or end user becoming a member of a reporting group.[4] Therefore, dealers carefully monitor the size of positions they set up for their counterparties and their hedging positions. In transactions where dealers expect to have a long hedge position, dealers typically ask for provisions and use hedging techniques that mitigate the risk of being subject to any reporting obligations.

Regulation M

Regulation M generally prohibits an issuer engaging in a distribution of its securities, and others that have an interest in such distribution, from purchasing or bidding for securities of the same class as, or related to, the securities being distributed during a specified restricted period applicable to the distribution. If an issuer or selling shareholder enters into an equity derivative transaction that will result in the dealer purchasing shares to hedge its exposure under the transaction, and such issuer or selling shareholder is, or will be, engaged in a distribution of shares during the term of the transaction, the issue arises as to whether such purchases of the shares by the dealer during the distribution period could violate Regulation M.

Margin Regulations

While the application of the US margin rules may be fairly straightforward to standard financings collateralized with equity securities, many equity derivative transactions present more complicated issues. Many long derivatives may be deemed to constitute equivalent financings and involve credit exposure of one party

to another and/or pledges of underlying shares as collateral (or could be recharacterized as such). Such transactions raise the question of whether they could be viewed as extensions of credit that would also be subject to the limitations imposed by the aforementioned margin rules. In general, market participants take the position that a typical long swap, in which the counterparty has no ownership rights in any shares and no right or agreement (formal or informal) with the dealer to acquire any shares, is not subject to the margin regulations.

Anti-Takeover/Antitrust and State Takeover Regulations

Similar to the analysis under Sections 13 and 16 of the Exchange Act, establishment and termination of derivatives that do not contemplate physical ownership generally do not convey such ownership under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 or HSR. Even physically settled derivatives ordinarily would not trigger HSR obligations prior to their settlement. Nevertheless, parties should exercise special care in connection with any long derivative transactions, particularly with respect to any agreements related to voting rights since such arrangements might trigger an acquisition under HSR.

In addition, state corporate laws also often restrict transfers of large ownership stakes. States may have anti-takeover or control share statutes, which prohibit business combinations with the target corporation and/or disable the ability to vote the shares acquired by specified acquirers. Thus, similar to the analysis under Section 13 and Section 16 of the Exchange Act, a synthetic derivative such as a swap that does not bestow any voting rights or the rights to dispose of the shares should not qualify the total return receiver as an owner or an interested stockholder. Nonetheless, unlike federal securities laws where there are multiple rules and precedents elaborating on the concept of beneficial ownership, there is very little case law regarding the interpretation of ownership under state corporate statutes. Moreover, states have different statutes accompanied by particular definitions and general jurisprudence, thereby further complicating the determination of ownership.

The Dodd-Frank Act

Dodd-Frank regulates certain equity derivatives that would constitute security-based swaps. Title VII of Dodd-Frank amended the Securities Act and the Exchange Act to substantially expand the regulation of the security-based swap market by establishing a new regulatory framework intended to make the market more transparent, efficient, fair, accessible, and competitive. Dodd-Frank provides that certain derivatives based on single securities, single loans, or narrow based security indexes will qualify and be regulated by the SEC as security-based swaps, while certain derivatives based on broad-based security indexes will qualify and be regulated by the CFTC as swaps. Importantly, equity options and equity forwards intended to be physically settled are exempt from the definition of security-based swap.

Security-based swap dealers are required to register and comply with the related rules and regulations under the SEC security-based swap regime, which includes rules regarding trade reporting and recordkeeping, portfolio reconciliation, regulatory margin requirements, and rules relating to the registration process and business conduct for security-based swap dealers. Further, while no security-based swap transactions are currently required to be centrally cleared, the SEC could begin issuing mandatory clearing orders on a going-forward basis. The SEC has also established procedures for its review of certain clearing agency actions and has recently proposed rules to prevent security-based swap-related fraud, manipulation and deception, additional reporting requirements for certain large security-based swap positions, and rules with respect to security-based swap execution facilities. While a few rulemakings remain outstanding, the majority of the rules implementing the SEC security-based swap regime under Dodd-Frank are now finalized and effective.

Conclusion

Equity derivatives raise complex and often unexpected issues under US law. This Chapter has only scratched the surface of the issues presented, many of which are complicated and subtle, and does not contemplate issues relating to matters such as insolvency, collateral analysis, and short selling regulations. Courts and regulators in the United States have provided very little guidance to market participants regarding the treatment of equity derivatives under US law. Many of the practices followed by market participants in the United States have emerged from the collective judgment of sophisticated US counsel based on limited formal and informal guidance from regulators. These practices are constantly evolving as new equity derivative structures are introduced and new guidance is given.

ENDNOTES

1 On December 19, 2023, the Fifth Circuit Court of Appeals vacated the SEC's new share repurchase disclosure rules, which were originally scheduled to apply to most issuers beginning with the first periodic report on either Form 10-Q or Form 10-K (or Form 20-F) in respect of the first full fiscal quarter that began on or after October 1, 2023. The new rules would have required public companies to disclose their reasons for repurchasing shares, and to collect daily repurchase data and file it quarterly. As a result of the Court's decision, issuers will not be required to comply with the now-vacated share repurchase disclosure rules in connection with their upcoming reports and can continue to disclose on a quarterly basis their monthly (rather than daily) share repurchase information. The SEC may appeal the Court's decision or propose a new share repurchase disclosure rule.

2 Recent amendments to Rule 10b5-1 updated the requirements for the affirmative defense by imposing cooling-off period on persons other than issuers, requiring certain certifications from the directors and officers, prohibiting overlapping Rule 10b5-1 plan, limiting single-trade Rule 10b5-1 plans to one trading plan per 12-month period, and extending good faith obligations throughout the duration of the plan. The amended Rule 10b5-1 also requires US domestic issuers to make quarterly disclosures of Rule 10b5-1 plans. Additionally, Form 4 and Form 5 filers must indicate by checkbox that a reported transaction was intended to satisfy the affirmative defense conditions of Rule 10b5-1(c). All issuers (including FPIs) must make annual disclosures of insider trading policies and include any such policies as an exhibit. Although the amended Rule 10b5-1 does not require a cooling-off period for issuers, the SEC indicated that it will continue to consider whether a cooling-off period should be required for issuers. *See Final Rule: Insider Trading Arrangements and Related Disclosures*, Release No. 33-11138 (Dec. 14, 2022). See also *Latham's Client Alert Amended Rule 10b5-1 and New Insider Trading Disclosure: Frequently Asked Questions* (Jan. 23, 2023).

3 On October 10, 2023, the SEC adopted rule amendments governing beneficial ownership reporting under Exchange Act sections 13(d) and 13(g). The amendments, among other things, (i) shorten the filing deadlines for initial and amended beneficial ownership reports on Schedules 13D and 13G, (ii) clarify when holders of certain cash-settled derivatives (other than cash-settled security-based swaps) are "deemed" to "beneficially own" the underlying securities, (iii) provide guidance on when a group has been formed under section 13(d) or 13(g), and (iv) expressly require any Schedule 13D filer to disclose interests in all derivatives (including security based swaps and other cash-settled derivatives) where issuer's equity securities are used as a reference. The amendments largely became effective on February 5, 2024 (while the compliance with the revised Schedule 13G filing will be required beginning on September 30, 2024). For the avoidance of doubt, the description of the various reporting obligations set forth in the following paragraphs gives effect to such amendments.

4 As part of the beneficial ownership rule amendments discussed earlier, the SEC reiterated its view that two or more persons taking concerted actions for the purpose of acquiring, holding or disposing of securities of an issuer may be sufficient to constitute the formation of a group, even without an express agreement.

CHAPTER 9

Cross-Border Tender and Exchange Offers – the Tier I and Tier II Exemptions; Rule 802

Tender offers, exchange offers, and business combinations involving a non-US target with US securities holders potentially trigger a variety of provisions of the US federal securities laws.[1] Depending principally on the level of US ownership of the target, certain exemptions from this regulatory scheme (the Tier I and Tier II exemptions) may be available.[2] We summarize below the requirements and scope of the Tier I and Tier II exemptions, as well as the related exemption from Rule 14e-5. We also summarize the exemption from Securities Act registration provided by Rule 802 for securities issued in connection with cross-border transactions.

A tender offer generally refers to a public, open solicitation by an entity or individual to purchase a substantial percentage of a company's securities directly from the holders of the securities, typically at a premium over the market price. While the term "tender offer" has never been defined in the federal securities laws, the courts generally analyze eight-factors developed through case law[3] to help determine whether a transaction qualifies as a tender offer:

- Involves an active and widespread solicitation of security holders;
- Involves a solicitation for a substantial percentage of the target company's securities;
- Offers a premium over the market price;
- Contains fixed rather than negotiable terms;
- Is contingent upon the tender of a fixed number of securities;
- Is open for a limited period of time;
- Pressures security holders to respond; and
- Would result in the bidder rapidly accumulating a substantial quantity of securities.

An exchange offer is a tender offer in which securities are offered as consideration.

The Regulatory Scheme

Cross-border M&A transactions are regulated by certain provisions of the Exchange Act and the SEC's rules, including Exchange Act Sections 13(d), 13(e), 14(d), 14(e), and 14(f), and Regulation 13D-G, Rule 13e-3, Rule 13e-4, Regulation 14D, and Regulation 14E under the Exchange Act. In addition, to the extent securities will be issued as consideration in the transaction, the registration requirements of the Securities Act will apply.

The Tier I Exemption

Tier I Relief

Tier I relief is sweeping. A tender offer for the equity securities of a foreign private issuer that meets the requirements of the Tier I exemption is exempt from most of the disclosure, filing, and procedural requirements of the Exchange Act.

Specifically, a Tier I-eligible tender offer is exempt from:[4]

- Sections 14(d)(1) through 14(d)(7) of the Exchange Act;
- Regulation 14D (Rules 14d-1 through 14d-10) under the Exchange Act;
- Schedules TO and 14D-9 under Regulation 14D;
- Rules 14e-1 and 14e-2 of Regulation 14E; and
- Rules 13e-3 and 13e-4 (in the case of a "going-private" transaction or an issuer self-tender offer).

A Tier I tender offer that meets certain additional requirements is also exempt from Rule 14e-5, which generally prohibits a bidder in a tender or exchange offer from purchasing the targeted security outside the offer.[5]

Tier I transactions remain subject to the antifraud provisions of the US federal securities laws, including Section 14(e) of the Exchange Act (applicable to tender and exchange offers).[6] Both US and non-US bidders may rely on the Tier I exemption.

Tier I Requirements

The Tier I exemption is available if the following conditions are met:[7]

Foreign Private Issuer

The target must be a foreign private issuer.[8]

10% Limit[9]

US securities holders must hold 10% or less of the class of securities sought in the tender offer. However, the 10% limitation does not apply in the case of a tender offer commenced during the pendency of a prior Tier I tender offer.

- *Calculation of 10% limit*: A US securities holder is a person resident in the United States.[10] In determining whether a holder is a US resident, a bidder must look through the record ownership of securities held by brokers, dealers, banks, and other nominees located in the United States, the target company's jurisdiction of incorporation and the jurisdiction that is the primary trading market of the target securities.[11] The Tier I eligibility calculation may be made any time within the period commencing 60 days prior to and ending 30 days after the date of announcement of the transaction.[12] Securities held by persons (whether US or foreign) owning more than 10% of the class of securities sought in the tender offer are no longer excluded from the Tier I eligibility calculation (whereas securities held by the bidder and securities convertible into or exchangeable for the subject securities are still excluded).[13]
- *Alternative average daily trading volume test*: There is an alternative Tier I eligibility test based on trading volume to determine US ownership in limited situations where an issuer or bidder is unable to complete the "look-through" analysis of the percentage of holders of the subject securities who are resident in the United States.[14] To qualify, among other things, the average daily trading volume for the subject securities in the United States over a 12-month period ending no more than 60 days before the announcement of the transaction must not be more than 10% of the average daily trading volume on a worldwide basis, information indicating otherwise must not be in annual information published by the target, and the acquiror must not have a reason to know that target's US ownership levels do not qualify.[15]

Equal Treatment of US Securities Holders

The bidder must permit US securities holders to participate in the offer on terms at least as favorable as those offered to other holders.[15] Notwithstanding this requirement, certain exceptions are available in the case of exchange offers:

- *Blue sky exemption*: If the bidder offers securities registered under the Securities Act, the bidder need not extend the offer to holders in those US states that prohibit the offer (after the bidder has made a "good faith effort" to register or qualify the offer in that state), except that the bidder must offer the same cash alternative to holders in that state that it has offered to holders in any other state.[17] In addition, if the bidder offers securities exempt from registration under Securities Act Rule 802 (discussed below), it need not extend the offer to holders in those US states that require registration, except that the bidder must offer the same cash alternative to holders in that state that it has offered to holders in any other state.[18]
- *Cash-only consideration*:[19] US securities holders may be offered only cash as consideration for the tender offer, even if non-US securities holders are offered consideration consisting in whole or in part of securities of the bidder. The bidder must have a reasonable basis to believe that the cash is "substantially equivalent" to the value of the consideration offered to non-US securities holders and must meet certain additional conditions.
- *Disparate tax treatment; loan notes*:[20] If a bidder offers loan notes solely to give sellers tax advantages not available in the US, and these notes are neither listed on an organized securities market nor registered under the Securities Act, the loan notes need not be offered to US securities holders.

Informational Documents in the United States

Three requirements apply to offering documents used in connection with a tender offer.

- *Comparable basis*:[21] Bidders must disseminate "any informational document" to US securities holders, in English, on a "comparable basis" to that provided to security holders in the home jurisdiction.
- *Publication*:[22] If the bidder disseminates by publication in its home jurisdiction, it must publish the information in a manner "reasonably calculated" to inform US securities holders of the offer.
- *Form CB*:[23] In the case of a tender offer that otherwise would be subject to Regulation 14D (generally, an offer for equity securities registered under the Exchange Act), or an issuer self-tender offer subject to Rule 13e-4, the bidder must furnish an English-language translation of the offering materials to the SEC under cover of Form CB by the first business day after publication or dissemination. A non-US offeror also must file a consent to service of process on Form F-X.

Limitation on Investment Companies

The issuer of the securities that is the subject of a Tier I tender offer may not be an investment company within the meaning of the Investment Company Act that is registered or required to be registered under that Act (other than a registered closed-end investment company).[24]

The Tier II Exemption

Tier II Relief

Tier II relief is considerably more limited than that available under Tier I. It is available for issuer self-tender offers subject to Rule 13e-4, third-party tender offers governed by Regulation 14D, tender offers subject to the provisions of Regulation 14E only, and also covers certain areas of frequent conflict between US and foreign regulatory requirements.

These include:

- *All-holders rule – loan notes and separate US and non-US offers*: Tier II tender offers are exempt from the all-holders rule of Exchange Act Rule 14d-10 (and related Exchange Act Rule 13e-4(f)(8) for issuer self-tender offers) in two ways. First, if a bidder offers loan notes solely to give sellers tax advantages not

available in the United States and these notes are neither listed on an organized securities market nor registered under the Securities Act, the loan notes need not be offered to US securities holders.[25] Second, under amendments to the cross-border tender offer rules adopted by the SEC in 2008, a bidder may split its offer into multiple separate offers, one made to US securities holders (including ADR holders) and one or more separate offers made to non-US securities holders.[26] In addition, the separate US offer can now include non-US securities holders, thereby accommodating the inclusion of all the target's ADRs in the US offer.[27] The offer to US securities holders must be on terms at least as favorable as those offered to any other holders of the target securities.[28]

- *Notice of extension*:[29] Notice of extension of the length of a tender offer made in accordance with home jurisdiction law or practice will be deemed to satisfy the requirements of Rule 14e-1(d) (which specifies how notice of extensions must be given).
- *Prompt payment*:[30] Payments made in accordance with home jurisdiction law or practice will be deemed to satisfy the prompt payment requirements of Rule 14e-1(c).[31]

Tier II Requirements

The Tier II exemption is available if the following conditions are met:

- *Forty percent limit*:[32] US securities holders must hold 40% or less of the class of securities sought in the tender offer, calculated in the same manner as the 10% limit of Tier I. The 40% limitation does not apply in the case of a tender offer commenced during the pendency of a prior Tier II tender offer.
- *Alternative average daily trading volume test available for certain negotiated and non-negotiated transactions*:[33] Similar to Tier I, there is an alternate Tier II eligibility test based on average daily trading volume to determine US ownership for the Tier II exemption, calculated in the same manner – and subject to the same conditions and limitations – as the 10% limit of Tier I, except that the relevant threshold is 40% instead of 10%.
- *Foreign private issuer; not an investment company*:[34] The target must be a foreign private issuer but must not be an investment company within the meaning of the Investment Company Act that is registered or required to be registered under that Act (other than a registered closed-end investment company).

Although the Rules and the 1999 Cross-Border Release do not state this explicitly, it appears that US and non-US bidders may rely on Tier II.[35]

Restrictions on Purchases Outside the Tender Offer – Rule 14e-5

Tier I Offers

Rule 14e-5 generally prohibits a bidder, its affiliates, and certain persons acting on their behalf in a tender or exchange offer from purchasing target equity securities outside the offer. Tier I tender offers are generally exempt from Rule 14e-5, if, in addition to meeting the Tier I requirements (and the requirements of its home jurisdiction):[36]

- the offering documentation provided to US securities holders prominently discloses the possibility of purchases outside the tender offer and the manner in which any information about such purchases will be disclosed; and
- the bidder discloses information in the US regarding these purchases in a manner comparable to the disclosure it makes in its home jurisdiction.

Tier II Offers

Tier II tender offers are also exempt from Rule 14e-5 if certain conditions are met, as follows:

- *Purchases by a bidder and its affiliates or an affiliate of the financial advisor*. Rule 14e-5(b)(12) provides for a broad exception from Rule 14e-5 for a bidder and its affiliates or an affiliate of a financial advisor that are permissible under and will be conducted in accordance with the law of the target company's home jurisdiction if the following conditions are satisfied:
  - the target is a foreign private issuer;
  - the covered person reasonably expects that the tender offer qualifies as a Tier II tender offer;
  - no purchases other than pursuant to the tender offer are made in the United States;
  - the US offering documents disclose the possibility of purchasing securities outside the tender offer, and all such purchases are publicly disclosed in the United States;
  - in the case of purchases by an offeror or its affiliates, the tender offer price must be increased to match any consideration paid outside the tender offer that is greater than the tender offer price; and
  - in the case of purchases by an affiliate of a financial advisor:
    - the financial advisor and the affiliate maintain and enforce written policies and procedures reasonably designed to prevent the transfer of information among the financial advisor and affiliate that might result in a violation of US federal securities laws and regulations through the establishment of information barriers;
    - the financial advisor has an affiliate that is registered as a broker or dealer under Exchange Act Section 15(a);
    - the affiliate has no officers or employees (other than clerical, ministerial, or support personnel) in common with the financial advisor that direct, effect, or recommend transactions in the subject securities or related securities who also will be involved in providing the offeror or subject company with financial advisory services or dealer-manager services; and
    - the purchases or arrangements to purchase are not made to facilitate the tender offer.
- *Purchases pursuant to a foreign tender offer*. Rule 14e-5(b)(11) provides a more targeted exemption designed to allow a bidder to purchase the securities through a US tender offer and a concurrent foreign offer, if the following conditions are satisfied:
  - both the US tender offer and the concurrent foreign offer qualify as Tier II tender offers;
  - the economic terms and consideration in the US tender and concurrent foreign offer are the same;
  - the procedural terms of the US offer are at least as favorable as the concurrent foreign offer;
  - the intention of the bidder to purchase the securities pursuant to the foreign tender offer is disclosed in the US offering documents; and
  - purchases by the bidder in the foreign tender offer are made solely pursuant to the foreign tender offer and not on the open market or in private transactions.

All Tender Offers

In a tender offer for the securities of a non-US issuer (whether Tier I, Tier II, or otherwise) purchases by "connected exempt market-makers" and "connected exempt principal traders" in accordance with the UK City Code on Takeovers and Mergers are generally exempt from Rule 14e-5 (subject to certain additional requirements).[37]

Securities Issued in Cross-Border M&A Transactions – Rule 802

Securities Act Rule 802 provides an exemption from registration for offers and sales in any exchange offer for a class of securities of a foreign private issuer, or in an exchange of securities for the securities of a foreign private issuer in any business combination. The term "exchange offer" means a tender offer in which securities are issued as consideration, while the term "business combination" means a statutory amalgamation, merger, arrangement, or other reorganization requiring the vote of security holders of one of the participating companies, as well as statutory short-form mergers that do not require a vote.[38]

Rule 802 does not impose a dollar limitation on the value of securities sold to US investors in an exempt transaction, and both domestic US issuers and foreign private issuers may rely on Rule 802.[39] Rule 802 provides an exemption only for the issuer of securities and not for affiliates of the issuer or any person who seeks to resell the securities.[40] Securities issued pursuant to the Rule 802 exemption will take on the restricted or unrestricted status (for purposes of Rule 144) to the same extent and proportion of the securities for which they were exchanged.[41] Accordingly, resales of securities acquired pursuant to Rule 802 may be restricted depending on their restricted or unrestricted status.

Requirements

The requirements of Rule 802 are as follows:

- *Limitation on US ownership*: US holders of securities must hold 10% or less of the class of securities that is the subject of the exchange offer or business combination. The SEC Staff has taken the position, however, that Rule 802 is not available if the target has no US shareholders.[42]
  - *Calculation of 10% limit*: A "US holder" is defined as a person resident in the US.[43] In determining whether a holder is a US resident, a bidder must look through the record ownership of securities held by brokers, dealers, banks, and other nominees located in the US, the target company's jurisdiction of incorporation, and the jurisdiction that is the primary trading market of the target securities (if different).[44] If, after reasonable inquiry, a bidder is unable to obtain information about the amount of securities held by US residents, it may assume that the customers are residents of the jurisdiction in which the nominee has its principal place of business.[45] The calculation date is a date no more than 60 days before or 30 days after the public announcement of the business combination.[46] If the bidder is unable to make the calculation within these time frames, the calculation may be made as of the most recent practicable date before the public announcement, but in no event earlier than 120 days before the public announcement.[47] The calculation excludes securities held by the bidder.[48]
  - *Alternative average daily trading volume test*: There is an alternative test based on trading volume to determine US ownership in limited situations where a bidder is unable to complete the "look-through" analysis of the percentage of holders of the subject securities who are resident in the US.[49] To qualify, among other things, the average daily trading volume for the subject securities in the United States over a 12-month period ending no more than 60 days before the announcement of the transaction must not be more than 10% of the average daily trading volume on a worldwide basis, information indicating otherwise must not be in annual information published by the target, and the acquiror must not have a reason to know that the target's US ownership levels do not qualify.[50]

- *Equal treatment of US holders; blue sky*:[51] The bidder must permit US holders of securities to participate in the exchange offer or business combination on terms at least as favorable as those offered to other holders, but it is not required to extend the offering into any US state that would require registration or qualification of the transaction.
- *Informational documents in the United States*:[52] If the bidder publishes or otherwise disseminates an informational document to security holders in connection with the exchange offer or business combination, it must furnish an English-language translation of that document to the SEC under cover of Form CB by the first business day after publication or dissemination and also file a consent to service of process on Form F-X (regardless of whether the equity securities of the target are registered under the Exchange Act, in contrast to the Tier I exemption relating to tender offers described above). It must disseminate any informational document to US security holders, in English, on a comparable basis to that provided to security holders in the home jurisdiction. In addition, if the bidder disseminates information by publication in its home jurisdiction, it must publish the information in a manner reasonably calculated to inform US security holders of the offer.
- *Legends*:[53] Any US offering documentation must contain a legend regarding the non-US nature of the transaction and the bidder's disclosure practices, and it must state that investors may have difficulty in enforcing rights against the bidder and its officers and directors.
- *Restricted securities*:[54] The securities acquired in a Rule 802 transaction will be restricted securities to the same extent and proportion as the target securities sought in the exchange offer and business combination (in other words, restricted securities will yield restricted securities, and unrestricted securities will yield unrestricted securities).
- *Not an investment company*: Rule 802 does not apply to an exchange offer or business combination by an investment company within the meaning of the Investment Company Act that is registered or required to be registered under that Act (other than a registered closed-end investment company).[55]

State Blue Sky Issues in Rule 802 Transactions

Securities issued in connection with cross-border exchange offers under Rule 802 do not qualify for federal preemption. Accordingly, it is necessary to review the securities laws of each of the states where existing security holders are resident to determine if there is any applicable state exemption.

ENDNOTES

1 Cross-border M&A transactions may also implicate the securities laws of the various US states (the so-called "blue sky" laws), and other areas of US federal law, such as the reporting requirements of the US Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended. These laws are not discussed here. We also do not discuss liability issues in connection with tender and exchange offers, and in particular the key antifraud provision in this area, Section 14(e) of the Exchange Act. Section 14(e) has been interpreted in largely the same way as Rule 10b-5 under the Exchange Act, although the Rule 10b-5 requirement that there be a purchase or sale of securities to trigger liability is not present in the context of actions under Section 14(e). *See Piper v. Chris-Craft Indus., Inc.*, 430 US 1, 38-39 (1977). This is so despite the similarities in wording between Rule 10b-5 and Section 14(e). *See,* e.g.*, Schreiber v. Burlington Northern, Inc.*, 472 US 1, 9-10 (1985) (Section 14(e) was modeled on Rule 10b-5).

2 *See Final Rule and Interpretation: Commission Guidance and Revisions to the Cross-Border Tender Offer, Exchange Offer, Rights Offerings, and Business Combination Rules and Beneficial Ownership Reporting Rules for Certain Foreign Institutions*, Release No. 33-8957 (Sept. 19, 2008) [*2008 Cross-Border Release*]; *Final Rule: Cross-Border Tender and Exchange Offers, Business Combinations and Rights Offerings, Release No. 33-7759* (Oct. 22, 1999) [*1999 Cross-Border Release*].

3 *See e.g., Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979).

4 *See* Exchange Act Rules 14d-1(c), 13e-3(g)(6), and 13e-4(h)(8).

5 Exchange Act Rule 14e-5(b)(10). In addition, Tier I rights offerings of equity securities by foreign private issuers meeting the conditions of Rule 801 and Tier I exchange offers meeting the conditions of Rule 802 are both exempt from the registration requirements of the Securities Act.

6 *1999 Cross-Border Release*, Section I.A.

7 Exchange Act Rule 14d-1(e).

8 Exchange Act Rule 14d-1(c).

9 Exchange Act Rule 14d-1(c)(1); Exchange Act Rule 13e-4(h)(8)(i).

10 Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 2; Exchange Act Rule 13e-4(h)(8), Instructions to paragraph (h)(8) and (i), Instruction 2.

11 Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 2(iii); Exchange Act Rule 13e-4(h)(8), Instructions to paragraph (h)(8) and (i), Instruction 2(iii); *see also* Exchange Act Rules 12g3-2(a) and 12g5-1.

12 Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 2(i); Exchange Act Rule 13e-4(h)(8), Instructions to paragraph (h)(8) and (i), Instruction 2(i). In the limited circumstances where the issuer or bidder is unable to complete the look-through analysis as of a date within the 90-day range, it may use a date within 120 days before the announcement. SEC Staff has also expressed the view that the issuer or bidder must conduct the US ownership calculation before commencement of the transaction, even if commencement occurs less than 30 days after the date of the announcement of the transaction. *See Cross-Border Exemptions Compliance and Disclosure Interpretations* [Cross-Border C&DIs], Question 101.05 (Oct. 17, 2018).

13 Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 2(ii); Exchange Act Rule 13e-4(h)(8), Instructions to paragraph (h)(8) and (i), Instruction 2(ii).

14 Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 3; Exchange Act Rule 13e-4(h)(8), Instructions to paragraph (h)(8) and (i), Instruction 3; *see also 2008 Cross-Border Release*, pp. 31-34. The Release states that merely needing to dedicate substantial time and resources to the look-through analysis or having concerns about the completeness and accuracy of the US ownership levels obtained by completing a look-through analysis will not necessarily justify use of the alternate test. Furthermore, it makes clear that acquirors must make a good faith effort to conduct a reasonable inquiry into determining the level of US beneficial ownership. The Release provides indicative situations where an issuer or acquiror could employ the alternative test, including: (1) non-US jurisdictions where security holder lists are generated only at fixed intervals during the year, are not otherwise available to the acquiror, and where the published information is as of a date outside the required range; (2) subject securities are issued in bearer form; (3) nominees are prohibited by law from disclosing information about the country of residence of the target securities' beneficial owners; or (4) where a business combination is a non-negotiated transaction. *Id.* at 32-33. The SEC Staff has taken the position that an acquiror must make a reasonable inquiry of nominees rather than use the alternate test even where nominees do not respond to inquiries about the number of securities held by customers in the US or the nominees provide incomplete information. See Cross-Border C&DIs, Question 101.04. If the acquiror receives no response from the nominees, it is permitted to assume that the customer accounts held by those nominees are held by persons with residences in the nominees' principal place of business. *See* Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 2.

15 Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 3; Exchange Act Rule 13e-4(h)(8), Instructions to paragraph (h)(8) and (i), Instruction 3.

16 Exchange Act Rule 14d-1(c)(2); Exchange Act Rule 13e-4(h)(8)(ii).

17 Exchange Act Rule 14d-1(c)(2)(i); Exchange Act Rule 13e-4(h)(8)(ii)(A).

18 Exchange Act Rule 14d-1(c)(2)(ii); Exchange Act Rule 13e-4(h)(8)(ii)(B).

19 Exchange Act Rule 14d-1(c)(2)(iii); Exchange Act Rule 13e-4(h)(8)(ii)(C).

20 Exchange Act Rule 14d-1(c)(2)(iv); Exchange Act Rule 13e-4(h)(8)(ii)(D).

21 Exchange Act Rule 14d-1(c)(3)(i); Exchange Act Rule 13e-4(h)(8)(iii)(B).

22 Exchange Act Rule 14d-1(c)(3)(ii); Exchange Act Rule 13e-4(h)(8)(iii)(C).

23 Exchange Act Rule 14d-1(c)(3)(iii); Exchange Act Rule 13e-4(h)(8)(iii)(A). These materials are "furnished" and not "filed" within the meaning of Section 18 of the Exchange Act.

24 Exchange Act Rule 14d-1(c)(4); Exchange Act Rule 13e-4(h)(8)(iv).

25 Exchange Act Rule 14d-1(d)(2)(i); Exchange Act Rule 13e-4(i)(2)(i).

26 Exchange Act Rule 14d-1(d)(2)(ii); Exchange Act Rule 13e-4(i)(2)(ii). For example, a bidder making a Tier II offer for a target organized in one non-US jurisdiction, listed in another non-US jurisdiction, and with US beneficial ownership of its equity securities would be allowed to make separate offers in each of the three jurisdictions, if necessary, to accommodate regulatory conflict between the applicable regulatory regimes. *See 2008 Cross-Border Release*, p. 50.

27 Exchange Act Rule 14d-1(d)(2)(ii); Exchange Act Rule 13e-4(i)(2)(ii).

28 *Id.*

29 Exchange Act Rule 14d-1(d)(2)(iii); Exchange Act Rule 13e-4(i)(2)(iii).

30 Exchange Act Rule 14d-1(d)(2)(iv); Exchange Act Rule 13e-4(i)(2)(iv).

31 Exchange Act Rule 13e-4(i); Exchange Act Rule 14d-1(d).

32 Exchange Act Rule 14d-1(d)(1)(ii); Exchange Act Rule 13e-4(i)(1)(ii).

33 Exchange Act Rule 14d-1, Instructions to paragraphs (c) and (d), Instruction 3; Exchange Act Rule 13e-4(h)(8), Instructions to paragraph (h)(8) and (i), Instruction 3.

34 Rule 14d-1(d)(1)(i); Rule 13e-4(i)(1)(i).

35 *See,* e.g., Rule 14d-1(d) (any person meeting Tier II conditions is entitled to Tier II relief).

36 Exchange Act Rule 14e-5(b)(10).

37 Exchange Act Rule 14e-5(b)(9).

38 *See* Securities Act Rules 800(a) and (c).

39 *See 1999 Cross-Border Release*, text at n.61.

40 General Notes to Securities Act Rules 800, 801, and 802, Note 6.

41 Securities Act Rule 144(a)(3)(vii).

42 *See* Cross-Border C&DIs, Question 100.01.

43 Securities Act Rule 800(h).

44 Securities Act Rule 800(h)(3).

45 Securities Act Rule 800(h)(4).

46 Securities Act Rule 800(h)(1). The SEC Staff has expressed the view that the bidder must conduct the US ownership calculation before commencement of the transaction, even if commencement occurs less than 30 days after the date of the announcement of the transaction. *See* Cross-Border C&DIs, Question 101.05.

47 *Id*.

48 Securities Act Rule 802(h)(2).

49 *See* Securities Act Rule 802(h)(7). *See also 2008 Cross-Border Release*, pp. 31-34. The Release states that merely needing to dedicate substantial time and resources to the look-through analysis or having concerns about the completeness and accuracy of the US ownership levels obtained by completing a look-through analysis will not necessarily justify use of the alternate test. Furthermore, it makes clear that acquirors must make a good faith effort to conduct a reasonable inquiry into determining the level of US beneficial ownership. The Release provides indicative situations where an issuer or acquiror could employ the alternative test, including: (1) non-US jurisdictions where security holder lists are generated only at fixed intervals during the year, are not otherwise available to the acquiror, and where the published information is as of a date outside the required range; (2) subject securities are issued in bearer form; (3) nominees are prohibited by law from disclosing information about the country of residence of the target securities' beneficial owners; or (4) where a business combination is a non-negotiated transaction. *Id*. at 32-33. The SEC Staff has taken the position that an acquiror must make a reasonable inquiry of nominees rather than use the alternate test even where nominees do not respond to inquiries about the number of securities held by customers in the US or the nominees provide incomplete information. See Cross-Border Exemptions C&DI, Question 101.04. If the acquiror receives no response from the nominees, it is permitted to assume that the customer accounts held by those nominees are held by persons with residences in the nominees' principal place of business. *See* Securities Act Rule 800(h)(4).

50 *See* Securities Act Rule 800(h)(7).

51 *See* Securities Act Rule 802(a)(2).

52 *See* Securities Act Rule 802(a)(3).

53 *See* Securities Act Rule 802(b).

54 General Notes to Securities Act Rules 800, 801, and 802, Note 8.

55 *Id.* Note 9.

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CHAPTER 10

Rights Offerings Under Rule 801 and Employee Equity Compensation Plans Under Rule 701

Securities Act Rule 801 Rights Offerings

Rule 801 provides an exemption from registration for certain rights offerings by foreign private issuers. A "rights offering" is defined for these purposes as the sale for cash of equity securities in which existing securities holders of a particular class (including holders of ADRs) are granted the right to purchase additional securities of that class, and the number of additional securities the holders may purchase is in proportion to the amount of securities they hold on the record date of the offering.[1]

Like Rule 802, Rule 801 does not impose a dollar limitation on the value of securities sold to US investors in an exempt transaction, but unlike Rule 802, only foreign private issuers may rely on Rule 801.[2] Rule 801 provides an exemption only for the issuer of securities and not for affiliates of the issuer or any person who seeks to resell the securities.[3] Securities issued pursuant to the Rule 801 exemption will take on the restricted or unrestricted status (for purposes of Rule 144) to the same extent and proportion of the securities held by the security holder of the class with respect to which the rights offering was made, as of the record date for the rights offering. Accordingly, resales of securities acquired pursuant to Rule 801 may be restricted depending on their restricted or unrestricted status.

Rule 801 Requirements

The requirements of Rule 801 are as follows:

- *Limitation on US ownership*: US securities holders must hold 10% or less of the class of securities that is the subject of the rights offering. The calculation is done in the same manner as the calculation under the Rule 802 exemption, except that the calculation keys off the record date of the rights offering.[4] As with the Rule 802 exemption, the SEC Staff has taken the position that Rule 801 is not available if the target has no US shareholders.[5]
- *Equal treatment of US security holders*: The bidder must permit US security holders to participate in the rights offering on terms at least as favorable as those offered to other holders, but is not required to extend the offering into any US state that would require registration or qualification of the transaction.
- *Informational documents in the United States*: If the issuer publishes or otherwise disseminates an informational document to security holders in connection with the rights offering, it must furnish an English-language translation of that document to the SEC under cover of Form CB by the first business day after publication or dissemination, and must also file a consent to service of process on Form F-X.[6] It must disseminate any informational document to US security holders, in English, on a comparable basis to that provided to security holders in the home jurisdiction. In addition, if the issuer disseminates by publication in its home jurisdiction, it must publish the information in a manner reasonably calculated to inform US security holders of the offer.
- *Eligibility of securities*: The securities offered in the rights offering must be equity securities of the same class as the securities held by offerees in the United States (directly or through ADRs).

- *Limitations on transfer*: The terms of the rights must prohibit transfers by US security holders except in accordance with Regulation S.
- *Legends*: Any US offering documentation must contain a legend regarding the non-US nature of the transaction and the issuer's disclosure practices, and must state that investors may have difficulty in enforcing rights against the issuer and its officers and directors.

Compensatory Benefit Plans – Securities Act Rule 701

Rule 701 provides an exemption from registration for offers and sales of securities pursuant to certain compensatory benefit plans.

Eligible Issuers

Rule 701 is available to any issuer that is not subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, and that is not an investment company registered or required to be registered under the Investment Company Act. This includes foreign private issuers that have never listed their securities in the US or offered them to the public in the United States, or that benefit from the exemption from Exchange Act registration provided by Rule 12g3-2(b). If an issuer becomes subject to Exchange Act reporting after it has made offers in compliance with Rule 701 (for example, by conducting a public offering), it may nevertheless rely on Rule 701 to sell securities previously offered to the persons to whom the offers were made. In addition, a reporting issuer may rely on Rule 701 to the extent it guarantees the payment of a subsidiary's securities that are sold under Rule 701.

Rule 701 is only available to the issuer of securities and not to any of its affiliates. It also may not be used for capital-raising transactions.

Eligible Transactions

Rule 701 exempts offers and sales of securities issued under a written compensatory benefit plan (or written compensation contract) established by the issuer, parent of the issuer, majority-owned subsidiary of the issuer, or majority-owned subsidiary of the issuer's parent. A "compensatory benefit plan" for these purposes means any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, deferred compensation, pension, or similar plan.

Eligible Plans and Participants

The plan must be limited to employees, directors, general partners, trustees (where the issuer is a business trust), officers, consultants and advisors, and family members[7] of those persons who acquire the securities by gift or a domestic relations order. Offers and sales may be made to former employees, directors, general partners, trustees, officers, consultants and advisors only if those persons were employed by or provided services to the issuer at the time the securities were offered.

Certain additional requirements apply to consultants and advisors. In particular, Rule 701 is only available to consultants and advisors if:

- they are natural persons;
- they provide *bona fide* services to the issuer, its parents, its majority-owned subsidiaries, or majority-owned subsidiaries of the issuer's parent; and
- the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities.

Amounts That May Be Offered and Sold

Any amount of securities may be offered under Rule 701. Sales, however, are limited. In particular, under Rule 701, the aggregate sales price or amount of securities sold in reliance on Rule 701 during any consecutive 12-month period must not exceed the greatest of the following:

- $1 million;
- 15% of the total assets of the issuer, measured at the issuer's most recent balance sheet date (or of the issuer's parent if the issuer is a wholly owned subsidiary and the securities represent obligations that the parent fully and unconditionally guarantees); or
- 15% of the outstanding amount of the class of securities being offered and sold in reliance on Rule 701, measured at the issuer's most recent balance sheet date.

The term "aggregate sales price" means the sum of all cash, property, notes, cancellation of debt, or any other consideration (including the value of the employee's services) received by the issuer for the sale of its securities. The aggregate sales price is calculated on the date of sale.

Disclosure Requirements

An issuer must deliver a copy of the plan to purchasers. In addition, if the aggregate sales price or amount of securities issued under Rule 701 exceeds $10 million within any 12-month period, Rule 701 requires the issuer to provide each purchaser with certain information within a reasonable period of time *before* the date of sale, including:

- if the plan is subject to the US Employee Retirement Income Security Act of 1974, a copy of the ERISA summary plan description;
- if the plan is not subject to ERISA, a summary of the plan's material terms;
- risk factors related to the securities being offered and the issuer; and
- financial statements required to be furnished by Part F/S of Form 1-A under Regulation A (as of a date no more than 180 days before the sale of securities), which must either be prepared in accordance with US GAAP or IASB IFRS, or if prepared in local GAAP/non-IASB IFRS must be reconciled to US GAAP.

Because the financial statements must be no more than 180 days old, foreign private issuers that report financial results on a semi-annual basis are subject to a "blackout" period each year from the last day of the first half of the financial year (June 30 for calendar-year reporting companies) until the half-year results are released and provided to plan participants, during which time Rule 701 is not available.

Issuances under Rule 701 are subject to the antifraud provisions of the US federal securities laws. An issuer should consider whether disclosure in addition to that specified above is appropriate (such as MD&A or a developed business description).

No Integration

Securities offerings under Rule 701 are not subject to integration with any other offers or sales by the issuer (including other unregistered offerings).

Resale Limitations

Securities issued under Rule 701 are deemed to be restricted securities within the meaning of Rule 144.

The Rule 701 exemption is only available to the issuer and does not cover the resale of the securities by any other person.

Resales must accordingly either be registered under the Securities Act or be structured to take advantage of an exemption from registration. However, if the issuer becomes subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act, securities issued under Rule 701 may be resold 90 days thereafter:

- by non-affiliates without any restrictions other than the requirement imposed by Rule 144 for sale in brokers' transactions; and
- by affiliates pursuant to Rule 144 without observing the normal holding-period requirement for restricted securities.

Any certificated securities issued under Rule 701 should contain a legend stating that the securities have not been registered under the Securities Act, and may not be sold or transferred in the absence of registration or an exemption from registration.

State Blue Sky Issues in Rule 701 and Rule 801 Transactions

Section 18 of the Securities Act preempts securities sold in Rule 701 offerings, but only where the issuer is an SEC reporting company. Many foreign private issuers choose to avoid registration with the SEC. In such a case, the blue sky laws would apply to any Rule 701 transactions.

In addition, rights offerings under Rule 801 (like cross-border exchange offers under Rule 802) do not qualify for federal preemption. Accordingly, it is necessary to review the securities laws of each of the states where existing security holders are resident to determine if there is any applicable state exemption.

ENDNOTES

1 Securities Act Rule 800(g).

2 *See 1999 Cross-Border Release*, text at n.61.

3 General Notes to Securities Act Rules 800, 801, and 802, Note 6.

4 Securities Act Rule 800(h).

5 *See* Cross-Border Exemptions C&DIs, Question 100.01.

6 Securities Act Rule 801(a)(4)(i).

7 Securities Act Rule 701(c)(3) defines the term “family member.”

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CHAPTER 11

Exchange Act Registration, Reporting, and Deregistration for Foreign Private Issuers

A foreign private issuer must register a class of equity securities under the Exchange Act if:

- that class will be listed on a US national securities exchange such as the NYSE or Nasdaq);[1] or
- unless the exemption from registration provided by Exchange Act Rule 12g3-2(b) is available, if the foreign private issuer has assets in excess of $10 million and the class is held of record by either (i) 2,000 persons or (ii) 500 persons who are not AIs (in both cases, of whom at least 300 are residents in the United States).[2] However, any employee who received securities under an employee compensation plan in a transaction exempt from registration under the Securities Act will not be counted for purposes of the 2,000/500/300 shareholder trigger.[3]

Rule 12g3-2(b) Exemption

Under the amendments to Rule 12g3-2(b) that took effect in 2008, foreign private issuers are no longer required to submit initial written applications to the SEC in order to qualify for the Rule 12g3-2(b) exemption and instead are now automatically eligible to claim the exemption if they satisfy the following conditions:[4]

- *No existing SEC reporting*. The foreign private issuer must not be required to file or furnish reports under Section 13(a) or 15(d) of the Exchange Act (this generally means that the foreign private issuer has not publicly offered any of its securities in the United States or registered its securities under the Exchange Act).
- *Foreign listing*. The foreign private issuer must maintain a listing on one or more markets constituting the primary trading market outside of the United States of the subject class of securities. For these purposes, primary trading market means:
  - a foreign market that, either alone or together with another foreign market, accounted for at least 55% of the trading in the relevant securities on a worldwide basis in the foreign private issuer's last fiscal year; and
  - if trading in the relevant securities in two foreign markets is combined to meet the 55% threshold, the trading on at least one of them was greater than the trading in the United States.
- *Electronic publication of non-US disclosure documents*. The foreign private issuer must publish in English, either via its website or through an electronic information delivery system, information material to an investment decision that it has released since the first day of its most recently completed fiscal year that it:
  - has made public or been required to make public;
  - has filed or has been required to file with the stock exchange on which its securities are listed (and has been made public by the exchange); or
  - has distributed or been required to distribute to its security holders.

The rule includes a list of the types of material information that should be disclosed, such as results of operations or financial condition; changes in business; acquisitions or dispositions of assets; the issuance, redemption, or acquisition of securities; changes in management or control; the granting of options or the payment of other remuneration to director or officers; and transactions with directors, officers, or principal security holders.

Once established, in order to maintain the Rule 12g3-2(b) exemption, a foreign private issuer must continue to publish electronically its disclosure documents in English promptly after the information has been made public in the foreign private issuer's primary trading market.

If a foreign private issuer no longer complies with the provisions of Rule 12g3-2(b), the foreign private issuer will have to either register the subject class of securities under the Exchange Act within 120 days after the foreign private issuer's fiscal year-end, qualify for the exemption under Rule 12g3-2(a) by concluding that it has fewer than 300 shareholders resident in the United States or, if possible, re-establish compliance with the rule's conditions within a "reasonably prompt manner."[5]

Exchange Act Reporting

Once a foreign private issuer has registered a transaction with the SEC under the Securities Act or a class of securities under the Exchange Act (a reporting foreign private issuer), it must make certain ongoing filings with the SEC under the Exchange Act.[6] Reporting foreign private issuers also become subject to various other provisions of the US federal securities laws.

Annual Report on Form 20-F

A reporting foreign private issuer must file an annual report on Form 20-F with the SEC four months after the foreign private issuer's fiscal year-end.[7]

> PRACTICE POINT
>
> Annual reports on Form 20-F must be certified by a foreign private issuer's chief executive officer and chief financial officer under Sections 302 and 906 of Sarbanes-Oxley.

Current Reports on Form 6-K

A reporting foreign private issuer must submit current reports to the SEC on Form 6-K.[8] Form 6-K reports must contain all material information that the issuer:[9]

- makes or is required to make public pursuant to the laws of its country of incorporation or organization;
- files or is required to file with a stock exchange on which its securities are traded and that was made public by that exchange; or
- distributes or is required to distribute to its security holders.

> PRACTICE POINT
>
> Form 6-K submissions do not need to be certified by a foreign private issuer's chief executive officer and chief financial officer under Sections 302 and 906 of Sarbanes-Oxley.[10]

Form SD – Conflict Minerals and Resource Extraction

SEC-reporting companies, including foreign private issuers, that are involved in manufacturing products containing "conflict minerals" or that are engaged in resource extraction must file Form SD.

Conflict Minerals

Exchange Act Rule 13p-1 and Section 1 of Form SD require an issuer that determines that "conflict minerals"[11] are "necessary to the functionality or production" of a product it manufactures or contracts to manufacture to annually file Form SD.

Issuers must first conduct a good faith inquiry to determine whether their conflict minerals originated from the Democratic Republic of the Congo or adjoining countries. If the issuer determines that its minerals did not originate from the covered countries, it must state this in Form SD and provide a brief description of its inquiry (Conflict Minerals Disclosure). If the issuer cannot determine the origin or finds that minerals did originate from the covered countries, it must conduct due diligence and file a long-form Conflict Management Report (CMR) together with an independent private sector audit of the design and execution of its diligence framework.

In 2017, following several rulings of the United States Courts of Appeals for the District of Columbia concluding that aspects of the rule violated the First Amendment, the SEC granted no-action relief to those issuers who would have been required to produce and file a CMR.[12] Unless and until the SEC proposes new rules, all issuers within the scope of Rule 13p-1 may instead file the short-form Conflict Minerals Disclosure.

An IPO company's initial Form SD is not due until May 31 after the end of **the company's first calendar year** that begins no sooner than eight months after the effective date of its IPO registration statement.[13] In other words, an IPO company that goes public on March 15, 2025, would file its first Form SD by May 31, 2027 in respect of the calendar year ending December 31, 2026. A company that goes public on May 15, 2025, date would file its first Form SD by May 31, 2028, in respect of the calendar year ending December 31, 2027.

Resource Extraction

Exchange Act Rule 13q-1 and Section 2 of Form SD require resource extraction issuers to annually file a Form SD with an exhibit providing detailed tabular data regarding payments made by the resource extraction issuer, a subsidiary of the resource extraction issuer, or an entity under the control of the resource extraction issuer to a foreign government or the US federal government for the purpose of the commercial development of oil, natural gas, or minerals.

Section 2 Form SD filing deadlines are calculated from the issuer's **fiscal year end** (unlike Section 1 Form SD filings, which key off the calendar year end).[14] The filing is due no later than 270 days following the end of the issuer's most recently completed fiscal year. An IPO company's initial Form SD is not due until it has completed a fiscal year following the IPO and would cover payments made during that fiscal year.[15]

Other Consequences of Exchange Act Reporting

A reporting foreign private issuer becomes subject to a variety of other provisions of the US federal securities laws, including:

- *Books and records; internal accounting controls*:[16] A reporting foreign private issuer must maintain and keep books, records, and accounts that "accurately and fairly reflect" the transactions and dispositions of assets of the foreign private issuer, and design and maintain a system of adequate "internal accounting controls."
- *Limitations on payments to foreign officials*:[17] A reporting foreign private issuer may not make corrupt payments to foreign officials, foreign political parties, or their intermediaries.
- *Audit requirements*:[18] A reporting foreign private issuer's audit must include procedures for the detection of illegal acts, and the issuer's auditors are required to take certain steps if illegal acts are found. Those steps include informing the issuer's management and audit committee, and potentially include a requirement to resign from the engagement or notify the SEC (if the issuer's board fails to take appropriate remedial action).
- *Sarbanes-Oxley*:[19] A reporting foreign private issuer is subject to the provisions of Sarbanes Oxley.

Deregistration Under the Exchange Act and Termination of Reporting

In 2007, the SEC adopted Rule 12h-6 (and related Form 15F), thereby making it considerably easier for foreign private issuers to deregister their securities and terminate Exchange Act reporting obligations than was previously the case.[20] Foreign private issuers are now able to terminate their reporting obligations under Section 15(d) of the Exchange Act permanently. (Under the previous rules, these reporting obligations were suspended but could be reinstated, depending on the number of US holders of the issuer's securities over time.)

Rule 12h-6 sets out two alternative ways for foreign private issuers to deregister their equity securities and terminate Exchange Act reporting obligations and imposes three additional conditions which must be met (regardless of which alternative is chosen).

Alternative 1: 5% Average Daily Trading Volume Test

Equity securities of foreign private issuers are eligible for deregistration and termination of the related Exchange Act reporting requirements if the average daily trading volume (ADTV)[21] of that class of securities during a recent 12-month period in the US has been 5% or less of the ADTV of the same class of securities on a worldwide basis.

An issuer will not be eligible to deregister a class of equity securities and terminate its Exchange Act reporting obligations under the ADTV standard if, within the previous 12 months, the issuer:

- terminated an ADR facility in the same class of securities and the US ADTV of that class of securities exceeded 5% of the issuer's worldwide ADTV at the time of such termination; or
- delisted the same class of equity securities from a US securities exchange and the US ADTV of that class of securities exceeded 5% of the issuer's worldwide ADTV at the time of such delisting.

Alternative 2: 300 Holder Test

As an alternative to the ADTV benchmark provision, Rule 12h-6 permits a foreign private issuer to terminate its reporting obligations under the Exchange Act regarding a class of equity securities if, on any date within 120 days before filing for deregistration, the foreign private issuer has less than 300 record holders on a worldwide basis or who are US residents. The rule employs a "look-through" counting method under which an issuer has to analyze the accounts of brokers, banks, and other nominees located in the United States, the jurisdiction in which the issuer is organized, and, if different, the jurisdiction of its primary trading market to make this calculation.

Additional Conditions

Regardless of whether it utilizes the ADTV alternative or the 300-holder alternative, a foreign private issuer wishing to deregister a class of equity securities must meet three additional conditions outlined below to deregister the class of equity securities and to terminate its Exchange Act reporting obligations.

- The foreign private issuer must have at least a 12-month Exchange Act reporting history, including having filed at least one Exchange Act annual report, and be current in its reports; note, however, that it need not have timely filed the required reports.[22]
- The equity securities of the foreign private issuer must not have been sold, subject to limited exceptions, through a registered public offering under the Securities Act in the 12 months leading up to the attempted deregistration. Securities sold via an exemption to the Securities Act are not subject to this limitation.
- Finally, the foreign private issuer must have had that class of securities listed on an exchange in the issuer's primary trading market[23] for at least 12 months preceding the deregistration filing in the United States.

Terminating Exchange Act Reporting for Debt Securities

A foreign private issuer may terminate its reporting requirements under the Exchange Act with regard to a class of debt securities if two principal criteria are satisfied. First, the issuer is required to have submitted all required Exchange Act filings, including at least one Exchange Act annual report, since the debt securities were registered and came under the Exchange Act reporting system. Second, as with "Alternative 2" discussed above, the foreign private issuer must have less than 300 record holders on a worldwide basis or who are residents of the US, in either case, on a date within 120 days before filing for deregistration. The method for counting these record holders is the same as for equity securities as described above.

Implications for M&A Transactions

The deregistration rules provide that a foreign private issuer that succeeds to the reporting obligations of another company following a merger, consolidation, exchange of securities, acquisition of assets, or similar transaction (a successor registrant) may terminate its inherited reporting obligations if it meets the prior reporting, foreign listing, and quantitative benchmark conditions described above.

Interaction With Rule 12g3-2(b) Exemption

Foreign private issuers that deregister are immediately eligible to take advantage of the exemption from registration under Rule 12g3-2(b).[24]

Interaction With Rule 13e-3

Deregistration may trigger the requirements of Rule 13e-3 of the Exchange Act, including the requirements to file a Schedule 13E-3 with the SEC,[25] although a foreign private issuer may be able to take advantage of the exemption provided by the cross-border tender offer rules (discussed above).

Reporting by Shareholders – Obligations of Major Shareholders to File Schedule 13D or 13G Reports and Forms 13F and 13H

Shareholders who acquire beneficial ownership of more than 5% of a class of equity securities registered under the Exchange Act (a registered equity class) become subject to certain filing obligations with the SEC.[26] In particular, the shareholder must file with the SEC and send to the issuer of the securities by registered or certified mail) a statement on Schedule 13D or, if eligible (as discussed below), a short-form statement on Schedule 13G.[27]

A person is generally deemed to be the beneficial owner of shares if he or she, directly or indirectly, has:[28]

- voting power including the power to vote (or direct the voting of) the shares; or
- investment power including the power to dispose (or direct the disposition of) those shares.

In addition, when two or more persons agree to act together for the purposes of acquiring, holding, voting, or disposing of the equity securities of an issuer, they are generally considered a "group," and their holdings of the registered equity class are aggregated for purposes of determining their filing obligations.[29]

Schedule 13D

Schedule 13D requires disclosure of a variety of information, including:

- the identity, residence, citizenship, and nature of the beneficial ownership of the person making the report, and of all persons on whose behalf the purchases have been made;

- the source and amount of funds used in making the purchases;
- the purpose of the purchases; and
- a description of any contracts, arrangements, understandings, or relationships with respect to the securities.

Reports on Schedule 13D must be amended to reflect any material change in the facts set forth in the report, such as an increase or decrease in the percentage of stock beneficially owned by the reporting stockholder or any change in the reporting person's intentions with regard to the acquisition, disposition, voting, or holding of the securities of the company. These amendments must be filed within two business days following any such change.

Schedule 13G

Rule 13d-1 under the Exchange Act allows certain stockholders who would otherwise be obligated to file a Schedule 13D to file a short-form Schedule 13G if they meet eligibility criteria. Eligible categories of investors comprise certain qualified institutional investors (QIIs);[30] investors that own less than 20% with neither the effect nor purpose of changing or influencing control of the company (Passive Investors);[31] and stockholders who acquired shares prior to the registration of shares under Section 12, such as pre-IPO investors (Exempt Investors).[32]

The ownership thresholds and amendments that trigger Schedule 13D and 13G filings for each investor category and the associated deadline are set out in the following table.

	Schedule 13D	Schedule 13G
Initial Filing Deadline	Within five business days after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G.	**QIIs & Exempt Investors**: 45 days after calendar quarter-end in which beneficial ownership exceeds 5%. **QIIs**: Five business days after month-end in which beneficial ownership exceeds 10%. **Passive Investors**: Within five business days after acquiring beneficial ownership of more than 5%.
Amendment Triggering Event	Material change in the facts set forth in the previous Schedule 13D.	**All Schedule 13G Filers**: Material change in the information previously reported on Schedule 13G. **QIIs & Passive Investor**s: Upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership.
Amendment Filing Deadline	Within two business days after the triggering event.	**All Schedule 13G Filers**: 45 days after calendar quarter-end in which a material change occurred. **QIIs**: Five business days after month-end in which beneficial ownership exceeds 10% or a 5% increase or decrease in beneficial ownership. **Passive Investors**: Two business days after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership.

Once a reporting person files an amendment reflecting ownership of 5% or less of the company's securities, no additional filings are required.

Form 13F: Institutional Investment Manager Reporting

All investment managers that exercise investment discretion with respect to accounts holding Section 13(f) securities having an aggregate fair market value of at least $100 million on the last trading day of any calendar month must file Form 13F with the SEC. The Form 13F must include an information table with a detailed list of security holdings of the investment manager and any "other included investment manager" as of the end of the calendar quarter for which the filing is being made.

"Section 13(f) securities" are defined by their inclusion on the Official List of Section 13(f) Securities that is published each quarter by the SEC. Generally, the list includes all US exchange-traded stocks, closed end investment companies, and exchange-traded funds (ETFs), as well as certain convertible debt securities, equity options, and warrants. Securities that are not included on the list of Section 13(f) securities should not be reported on Form 13F. Derivatives only need to be included insofar as they are included in the list of Section 13(f) securities.

An investment manager must file a Form 13F (or be included as an "Other Included Manager" in another a controlling manager's 13F filing) within 45 days after the end of the calendar year in which the $100 million threshold was met, and then subsequently within 45 days after the end of the first three calendar quarters of the following year.

Form 13H: Large Trader Reporting

Any person or entity that directly or indirectly exercises investment discretion[33] over one or more accounts and effects transactions for the purchase or sale of any NMS security[34] in an aggregate amount of at least 2 million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month is considered a "Large Trader" and is required to file a Form 13H.

The initial Form 13H must be filed 10 days after effecting aggregate transactions in an NMS security equal to or greater than the identifying activity level. Thereafter, an annual Form 13H filing must be made within 45 days after the end of each calendar year. In addition to the annual filing, an amended Form 13H filing must be made "promptly" after the end of each calendar quarter if the information contained in the most recent Form 13H filing has changed in any way. If there have been no changes during a particular quarter, then no amended Form 13H would be filed for that quarter.

The information required by Form 13H includes:

- A list of all affiliates of the Large Trader that exercise discretion over NMS Securities (called "Securities Affiliates") and their business in relation to the Large Trader.
- A list of all other SEC forms filed by Securities Affiliates.
- Corporate governance of the Large Trader, including a list of all executives and directors.
- A list of all US broker-dealers at which the large trader or its securities affiliates has an account.

Form 13H filers are assigned a Large Trader ID Number (LTID) and are obligated to give this number to each US broker-dealer at which the large trader has an account. The LTID is used to tag all trades made by the Form 13H filer. If and when an inactive status report is filed, the broker-dealers can be notified and they can stop tagging the large trader's trades.

Filing Electronically

Under Rule 101 of Regulation S-T, documents such as registration statements for offerings of securities, annual reports on Form 20-F, and all current reports on Form 6-K must be filed electronically on the SEC's EDGAR system. In addition, all exhibits and attachments to SEC filings (such as material contracts) must be filed electronically, except for exhibits and attachments previously filed in paper form, which may generally be incorporated in an EDGAR filing by reference.

As a general matter under Rule 306 of Regulation S-T, all filings in EDGAR must be made in the English language. Non-English documents must be fairly and accurately translated into English for filing in accordance with the SEC's rules on foreign-language documents, including most documents submitted to the SEC under cover of Form 6-K.[35] Alternatively, a summary of certain documents filed with the SEC as exhibits may be provided, although the SEC's rules require specified significant documents (for example, articles of incorporation, articles of association, instruments defining the rights of security holders, and contracts on which an issuer's business is substantially dependent) to be provided in full translation.[36] Similarly, certain documents provided to the SEC on Form 6-K may be provided in English summary, including a report required to be furnished and made public under the laws of the issuer's home country or the rules of the issuer's home-country stock exchange, as long as it is not a press release and is not required to be, and has not been, distributed to the issuer's security holders.[37] Any permitted summary must fairly and accurately summarize the terms of each material provision of the original text and fairly and accurately describe the terms that have been omitted or abridged.[38]

ENDNOTES

1 Exchange Act Section 12(a) prohibits transactions on US national securities exchanges with respect to unregistered securities, while Section 12(b) sets out the requirement for that registration.

2 Exchange Act Section 12(g)(1); Exchange Act Rules 12g-1, 12g3-2(a).

3 Exchange Act Section 12(g)(5).

4 *Final Rule: Exemption from Registration Under Section 12(g) of the Securities Exchange Act of 1934 for Foreign Private Issuers*, Release No. 34-58465, Section II.D, pp. 34-35 (Sept. 5, 2008).

5 *Id*. at 36-37.

6 Exchange Act Sections 13(a), 15(d).

7 Form 20-F, General Instructions A(b); *see also* Exchange Act Rule 13a-1 (each issuer with Section 12 registered securities must file an annual report within the time period specified in the relevant form).

8 Exchange Act Rules 13a-16(a), 15d-16(a); Form 6-K, General Instruction A. For a comprehensive discussion of the law, lore, and market practice for making Form 6-K disclosures, see Latham's Client Alert *The Secrets of Form 6-K: Getting Behind the Curtain with the FPI Wizard* (Oct. 22, 2018).

9 Form 6-K, General Instruction B. In addition, General Instruction B lists examples of items that may be material. The matters listed roughly correspond to a similar list mandated by Form 8 K reports filed by US companies, and which are "material with respect to the issuer and its subsidiaries" on a consolidated basis. The list includes "changes in business; changes in management or control; acquisitions or dispositions of assets; bankruptcy or receivership; changes in registrant's certifying accountants; the financial condition and results of operations; material legal proceedings; changes in securities or in the security for registered securities; defaults upon senior securities; material increases or decreases in the amount outstanding of securities or indebtedness; the results of the submission of matters to a vote of security holders; transactions with directors, officers or principal security holders; the granting of options or payment of other compensation to directors or officers; material cybersecurity incident; and any other information which the registrant deems of material importance to security holders."

10 *Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports*, Release No. 33-8124, text at n.49 (Aug. 28, 2002) (Section 302 certification not required) [*Certification Adopting Release*]; *Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date*, Release No. 33-8400, text at n.146 (Mar. 16, 2004) (Section 906 certification not required) [*Additional Form 8-K Disclosure Adopting Release*].

11 Form SD Item 1.01(d)(3) defines "conflict minerals" as "Columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives, which are limited to tantalum, tin, and tungsten."

12 US Securities and Exchange Commission, Division of Corporation Finance, Statement on the Conflict Minerals Rule (Apr. 7, 2017).

13 Form SD, General Instruction B.1

14 Form SD, General Instruction B.2

15 Form SD, Section 2, Item 2.01(b)(3).

16 Exchange Act Sections 13(b)(2)-(7); Exchange Act Regulation 13B-2; *see also* Exchange Act Rules 13a-15(a), 15d-15(a) (reporting issuer must maintain "internal control over financial reporting").

17 Exchange Act Section 30A. In addition, any "domestic concern" whether or not registered with the SEC is subject to substantially identical anti-bribery provisions. 15 U.S.C. Section 78dd-2(a). A *domestic concern* for these purposes means any US citizen, national, or resident, or any entity (such as a corporation or a partnership) that has its principal place of business in the United States or that is organized under the laws of a US state or territory. 15 U.S.C. Section 78dd-2(h)(1).

18 Exchange Act Section 10A.

19 Sarbanes-Oxley Act, Section 2(a)(7) (definition of *issuer* subject to Sarbanes-Oxley). *See* the Chapter "The US Sarbanes-Oxley Act of 2002" for additional information on these requirements.

20 *See Final Rule: Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, Release No. 34-55540, p. 1 (Mar. 27, 2007) [*Foreign Issuer Deregistration Release*].

21 While Rule 12h-6 does not specify how ADTV is measured (which is consistent with other provisions in the Exchange Act, such as Regulation M, where the concept of ADTV is used), the rules do provide welcome guidance in two central areas. First, the rules specify that the number of shares underlying an issuer's ADRs shall be included in calculating ADTV. *See* Exchange Act Rule 12h-6 (Note to paragraph (a)(4)). Second, the SEC has clarified that an issuer may include off-market transactions, including ones completed through an alternative trading system, in its calculation of worldwide ADTV. *See Foreign Issuer Deregistration Release*, p. 22. In addition, the rules provide that trading volume related to equity-linked securities, such as convertible debt securities, options, and warrants, should be excluded when calculating ADTV. *See Foreign Issuer Deregistration Release*, p. 28.

22 *See Foreign Issuer Deregistration Release*, p. 37 ("In the event that an issuer determines that it should have filed a Form 6-K during this period, it can do so before it files its Form 15F.").

23 *Primary trading market* under Rule 12h-6 is defined as the market where at least 55% of the trading in the class of securities to be deregistered must have taken place through the facilities of a securities market during a recent 12-month period. Although two foreign jurisdictions can be aggregated to calculate this percentage, if this is done, the trading market for the class of securities in at least one of these jurisdictions must be larger than the US trading market for the same class of securities.

24 *See* Form 15F, General Instruction E.

25 Exchange Act Rule 13e-3(a)(3)(ii)(A).

26 Exchange Act Section 13(d)(1).

27 Exchange Act Rule 13d-1. The obligation to provide the issuer (and each exchange on which the issuer's securities are traded) with copies of the Schedule 13D or 13G is set out in Exchange Act Section 13(d)(1).

28 Exchange Act Rule 13d-3(a).

29 Exchange Act Rule 13d-5(b). Amendments to the Beneficial Ownership Reporting Framework adopted in October 2023, provided additional guidance on when a Section 13(d) or 13(g) "group" has been formed. The guidance clarifies that group formation does not solely depend on the presence of an express agreement; concerted actions and informal agreements are sufficient. By issuing the guidance, the SEC declined to adopted proposed rule changes and instead provided guidance for determining whether two or more persons have formed a "group" based on existing concepts, such as informal arrangements or coordination in furtherance of a common purpose to acquire, hold, or dispose of an issuer's securities. Shareholder engagement activities that merely involve engaging in discussions and exchanging views, without more, will not result in the formation of a group. As examples, the SEC's guidance clarifies that discussions among shareholders without committing to a course of action, jointly engaging with management without attempting to convince the board to change existing board membership, and jointly submitting a non-binding shareholder proposal will not form a group. On the other hand, shareholders involved in a "tipper-tippee" relationship, where one person intentionally shares non-public information that it will soon be filing a Schedule 13D with the purpose of causing others to make purchases of the same class of securities, would potentially result in the formation of a group. *See Final Rule: Modernization of Beneficial Ownership Reporting*, Release No. 33-11253 (Oct. 10, 2023) [Beneficial Ownership Reporting Release].

30 Exchange Act Rule 13d-1(b)(1). QIIs include, among others: (1) US-registered broker-dealers, (2) US-regulated banks, (3) US-regulated insurance companies, (4) US-registered investment companies, and (5) foreign institutions that are the functional equivalent of any of the US-regulated institutions that qualify to report on a Schedule 13G, provided that the foreign institution certifies that it is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to the equivalent US institution and will undertake to furnish to the SEC, upon request, information that it otherwise would be required to provide on a Schedule 13D.

31 Rule 13d-1(c). Passive Investors include those who have not acquired the securities with the purpose or effect of changing or influencing control of the issuer, are not 13G institutional investors, and do not beneficially own (directly or indirectly) more than 20% of the registered equity class.

32 Rule 13d-1(d). Exempt Investors include those who own more than 5% of a registered equity class as of the end of any calendar year, including investors who owned their positions before the issuer registered its equity securities under the Exchange Act, and following registration have not acquired more than 2% of the outstanding shares in any 12-month period.

33 "Investment discretion" exists if the large trader: (i) is authorized to determine what securities shall be purchased or sold by or for the account; (ii) makes decisions as to what securities shall be purchased or sold by or for the account, even though some other person may have responsibility for such investment decisions; or (iii) controls a natural person or a company that exercises investment discretion.

34 "NMS Securities" include certain US exchange-listed equity securities and options, but do not include debt securities or open-end mutual funds.

35 Form 6-K, General Instruction D(1).

36 Securities Act Rule 403(c)(2); Exchange Act Rule 12b-12(d)(2).

37 Form 6-K, General Instruction D(2).

38 Securities Act Rule 403(c)(3)(ii); Exchange Act Rule 12b-12(d)(3)(ii); Form 6-K, General Instruction D(4).

CHAPTER 12

The US Sarbanes-Oxley Act of 2002

The US Congress enacted Sarbanes-Oxley in 2002 in response to several high-profile, accounting-related scandals at US companies. Sarbanes-Oxley instituted a number of significant changes for public companies in the United States that were designed to enhance the reliability of financial information published by public companies and promote investor confidence in US markets.

Who Is Subject to Sarbanes-Oxley?

Sarbanes-Oxley applies to all issuers (including foreign private issuers) that:

- have registered securities under the Exchange Act;
- are required to file reports under Section 15(d) of the Exchange Act; or
- have filed a registration statement under the Securities Act that has not yet become effective.[1]

This means, for example, that any foreign private issuer that has listed its securities in the US, or issued securities to the public in the US whether or not listed (such as in a registered exchange offer for high-yield bonds) is subject to Sarbanes-Oxley. A foreign private issuer, however, that has not sold securities to the public in the US, or that is exempt from Exchange Act registration by virtue of Exchange Act Rule 12g3-2(b), is not subject to the requirements of Sarbanes-Oxley.

We highlight below some key aspects of Sarbanes-Oxley.

Internal Control Over Financial Reporting – Section 404

Section 404 of Sarbanes-Oxley contains two related requirements. Section 404(a) requires an assessment by management of the effectiveness of the issuer's ICFR, while Section 404(b) requires an attestation report of the issuer's independent auditors on management's assessment. Compliance with Section 404 can be a major undertaking for a newly public company. Fortunately, the SEC has adopted rules to allow an IPO issuer to wait until its second annual report to provide management's Section 404(a) assessment and its auditor's Section 404(b) attestation.[2]

Foreign private issuers that are "large accelerated filers" or "accelerated filers" must comply with both Sections 404(a) and 404(b), starting with the second annual report on Form 20-F following the IPO.[3] By contrast, foreign private issuers that are neither large accelerated filers nor accelerated filers, and those that are EGCs, are required in their second annual report only to provide management's assessment of internal control under Section 404(a).[4]

Management may not determine that an issuer's internal control over financial reporting is effective if it identifies one or more material weaknesses in the issuer's internal control.[5] The SEC has adopted a definition of the term material weakness in Exchange Act Rule 12b-2 and S-X Rule 1-02. A "material weakness" is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Disclosure Controls and Procedures

In addition to internal control, an issuer must maintain and evaluate the effectiveness of its "disclosure controls and procedures."[6] There is, however, no required auditor's attestation with respect to disclosure controls and procedures.

Disclosure controls and procedures mean controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is (i) timely recorded, processed, summarized, and reported; and (ii) accumulated and communicated to the issuer's management to allow for timely decisions about disclosure.[7] There is substantial overlap between the concepts of disclosure controls and procedures and internal control over financial reporting, although there are some elements of each term that are not subsumed within the other. In particular, "disclosure controls and procedures will include those components of internal control over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles."[8] By contrast, disclosure controls and procedures would not necessarily include accurate recording of transactions and disposition or safeguarding of assets, which would remain components of internal control.[9] The existence of a material weakness in internal control may not prevent management from concluding that an issuer's disclosure controls and procedures are effective, but, in practice, this can be a challenging determination.

Certification Requirements – Sections 302 and 906

Sarbanes-Oxley contains two overlapping certifications that must be provided by an issuer's CEO and CFO (or persons performing similar functions): the Section 302 certification and the Section 906 certification. Section 302 amends the Exchange Act, whereas Section 906 amends the US federal criminal code. Under the rules adopted by the SEC, both certifications must be included with a foreign private issuer's annual report on Form 20-F.[10] Neither certification is required, however, for current reports on Form 6-K.[11]

Listed Company Audit Committees – Rule 10A-3

Exchange Act Rule 10A-3 (which implements Section 301 of Sarbanes-Oxley) requires that each audit committee member has to be a member of the board of directors and meet certain independence requirements. To be "independent," an audit committee member is barred from accepting any compensatory fees from the issuer or any subsidiary, other than in his or her capacity as a member of the board, and may not be an "affiliated person" of the issuer. The definition of affiliated person includes a person who, directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the specified person. There is, however, a safe harbor for certain non-executive officers and other persons who are 10% or less shareholders of the issuer.

Rule 10A-3 also requires that:

- the audit committee must be "directly responsible" for the appointment, compensation, oversight, and retention of the external auditors, who must report directly to the audit committee;
- the audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal controls, or auditing matters, and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters;
- the audit committee must have the authority to engage independent counsel and other advisers as it deems necessary to carry out its duties; and
- the issuer must provide the audit committee with appropriate funding for payment of external auditors, advisers employed by the audit committee, and ordinary administrative expenses of the audit committee.

Foreign private issuers are entitled to certain exemptions from the independence requirement of Rule 10A-3. For example, the inclusion of a non-management employee representative, a non-management affiliated person with only observer status, or a non-management governmental representative on the audit committee will not violate the affiliated person prong of the independence test. In addition, issuers involved in an IPO are entitled to certain exemptions during a transitional period following their public offering.

These requirements are not intended to conflict with local legal or listing provisions (or requirements under the foreign private issuer's organizational documents), and instead relate to the allocation of responsibility between the audit committee and the issuer's management.[12] Accordingly, the audit committee may recommend or nominate the appointment or compensation of the external auditor to shareholders if these matters are within shareholder competence under local law, and it must be granted those responsibilities that the board of directors can legally delegate.[13]

Rule 10A-3 contains a general exemption for foreign private issuers that have a statutory board of auditors or statutory auditors established pursuant to home-country law or listing requirements, which in turn meet various requirements. A foreign private issuer relying on Rule 10A-3's exemption from independence, or the general exemption noted above, will need to disclose in its annual report its reliance on the exemptions and an assessment of whether this reliance will materially adversely affect the audit committee's ability to act independently and to satisfy any of the other requirements of Rule 10A-3.[14]

Audit Committee Financial Expert

Item 16A of Form 20-F (implementing Section 407(a) of Sarbanes-Oxley) requires a foreign private issuer to disclose that the issuer's board of directors has determined whether or not it has one audit committee financial expert serving on its audit committee, or, if not, to state why not. If the issuer has a two-tier board of directors, the supervisory or non-management board would make this determination. The issuer must also disclose the name of the audit committee financial expert (if any) and whether that person is "independent" from management.[15]

The SEC defines an audit committee financial expert as someone who has: (i) education and experience as a public accountant, auditor, principal financial officer, principal accounting officer, or controller, or experience in one or more positions that involve performance of similar functions; (ii) experience actively supervising persons in the positions above; (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or (iv) other relevant experience, and who has:[16]

- an understanding of GAAP and financial statements;
- the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves;
- experience preparing, auditing, or analyzing financial statements similar to those of the issuer, or actively supervising others engaged in these activities;
- an understanding of internal controls over financial reporting; and
- an understanding of audit committee functions.

The term "GAAP" as used in Item 16A refers to the body of GAAP used by the issuer in its primary financial statements filed with the SEC.

Item 16A also contains a liability safe harbor for the audit committee financial expert, under which:

- a person who is determined to be an audit committee financial expert is not deemed to be an expert for any purpose, such as Section 11 of the Securities Act; and

- the designation of a person as an audit committee financial expert does not impose greater duties, obligations, or liabilities on the person than on other audit committee and board members, and does not affect the duties, obligations, or liabilities of other audit committee and board members.

Loans to Executives – Section 402

Under Section 402 of Sarbanes-Oxley (which added Section 13(k) to the Exchange Act), it is illegal for an issuer to "extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof)" of that issuer. Section 402 covers both direct extensions and indirect extensions of credit, including through subsidiaries.

Section 402 contains certain exemptions, including:

- any loan existing on July 30, 2002, unless its terms are materially modified or the loan is renewed;
- consumer credit and extensions of credit under a charge card; and
- certain bank loans.

The broad sweep of Section 402, coupled with the absence of SEC guidance, has raised a number of thorny questions for issuers. In response, Latham & Watkins (together with 24 other law firms) issued a paper concluding that the following should generally be regarded as permissible under Section 402:[17]

- cash advances to reimburse travel and similar expenses while performing executive duties;
- personal usage of a company credit card and company car, and relocation expenses required to be reimbursed;
- "stay" and "retention" bonuses subject to repayment if an employee terminates employment before a designated date;
- indemnification advances for litigation;
- tax indemnity payments to overseas-based executive officers;
- loans by a parent or shareholder that is a foreign private issuer but not subject to Sarbanes-Oxley, to the executive officer of a wholly owned subsidiary that is subject to Sarbanes-Oxley, if the subsidiary has not "arranged" the loan and the loan is made by reason of service to the parent, not the subsidiary; and
- most "cashless" option exercises.

Forfeiture of Bonuses – Section 304

Section 304 of Sarbanes-Oxley provides that if an issuer is required to "prepare an accounting restatement due to the material non-compliance of the issuer, as a result of misconduct" with any financial reporting requirements under the securities laws, the CEO and CFO must reimburse the issuer for:

- all bonuses or other incentive-based or equity-based compensation received from the issuer during the 12-month period following the first public issuance or filing with the SEC (whichever is first) of the financial document embodying the financial reporting requirement; and
- any profits received from the sale of the issuer's securities during that 12-month period.

Incentive-Based Compensation Clawbacks

Listing standards adopted by Nasdaq and the NYSE require listed issuers (including FPIs) to adopt and implement incentive-based compensation clawback policies and to make applicable disclosures in their SEC filings.[18]

The clawback policy must be in writing and provide that a listed issuer that is required to prepare an accounting restatement must recover from any current or former executive officer incentive-based compensation erroneously paid based on the misstated financial measure during the three most recently completed fiscal years prior to the restatement (but in no event prior to the effective date of October 2, 2023).[19] Recovery must be made "reasonably promptly" and without regard to misconduct by any executive officer from whom recovery is sought.[20]

The final rule includes a limited impracticability accommodation to alleviate some of the implementation challenges FPIs may face. Under the narrow accommodation, a company is not required to recover relevant incentive compensation if doing so would violate a law of the company's home country that was adopted before November 28, 2022.[21] To take advantage of this exception, a company must provide its US stock exchange with an opinion of home country counsel that recovery would violate home country law.

The exchanges were directed to impose these requirements by – and the listing standards track the language of – Exchange Act Rule 10D-1, adopted in 2022 by the SEC to implement the original requirement under Dodd-Frank.[22] Exchange Act Rule 10D-1 broadens the statutory mandate in two respects:

- First, the rule requires compensation recovery not only upon so-called "Big R" restatements, which correct errors that are material to previously issued financial statements, but also upon "little r" restatements, which correct only immaterial prior-period errors that (despite their immateriality to previously issued financial statements) would result in a material misstatement of an as-yet unreported current period if the historical errors were left uncorrected in the current period or if the error correction were made in the current period.[23] As a result, compensation will be subject to clawback after correction of exclusively immaterial errors even though the statutory prerequisite for a clawback event is "an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws."

- Second, the rule requires compensation recovery for a broader group of persons than "executive officers" as generally defined under the Exchange Act. Instead, the rule introduces a new definition of "executive officer" that tracks the "officer" definition under the Section 16 rules, which includes the principal accounting officer (or, if there is no such accounting officer, the controller) even if that person is not an executive officer for Exchange Act purposes and not publicly reported as an executive officer.[24] As a result, the compensation of some persons who are not executive officers for Exchange Act purposes will be subject to clawback even though the statute refers to "any current or former executive officer."

  – While US issuers are accustomed to identifying their corporate officers for purposes of the rules under Section 16, FPIs are not subject to Section 16 and have had no reason to identify their officers for this purpose. The title "executive officer" is less common outside the United States. For instance, Form 20-F largely avoids the term and refers instead to "senior management," i.e., those members of the company's administrative, supervisory or management bodies. FPIs will thus have to address the initial question of developing controls to identify which positions will be subject to the policy.[25]

The listing standards require a listed issuer to make all required disclosures[26] including filing its clawback policy as an exhibit to its Form 20-F[27] (or 10-K for domestic issuers[28]) and disclosing how it has applied the policy, including, as relevant:

- the date the issuer was required to prepare an accounting restatement;

- the aggregate dollar amount of erroneously awarded compensation; and
- the aggregate amount that remains outstanding and any outstanding amounts due from any current or former named executive officer for 180 days or more.[29]

Attorney Conduct – Part 205

The SEC's Part 205 standards (implementing Section 307 of Sarbanes-Oxley) impose various requirements on attorneys who are appearing and practicing before the SEC in the representation of an issuer. The term "appearing and practicing" before the SEC is broader than it might first appear. It potentially covers any lawyer who transacts business with the SEC, represents an issuer in SEC proceedings, provides advice on the US securities laws regarding any document the attorney "has notice" will be submitted to the SEC (including in the context of preparing documents to be filed), or advises an issuer whether information must be included in or filed with any SEC document.

If a covered attorney becomes aware of evidence of a "material violation" – which is defined to include a material violation of US securities law or a breach of fiduciary duty or a similar material violation of any US federal or state law – Part 205 creates a duty to report the matter to the issuer's chief legal officer (CLO) or to both the CLO and the CEO. The CLO must then open an inquiry into the matter and take all reasonable steps to cause the issuer to adopt an appropriate response. Unless the attorney reasonably believes that the CLO's response was adequate, he or she must report the matter "up the ladder" to the audit committee, to another independent board committee (if the issuer does not have an audit committee), or the board of directors as a whole (if there is no independent board committee).

As an alternative to reporting to the CLO or CEO, the attorney may refer the matter to the issuer's qualified legal compliance committee (QLCC), if one has been set up. A QLCC – which may also be the audit committee – is any committee of the issuer that includes at least one member of the audit committee and two or more non-employee members of the board of directors and that has been duly established by the board of directors with certain requirements. If the attorney reports the matter to the QLCC, he or she has no further obligations under Part 205. In addition, the CLO may refer a reported matter to the QLCC in lieu of conducting the required investigation, in which case the QLCC will be responsible for responding.

Part 205 contains an exemption for "non-appearing foreign attorneys," which is defined as an attorney who (1) is himself or herself admitted to practice law in a jurisdiction outside of the United States and does not hold himself or herself out as practicing US federal or state securities or other laws, and (2) either:

- conducts activities that would constitute appearing and practicing before the SEC only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or
- is appearing and practicing before the SEC only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

NYSE and Nasdaq Corporate Governance and Board Composition Requirements

Nasdaq and NYSE impose corporate governance and board composition requirements as part of their respective listing standards. Foreign private issuers and controlled companies are exempt from some of these standards. (A "controlled company" is one in which more than 50% of the voting power for the election of directors is held by an individual, a group, or another company.)

We summarize these in detail in Annexes A and B, and highlight the NYSE and Nasdaq board composition requirements in the following table:

Nasdaq/NYSE Requirement	Foreign Private Issuers	All Others (e.g., EGCs, non-EGCs)
Majority of independent directors	May follow home-country practice	Yes, within 12 months of listing
Nominating/corporate governance committee	Same	Yes†
• Compensation committee	Same	Yes†
Audit committee		
• Must meet requirements of Rule 10A-3‡	Yes	Yes
• Must have at least three members	May follow home-country practice	Yes

† The requirements for these committees are:

- one independent director on each committee at the time of listing (under Nasdaq rules) or by the earlier of the date the IPO closes or five business days from the listing date (under NYSE rules);
- a majority of independent directors within 90 days thereafter (under both Nasdaq and NYSE rules); and
- fully independent committees within one year (under both Nasdaq and NYSE rules).

‡ The following transition periods apply to all IPO companies:

- *for the first 90 days* after an IPO, all but one of the members of the audit committee are exempt from Rules 10A-3's independence requirement; and
- *for the first year* after an IPO, a minority of the members of the audit committee are exempt from Rule 10A-3's independence requirements (since most audit committees have three members, this means that only two need to be independent for the days 91 through 365 following the IPO).

Regulation BTR

Regulation Blackout Trading Restrictions (Regulation BTR) implements Section 306 of Sarbanes Oxley. It prohibits, subject to certain exceptions, any director or executive officer of an issuer from purchasing, selling, or otherwise transferring the issuer's equity securities during any blackout period applicable to the securities if the officer acquires or previously acquired the securities in connection with his or her service or employment as a director or officer.

For a foreign private issuer, a blackout period generally means any period of more than three consecutive business days during which the ability to purchase or sell an interest in the issuer's equity securities held in an "individual account plan" (such as a qualifying retirement plan under Section 401(k) of the US Internal Revenue Code)[30] is temporarily suspended by the issuer or by a fiduciary of the plan with respect to not less than 50% of participants or beneficiaries located in the United States and either:

- the number of participants and beneficiaries located in the United States subject to the temporary suspension exceeds 15% of the total number of employees of the issuer and its consolidated subsidiaries; or
- more than 50,000 participants or beneficiaries located in the United States are subject to the temporary suspension.

ENDNOTES

1 *See* Sarbanes-Oxley Section 2(a)(7).

2 *See* Form 20-F, Instruction 1 to Item 15 (providing a "transition period" for "newly public companies" pursuant to which the management's assessment and the auditor's attestation is not required until the company "either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Exchange Act for the prior fiscal year or had filed an annual report with the Commission for the prior fiscal year").

3 *See* Form 20-F, Item 15. Under Exchange Act Rule 12b-2, a "large accelerated filer" is an issuer that, as of the end of its fiscal year:
- has an aggregate worldwide market value of voting and non-voting common equity held by non-affiliates (market capitalization) of $700 million or more (measured as of the last business day of the issuer's most recently completed second fiscal quarter);
- has been subject to SEC reporting under the Exchange Act for a period of at least 12 calendar months
- has filed at least one annual report under the Exchange Act with the SEC; and
- is not eligible to be a "smaller reporting company" and had annual revenues of less than $100 million in the most recent fiscal year for which financial statements are available.

In addition, under Exchange Act Rule 12b-2, an "accelerated filer" is an issuer meeting the same conditions, except that it has a market capitalization of $75 million or more but less than $700 million (measured as of the last business day of its most recently completed second fiscal quarter). *See Final Rule: Accelerated Filer and Large Accelerated Filer Definitions*, Release No. 34-88365 (Mar. 12, 2020). *See also Final Rule: Smaller Reporting Company Definition*, Release No. 33-10513 (July 10, 2018).

4 *See Final Rule: Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, Release No. 33-9142 (Sept. 21, 2010). This rule implemented Section 989G of the Dodd-Frank Act, which added Section 404(c) to Sarbanes-Oxley. Under Section 404(c), the requirements of Section 404(b) do not apply to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer. *See also* Section 103 of the JOBS Act, which modified Section 404(b) to exempt EGCs from the auditor attestation requirement.

5 *See* Form 20-F, Item 15(b)(3).

6 *See* Exchange Act Rules 13a-15 and 15d-15.

7 *See* Exchange Act Rules 13a-15(e) and 15d-15(e).

8 *See Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Release No. 33-8238, at II.D (June 5, 2003).

9 *See id*.

10 *See* Exchange Act Rules 13a-14 and 15d-14.

11 *See Certification Adopting Release*, text at n.49 (Section 302); *see Additional Form 8-K Disclosure Adopting Release*, n.146 (Section 906).

12 *See* Instruction 1 to Exchange Act Rule 10A-3.

13 *See* Instruction 2 to Exchange Act Rule 10A-3.

14 *See also* Form 20-F, Item 16.D.

15 For listed issuers, the audit committee financial expert will need to satisfy the definition of "independence" as set out under Exchange Act Rule 10A-3.

16 S-K Item 407(d)(5).

17 *See Sarbanes-Oxley Act: Interpretive Issues under Section 402 – Prohibition of Certain Insider Loans* (Oct. 15, 2002).

18 Nasdaq Rule 5608; *NYSE Listed Company Manual § 303A.14*.

19 Nasdaq Rule 5608(b)(1); NYSE Listed Company Manual § 303A.14(c)(1).

20 *Id. See also Final Rule: Listing Standards for Recovery of Erroneously Awarded Compensation*, Release No. 33-11126 (Oct. 26, 2022) [Recovery of Erroneously Awarded Compensation Release], at 5 ("recovery policy mandated by Section 10D 'does not require adjudication of misconduct in connection with the problematic accounting that required restatement.'" (quoting Report of the Senate Committee on Banking, Housing, and Urban Affairs, S.3217, Report No. 111.176, at 135-6 (Apr. 30, 2010)).

21 Exchange Act Rule 10D-1(b)(iv)(B). November 28, 2022 was the publication date of the adopting release in the Federal Register.

22 Dodd-Frank Section 954 (adding Exchange Act Section 10D *Recovery of Erroneously Awarded Compensation Policy). See also* Recovery of Erroneously Awarded Compensation Release.

23 Exchange Act Rule 10D-1(b)(1); Nasdaq Rule 5608(b)(1); NYSE Listed Company Manual § 303A.14(c)(1).

24 Nasdaq Rule 5608(d); NYSE Listed Company Manual § 303A.14(e).

[25] For US issuers, the officers to whom the clawback policy applies will be evident since they will be the ones who also file reports under Section 16. Since this information will not be readily apparent for FPIs, the SEC Staff may insist on additional disclosures to identity such officers.

[26] Nasdaq Rule 5608(b)(2); NYSE Listed Company Manual § 303A.14(c)(2).

[27] Form 20-F Instructions as to Exhibits 97.

[28] Regulation S-K Item 601(b).

[29] Form 20-F Item 6.F; see also Regulation S-K Item 402(w).

[30] The term “individual account plan” is defined in Regulation BTR, Rule 100(j).

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CHAPTER 13

Liability Under the US Federal Securities Laws for Foreign Private Issuers

A foreign private issuer becomes exposed to liability under the US federal securities laws in a variety of ways as a result of offering or listing its securities in the United States. This liability can be civil or, in certain circumstances, criminal. Although litigation by private plaintiffs is more common, the SEC frequently initiates civil enforcement actions against foreign private issuers and persons associated with them. In cases involving serious securities fraud, the US Department of Justice, or DOJ, sometimes brings criminal proceedings, often in parallel with an SEC civil action. We summarize below the key areas of US federal securities law liability for foreign private issuers.

Registration Under Section 5 of the Securities Act

Section 5 of the Securities Act effectively requires every US offer and sale of securities to be either registered with the SEC or made pursuant to an available exemption from registration. The terms "offer" and "sale" in the Securities Act are broadly construed. For example, an offer includes any attempt to dispose of a security for value.[1] As a result, publicity in the United States about an impending offering, website disclosure of the offering, or even an email communication to "friends and family" announcing an offering can constitute an unregistered offer in violation of Section 5.

Violations of Section 5 can give rise to liability in SEC enforcement actions and also in actions brought by investors under Section 12(a)(1) of the Securities Act, as discussed below. They can also lead to the delay (or even abandonment) of a securities offering if the SEC imposes a cooling-off period. As a result of these onerous remedies, it is critical to control publicity and comply carefully with the requirements for any applicable exemptions from Section 5 registration.

Under Section 12(a)(1), an investor who buys securities issued in transactions violating Section 5 can rescind the sale and recover his or her purchase price (plus interest, less any amount received on the securities). If the investor no longer owns the securities, he or she can recover damages equal to the difference between the purchase and the sale price of the securities (again, plus interest, less any amount received on the securities).[2]

Section 12(a)(1) imposes strict liability, and an investor is not required to demonstrate any causal link between his or her damages and the violation of Section 5.[3] However, in order to be liable, a defendant must be a seller – that is, a person who successfully solicits the purchase, motivated at least in part by financial interest – and the plaintiff must actually have bought the securities from that defendant.[4]

Antifraud

As a general matter, there is no duty under the US federal securities laws to disclose material information unless an applicable rule or regulation specifically requires disclosure.[5] A foreign private issuer's duty to disclose may arise in situations such as:

- purchasing or selling securities;
- filing a registration statement;
- filing an annual report on Form 20-F;

- submitting information on Form 6-K;
- issuing a press release; and
- NYSE or Nasdaq requirements.

Once an issuer chooses to disclose information to investors or the public, it must do so completely and accurately.[6] If a statement is believed by the issuer to be true when made, but the issuer subsequently learns that it was not true, the issuer generally has a duty to correct that statement.[7] If, on the other hand, a statement by an issuer was reasonable when made, but it becomes misleading in light of subsequent events, the issuer might or might not have a "duty to update" the statement, depending on a number of factors.[8] This is one reason why projections of future results require careful thought.

What Is "Material"?

The various antifraud provisions of the Securities Act and the Exchange Act impose liability for material misstatements or omissions in the offer or sale, or in connection with the purchase or sale, of securities. The fundamental test for "materiality" is whether there is a substantial likelihood that a reasonable investor would consider the misstatement or omission important in deciding whether or not to purchase or sell a security.[9] As the US Supreme Court has explained, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[10]

The determination of materiality is a mixed question of law and fact,[11] and there is no bright-line quantitative test for materiality.[12] In adopting Regulation FD, for example, the SEC indicated that the following subjects should be carefully reviewed to determine whether they are material:[13]

- earnings information;
- mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- new products or discoveries, or developments regarding customers or suppliers (for example, the acquisition or loss of a contract);
- changes in control or in management;
- change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report;
- events regarding the issuer's securities – for example, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits, or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and
- bankruptcies or receiverships.

In addition, in Staff Accounting Bulletin No. 99, the SEC Staff pointed to several qualitative factors that may need to be considered in assessing materiality, and that could render a quantitatively minor misstatement material, including whether the misstatement:

- arises from an item capable of precise measurement or from an estimate and, if so, the degree of imprecision inherent in the estimate;
- masks a change in earnings or other trends;
- hides a failure to meet analysts' consensus expectations;

- changes a loss into income or vice versa;
- concerns a segment or other portion of the issuer's business that has been identified as playing a significant role in the issuer's operations or profitability;
- affects the issuer's compliance with regulatory requirements;
- affects the issuer's compliance with loan covenants or other contractual requirements;
- has the effect of increasing management's compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation; and
- involves concealment of an unlawful transaction.

Fraud in Connection With the Purchase or Sale of Securities – Rule 10b-5

Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 provide a broad (and heavily litigated) basis for both civil and criminal liability in securities transactions. Such claims can be brought by parties to the transaction as well as by the SEC, the DOJ, and investors who were effecting transactions in the subject securities during the period of improper disclosure. Rule 10b-5 prohibits, in connection with the purchase or sale of securities:

- employing "any device, scheme, or artifice to defraud;"
- making "any untrue statement of material fact" or omitting "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
- engaging in any "act, practice, or course of business which operates or would operate as a fraud or deceit."

Elements of a Claim Under Rule 10b-5

The elements of a claim under Rule 10b-5 by a private plaintiff[14] are:

- a misrepresentation or omission of a material fact when the omission renders any statements made misleading;[15]
- made with *scienter* – that is, an intent to deceive, manipulate, or defraud,[16] meaning intentionally or recklessly (beyond mere negligence);[17]
- in connection with the purchase or sale of a security;
- upon which the plaintiff relied; and
- which caused the injury.[18]

In government enforcement actions under Rule 10b-5, only the first three elements apply.

The requirement that the alleged fraud must have been "in connection with" the purchase or sale of securities is flexibly construed to effectuate the remedial purposes of the Exchange Act, particularly when the SEC is the plaintiff.[19] A private plaintiff, by contrast, must show that he or she actually purchased or sold stock,[20] but Rule 10b-5 does not require privity between the defendant and the plaintiff,[21] and accordingly a plaintiff need not show that he or she actually bought securities from the person who made the misleading statements.

Scope of Rule 10b-5

Rule 10b-5 is not limited to public offerings of securities, and applies to unregistered transactions and secondary market trading. In addition, Rule 10b-5 covers oral and written statements, whether or not relating to a registration statement or prospectus.[22] These would potentially include statements made:

- in an offering memorandum for a Rule 144A offering or other private placement;
- during a press conference or an interview, or in a press release;
- in an annual report on Form 20-F; and
- in a document submitted on Form 6-K.

In addition, while an issuer is generally not liable for the statements of others, there may be exceptions. For example, the issuer could be liable for misstatements in an analyst's report if a corporate insider participates sufficiently in the preparation of the report or circulates the report to prospective investors.[23]

Insider Trading

Insider trading is also prosecuted under Rule 10b-5, civilly by the SEC and criminally by the DOJ. As interpreted by the SEC and the US federal courts, Rule 10b-5 prohibits a person from buying or selling securities on the basis of material nonpublic information, or providing such information to another person who trades, in violation of a fiduciary duty or similar duty of trust and confidence.[24] Rule 10b-5 imposes an obligation to either disclose material nonpublic information or abstain from trading on:

- corporate insiders, such as directors, officers, and controlling shareholders, who owe a fiduciary duty to the issuer's shareholders;[25]
- temporary insiders, such as lawyers, accountants, or investment bankers;[26] and
- outsiders who "misappropriate" material nonpublic information for trading purposes in breach of a duty owed to the source of the information.[27]

> PRACTICE POINT
>
> Bear in mind that a person can be liable under Rule 10b-5 even if he or she did not actually trade on the material nonpublic information, but instead passed it directly or indirectly to a third party – a practice known as "tipping" – to get some "personal benefit."[28] The personal benefit could be pecuniary gain (such as a kickback or a "reputational benefit that will translate into future earnings") or even the benefit one gets from making "a gift of confidential information to a trading relative or friend."[29] In addition to the tipper, the "tippee" (the person to whom the information is disclosed) may also be liable under Rule 10b-5 if he or she trades on the basis of the tipped information and had reason to know the information came from a person who violated a duty of trust and confidence.[30]

Damages Under Rule 10b-5

In private actions, violations of Rule 10b-5 can lead to rescission or damages.[31] Damages comprise a purchaser's out-of-pocket loss, which cannot exceed the difference between the purchase or sale price the plaintiff paid or received and the mean trading price of the security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.[32] Punitive damages are, however, not available in private actions under Rule 10b-5.[33]

In civil or administrative actions, the SEC can obtain money penalties, disgorgement, and injunctions or cease-and-desist orders. In criminal prosecutions, the DOJ can obtain penalties that include imprisonment, fines, and disgorgement.

Extraterritorial Application of Section 10(b) and Rule 10b-5

Section 10(b) is entirely silent about how it applies extraterritorially. Nevertheless, for decades US courts generally allowed plaintiffs to bring suit under Section 10(b) and Rule 10b-5 in extraterritorial situations if there was sufficient "conduct" and/or "effects" in the US. Under the "conduct-and-effects" test, such provisions applied extraterritorially when wrongful conduct occurred in the US or when conduct outside the US had a "substantial effect" in the US or upon US citizens. In 2010, however, the US Supreme Court swept away this test in *Morrison v. National Australia Bank Ltd.* and applied a new "transactional" test, holding that Section 10(b) and Rule 10b-5 apply only to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities[.]"[34]

Morrison was a "foreign-cubed" case – that is, one in which the alleged victims were (1) foreign investors who traded in the securities of a (2) foreign issuer on a (3) foreign exchange, but where some significant conduct in furtherance of the violation or some foreseeable substantial effect allegedly occurred within the US. Clearly the majority of justices that decided *Morrison* meant to limit the number of securities class action lawsuits brought in the US against non-US issuers by non-US investors, in light of their fear that the US had "become a Shangri-La of class-action litigation for lawyers representing those allegedly cheated in foreign securities markets."[35]

Morrison involved solely Exchange Act claims, and subsequently plaintiffs in foreign-cubed (otherwise known as "f-cubed") class actions have hoped to evade *Morrison's* effects by alleging violations of Securities Act provisions that are similar to Section 10(b) and Rule 10b-5. However, *Morrison* expressly stated that the Securities Act and the Exchange Act share "[t]he same focus on domestic transactions,"[36] and thus far, not surprisingly, the lower courts have extended the logic of *Morrison* to Securities Act claims and dismissed them on that basis.[37]

One of the questions that courts have wrestled with in the wake of Morrison is whether its transactional test applies to American Depositary Receipts (ADRs), which are securities issued by US-based financial institutions that represent shares of foreign stock. In *Stoyas v. Toshiba Corporation*, the Ninth Circuit addressed whether the transactional test applies extraterritorially to US over-the-counter (OTC) transactions in unsponsored ADRs.[38] The district court granted the company's motion to dismiss on the grounds that the Exchange Act did not apply to OTC transactions in unsponsored ADRs. Specifically, the court found that *Morrison*'s first prong does not apply because the ADRs are not listed on any US stock exchange. As to Morrison's second prong, the court found that plaintiffs failed to allege that Toshiba engaged in any affirmative act in connection with securities sales in the US, and as such the company's ADRs are not domestic transactions.[39]

On appeal, the Ninth Circuit agreed that the OTC market is not an "exchange" under the Exchange Act, and therefore *Morrison*'s first prong does not apply to Toshiba's ADRs. As to the second prong, however, the Court held that OTC transactions in unsponsored ADRs could qualify as domestic transactions if properly pled in an amended complaint.[40] Applying the "irrevocable liability" test (under which the place of the transaction is determined by the place in which the parties to the transaction incur "irrevocable liability"), the Ninth Circuit stated that "an amended complaint could almost certainly allege sufficient facts to establish that [the plaintiffs] purchased [their] Toshiba ADRs in a domestic transaction." The Court pointed to numerous US connections, stating that the ADRs were purchased in the US, the plaintiffs are US entities located in the US, the OTC platform on which the ADRs were traded is located in the US, and the depositary banks that maintain the ADR trading are located in the US. Accordingly, the Ninth Circuit reversed and remanded the case to allow plaintiffs to amend their complaint. In June 2019, the US Supreme Court declined to hear the case.[41]

As to governmental actions, shortly after *Morrison* was decided, the US Congress, in Section 929P(b) of the Dodd-Frank Act, acted to undo the effect of *Morrison* by reinstating the conduct-and-effects test on securities actions brought under both the Securities Act and the Exchange Act by the US government (that is, by the SEC or the Department of Justice).[42] In the first circuit court decision to directly address the extraterritorial application of this authority after *Morrison*, the Tenth Circuit affirmed the SEC's ability to bring enforcement

actions under the conduct-and-effects test in *SEC v. Scoville*.[43] While acknowledging that the Dodd-Frank provision amended only the jurisdictional sections of the Securities Act and the Exchange Act, the Tenth Circuit concluded based on the specific context for those amendments that "Congress has 'affirmatively and unmistakably' indicated that the antifraud provisions of the federal securities acts apply extraterritorially when the statutory conduct-and-effects test is met."[44] The Court then determined that because the US defendants engaged in conduct within the US, the antifraud provisions apply to their sale of Adpacks (which the Court found to be an investment contract that qualifies as a security) outside the US.[45] In November 2019, the US Supreme Court declined to hear the case.

Thus, at least in cases currently brought in the Tenth Circuit, US regulatory authorities, unlike private litigants, may seek to enforce federal securities laws abroad where the conduct-and-effects test is satisfied. Given that the defendants in *Scoville* are US-based entities, however, there remains some question as to whether the SEC and the DOJ can satisfy the conduct-and-effects test for "f-cubed" enforcement actions and prosecutions.

Section 11 of the Securities Act – Registered Offerings

Section 11(a) of the Securities Act imposes liability if any part of a registration statement, at the time it became effective, "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 11 liability only covers statements made in a registration statement, and does not reach other documents that are not considered part of a registration statement (such as road show materials, FWPs, or research reports).[46] In addition, Section 11 does not extend to unregistered transactions, since these do not involve a "registration statement."[47]

A Section 11 claim can be brought by a purchaser[48] (and not by the government) against:

- each person who signed the registration statement, including the issuer and members of management;[49]
- each member of the issuer's board of directors, or similar governing body, regardless of whether he or she signed the registration statement;[50]
- any expert named as responsible for a portion of the registration statement, such as an issuer's auditors; and
- each underwriter participating in the offering.

Issuers are strictly liable under Section 11. Potential defendants other than the issuer[51] have statutory defenses to Section 11 liability by virtue of Section 11(b)(3):

- *Due diligence defense*: in the case of a non-expert with respect to the non-expertized portions of the registration statement, or in the case of an expert with respect to the expertized portions (for example, the financial statements that include the auditors' opinion), a defendant must show that he or she had, after reasonable investigation, reasonable grounds to believe – and did believe – that the included information was true and that no material facts were omitted;[52] and
- *Reliance defense*: in the case of a non-expert with respect to expertized portions of the registration statement, a defendant must show he or she had no reasonable ground to believe, and did not believe, that the registration statement contained a material misstatement or omission.[53]

Damages for violation of Section 11 are generally limited to:[54]

- the difference between the price paid for a security and its value at the time a plaintiff brings a lawsuit;
- if the security has already been sold at the time a lawsuit is brought, the amount paid for the security, less the price at which the security was sold in the market; or

- if the security was sold after the lawsuit was brought but before judgment, the lesser of (1) the amount the plaintiff paid for the security, less the price at which the security was sold in the market, or (2) the amount the plaintiff paid for the security, less the value of the security as of the time the suit was brought. Punitive damages are not available under Section 11.[55]

The *Morrison* case may prevent a Section 11 claim against a non-US issuer in a case brought by non-US plaintiffs who traded on non-US exchanges (an "f-cubed" case). For a discussion of the *Morrison* case, see "Extraterritorial application of Section 10(b) and Rule 10b-5" above.

Section 12(a)(2) of the Securities Act – Registered Offerings

Section 12(a)(2) of the Securities Act imposes liability on any person who "offers or sells a security" by means of a prospectus, or any oral communication, which contains "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading."

The Supreme Court has interpreted the phrase "offers or sells" to limit liability to "statutory sellers," i.e., persons who pass title of the security of to the plaintiff (intermediate sellers) or who directly solicited the plaintiff's purchase "motivated at least in party by a desire to serve his own financial interests or those of the securities owner."[56]

Section 12(a)(2) overlaps with Section 11, but covers oral statements, FWPs, and statements in a prospectus, rather than the registration statement alone (of which the prospectus is a part). Actions under Sections 11 and 12(a)(2) are brought by purchasers in private litigation. As for enforcement by the US government, civil and criminal actions involving material misstatement or omissions in sales of securities may be brought, respectively, by the SEC and the DOJ under Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Exchange Act Rule 10b-5.

The US Supreme Court has construed the term "prospectus" in Section 12(a)(2) to mean a prospectus in connection with a public offering under the Securities Act. As a result, it ruled that Section 12(a)(2) does not apply to unregistered offerings or secondary market trading.[57]

Section 12(a)(2) provides a statutory due diligence defense if the seller can show he or she "did not know, and in the exercise of reasonable care could not have known," of the material misstatements or omissions.

Under Section 12(a)(2), a person who buys securities on the basis of a prospectus that contains a material misstatement or omission – such as a person who buys securities issued in violation of Section 5 of the Securities Act – can rescind the sale and recover his or her purchase price (plus interest, less any amount received on the securities). If the investor no longer owns the securities, he or she can recover damages equal to the difference between the purchase and the sale price of the securities (again plus interest, less any amount received on the securities).

The *Morrison* case discussed above under "Extraterritorial application of Section 10(b) and Rule 10b-5" may prevent a Section 12(a)(2) claim against a non-US issuer in a case brought by non-US plaintiffs who traded on non-US exchanges (an "f-cubed" case).

Timing of the Investment Decision Under Section 12(a)(2) – Rule 159

Rule 159 provides that, for purposes of determining whether a prospectus or oral statement included a material misstatement or omission at the time of the contract of sale under Section 12(a)(2), "any information conveyed to the purchaser only after such time of sale" will not be taken into account.

The key implication of Rule 159 is that Section 12(a)(2) liability is determined by reference to the total package of information conveyed to the purchaser at or before the time of sale. Accordingly, a preliminary prospectus, an FWP, or an oral communication at a road show may give rise to liability under Section 12(a)(2) (in suits by private plaintiffs), even if later corrected or supplemented in a final prospectus that is filed or delivered after pricing.

Liability Considerations in Connection With Pending M&A Transactions

Merger negotiations or major corporate acquisitions can pose particularly difficult disclosure questions. A foreign private issuer that is holding merger negotiations need not disclose the existence of those negotiations, absent some other duty to disclose, or may respond to press inquiries by stating "no comment." Once an issuer's duty to disclose is triggered, however, it must disclose information about pending merger and acquisition transactions that are material and probable. Materiality is judged on the basic materiality standard under the US federal securities laws – that is, whether a reasonable investor would consider disclosure about the transaction important in deciding whether or not to purchase or sell a security. There is no bright-line test for when a transaction becomes probable. This may occur prior to the date a definitive agreement is signed and, therefore, prior to the date on which the parties would otherwise be prepared to announce the transaction.[58]

There is also an interaction between materiality and probability, so that high probability can compensate for a lower level of significance and vice versa.[59] The US Supreme Court has explained that "materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'"[60] In short, the more substantial an acquisition or disposal is likely to be, the less probable it needs to be before it becomes material and must be disclosed.[61]

Controlling Person Liability

Liability under the US federal securities laws potentially extends beyond issuers, underwriters, and other direct participants in securities offerings to the persons who control those participants. In particular, Section 15 of the Securities Act and Section 20 of the Exchange Act provide that controlling persons may be jointly and severally liable with the persons they control. As a result, an issuer's significant shareholders, its board of directors (or similar governing body), and members of its management may be liable along with the issuer for violations of Section 11, Section 12, or Rule 10b-5.

The term "control" generally means the possession, directly or indirectly, 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.[62] This is not a bright-line test, and instead depends on the facts and circumstances of any particular case. A defendant generally will be found to have controlled an issuer if he or she actually participated in (that is, exercised control over) the operations of the issuer and possessed the power to control the specific transaction or activity from which the issuer's primary liability derives.[63] Some courts have held that the defendant must be a "culpable participant" in the issuer's wrongful conduct in order to trigger liability.[64]

The controlling person has a defense to liability under Section 15 if he or she "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," and a defense under Section 20 if he or she "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." This analysis is obviously quite fact specific,[65] and may depend on such factors as whether the defendant is an inside or outside director.

The *Morrison* case discussed above under "Extraterritorial application of Section 10(b) and Rule 10b-5" may prevent Section 15 and Section 20 claims against controlling persons of a non-US issuer in a case brought by non-US plaintiffs who traded on non-US exchanges (an "f-cubed" case).

PRACTICE POINT

Potential controlling persons, such as controlling shareholders and members of an issuer's board of directors, should familiarize themselves generally with the disclosure used in connection with an offering, and should pay particular attention to any high-level statements about an issuer's strategy, business, or financial performance. They should also review carefully any statements about themselves (for example, disclosure about a controlling shareholder).

PSLRA Safe Harbor[66]

The Private Securities Litigation Reform Act of 1995 (PSLRA) provides a safe harbor for SEC reporting issuers, including SEC reporting foreign private issuers, for certain types of written or oral forward-looking statements,[67] including:[68]

- projections of revenues, income, losses, earnings, and other financial items;
- statements of the plans and objectives of management for future operations; and
- statements of future economic performance.

The PSLRA does not, however, protect forward-looking statements made in connection with initial public offerings or tender offers, or those statements that are included in financial statements prepared in accordance with GAAP.[69]

In order to take advantage of the PSLRA safe harbor, among other things, the forward-looking statement must be identified as such, and must be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.[70] As a practical matter, issuers try to bring themselves within the safe harbor with respect to written forward-looking statements by inserting cautionary language noting that the relevant document contains forward-looking statements and by keeping current, in a widely available public document such as a periodic SEC filing, the key market variables and risk factors affecting the issuer's business. (This is the reason many earnings announcements and other press releases routinely include long disclaimers.) As for forward-looking oral statements, a spokesperson will often make a formal statement to the following (rather stilted) effect:

> "The statements I am about to make include statements about our plans and future prospects for the company and our industry that are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Our actual performance may differ materially from performance suggested by those statements. I encourage you to review the 'Cautionary Statement' section of [our annual report on Form 20-F] filed with the SEC for additional information concerning factors that could cause those differences."

We suggest that this statement be made at the beginning of each conference call with investors or analysts. Some issuers have the statement made by the moderator of the call, rather than by an officer.

Enforcement

Background

The SEC prosecutes civil violations of the US federal securities laws.[71] It has wide-ranging powers to investigate any conduct that could constitute a violation of those laws.[72] SEC investigations are conducted by the Division of Enforcement, which reports to the five members appointed by the President of the United States who constitute the Commission itself. If, after investigating, the Division of Enforcement believes it has found

a violation, it typically recommends to the Commission that enforcement action be taken. The Commission then decides by majority vote whether to take action or not and what action to take. Charges may be brought administratively within the SEC or in a US federal district court. In either venue, the preponderance-of-the-evidence standard of proof applies, meaning that the finder of fact needs only to find that it is more likely than not that the Division of Enforcement has proved the elements of the offense. The proof need not be "clear and convincing" or "beyond a reasonable doubt" (the latter being the standard of proof in criminal cases).[73] An adverse decision in an SEC administrative or civil trial can be appealed to a US federal appellate court, and some appeals are eventually heard by the US Supreme Court.

While the SEC has civil enforcement authority only, Section 24 of the Securities Act and Section 32(a) of the Exchange Act make it a federal crime for any person to willfully violate any provision of those acts or a rule promulgated under the acts. "Willfully" is not defined uniformly by all US federal courts, but in most courts it means that the defendant knew his conduct was wrongful, but did not necessarily know it was unlawful (whereas in the SEC civil context "willfully" simply means that the actor was conscious of taking the action and not sleepwalking or the like). Consequently, the SEC works closely with criminal law enforcement agencies throughout the US to develop and bring criminal cases when the misconduct warrants more severe action and can be proved beyond a reasonable doubt.

Criminal penalties under the federal securities laws can be severe. Under Securities Act Section 24, conviction for each violation can result in a fine of up to $10,000 and/or imprisonment for up to five years. Under Exchange Act Section 32, for individuals, conviction can result in a fine of up to $5 million and/or imprisonment for up to 20 years, per violation; however, no one can be imprisoned for violating an Exchange Act rule or regulation if he or she proves that he or she had no knowledge of the rule or regulation. Fines against entities can reach $25 million per violation.

Enforcement Against Foreign Private Issuers and Non-US Nationals

The SEC actively enforces the US federal securities laws against foreign private issuers and non-US nationals, subject to the extraterritorial reach issues discussed above with respect to the *Morrison* case and Section 929P(b) of the Dodd-Frank Act. In addition, the Commission and the SEC Staff will often defer to some degree to foreign regulators and prosecutors when the other nation has a more substantial interest in the matter.

The SEC's ability to take enforcement action against foreign private issuers and non-US nationals is also limited by its ability to obtain evidence from outside the United States. The SEC is a signatory to the Multilateral Memorandum of Understanding (MMOU) of the International Organization of Securities Commissions (IOSCO), which is the first global multilateral information-sharing arrangement among securities regulators. As of November 2015, 109 securities and derivatives regulators had become signatories to the MMOU. Another more formal, negotiated mechanism used to obtain information is a Mutual Legal Assistance Treaty (MLAT) between the US and another country. The SEC must make an MLAT request through the US Department of Justice.[74] In addition, IOSCO is in the process of implementing among its membership an Enhanced Multilateral Memorandum of Understanding (EMMOU) that is intended to foster great cross-border enforcement cooperation and assistance through an expanded enumeration of powers which securities regulators will exercise on behalf of another requesting regulator.

Particular difficulties may arise for foreign private issuers and non-US nationals who have legal obligations in both the US and in their home countries. While every jurisdiction prohibits fraud, there is no universally accepted definition of fraud, and thus activities that comply with local laws may violate the US federal securities laws under certain circumstances. For example, in *E.On AG*,[75] the SEC brought and settled an enforcement action against a German company whose shares were listed on the NYSE. The SEC charged that the company had denied falsely that it was involved in merger negotiations and that the denials (issued in both English and German) violated Rule 10b-5. While acknowledging that disclosure practices regarding

the existence of negotiations may differ in other jurisdictions, the SEC nevertheless asserted that it would not apply a different standard to foreign private issuers for commenting on pending merger negotiations than to domestic US issuers.[76]

ENDNOTES

1 Securities Act Section 2(a)(3).

2 David M Brodsky & Daniel J Kramer, *Federal Securities Litigation*, 4-16 to 4-17 (1st ed. 1997) [*Federal Securities Litigation*].

3 *Id*. at 4-2 to 4-3.

4 *Id*. at 5-20 (citing *Pinter v. Dahl*, 486 US 622, 641-54 (1988)).

5 Federal Securities Litigation at 6-4.

6 *Id*. at 6-4 to 6-5.

7 *See,* e.g.*, Stansky v. Cummins Engine Co., Inc*., 51 F.3d 1329 (7th Cir. 1995) (distinguishing duty to correct from duty to update).

8 *See,* e.g.*, In re Burlington Coat Factory Sec. Litig*., 114 F.3d 1410 (3d Cir. 1997).

9 *See TSC Indus., Inc. v. Northway, Inc*., 426 US 438, 449 (1976); see also Securities Act Rule 405 ("material" information is "matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered"). *TSC* involved the interpretation of Section 14(a) of the Exchange Act and Rule 14a-9. The Supreme Court has, however, explicitly extended TSC's definition of materiality to Rule 10b-5, *Basic, Inc. v. Levinson*, 485 US 224, 231-32 (1988), and the lower US federal courts have generally used the *TSC* standard in all contexts involving the antifraud provisions of the US federal securities laws. *See* Louis Loss & Joel Seligman, *Securities Regulation*, 2074-75 (3rd ed. 1992) [*Loss & Seligman*].

10 *TSC Indus., Inc*., 426 US at 449.

11 *Id*. at 450.

12 SAB 103, Topic 1.M.1 (SAB 103 recodifies Staff Accounting Bulletin 99).

13 *Final Rule: Selective Disclosure and Insider Trading*, Release No. 33-7881, text at n.47 (Aug. 15, 2000) [*Regulation FD Release*].

14 Many securities suits are brought as class actions, which are subject to the Private Securities Litigation Reform Act of 1995 (PSLRA). Congress passed the PSLRA in 1995 to address the filing of frivolous or unwarranted securities lawsuits. Among other things, the PSLRA imposes heightened pleading requirements in order to withstand a motion to dismiss, each of which applies to the elements of a fraud claim, as discussed below.

15 *See Macquarie Infrastructure Corp. v. Moab Partners L.P*., No. 22-1165, 601 US 257 (Apr. 12, 2024) (holding that a pure omission, absent a showing that the omission rendered any affirmative statements to be materially misleading, is not actionable under Rule 10b-5(b)). Under the PSLRA, the complaint must identify each specific statement or omission alleged to be false or misleading and explain why it is misleading. 15 U.S.C. § 78u-4(b)(1).

16 *Ernst & Ernst v. Hochfelder*, 425 US 185, 193 (1976). The PSLRA requires the plaintiff to state particular facts giving rise to a strong inference that the defendant made the allegedly false or misleading statement or omissions with the requisite state of mind, i.e., the intent to manipulate, deceive or defraud. 15 U.S.C. § 78u-4(b)(2).

17 *Federal Securities Litigation* at 6-13 to 6-14. Recklessness is typically defined by courts as conduct demonstrating an extreme departure from the standard of ordinary care.

18 Under the PSLRA, the plaintiff has the burden to prove that the false, misleading, or omitted information was the cause of the actual loss the plaintiff suffered. 15 U.S.C. § 78u-4(b)(4).

19 *Cf.,* e.g., *SEC v. Zandford*, 535 U.S. 813, 822 (2002).

20 *Blue Chip Stamps v. Manor Drug Stores*, 421 US 723, 754-55 (1975).

21 *Loss & Seligman* at 3679 n.553.

22 *See id*. at 3688 (explaining that "[t]he Rule may be violated by feeding misinformation into the marketplace, or even withholding information too long," regardless of whether the defendants themselves bought or sold securities) (citation omitted).

23 *Federal Securities Litigation* at 6-30 to 6-31. The SEC has stated that an issuer may be "fully liable" if it disseminates and adopts false third-party reports "even if it had no role whatsoever in the preparation of the report." *Use of Electronic Media Release,* n.54 (citing *In the Matter of Presstek, Inc*., Release 34-39472 (Dec. 22, 1997)).

24 *Federal Securities Litigation* at 6-32; *see also Regulation FD Release*, text at footnote 28 (referring to a temporary insider as "a person who owes a duty of trust or confidence to the issuer," such as an attorney, investment banker, or accountant).

25 *Federal Securities Litigation* at 6-32 to 6-33.

26 *Id.* at 6-34; *see also Regulation FD Release*, n.28 (referring to a temporary insider as "a person who owes a duty of trust or confidence to the issuer," such as an attorney, investment banker, or accountant).

27 *Id*. at 6-34 to 6-35 (citing *United States v. O'Hagan*, 521 US 642 (1997)). The SEC has added two rules to clarify issues that have arisen in insider trading cases. First, Rule 10b5-1 provides that trading "on the basis of" material nonpublic information includes all trading while in possession of that information, except certain trades previously contracted for in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1. Second, Rule 10b5-2 fleshes out the meaning of a "duty of trust or confidence" for purposes of the misappropriation theory.

28 *SEC v. Dirks*, 463 U.S. 646 (1983).

29 *Id.; see also SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (applying the *Dirks* personal benefit rule to misappropriation case).

30 *Federal Securities Litigation*, at 6-34.

31 *Id*. at 6-42.

32 Exchange Act Section 21D(e)(1); *see also* Exchange Act Sections 21(d)(3) (providing for money penalties in SEC civil actions) and 32(a) (providing for criminal penalties for willful violations of the Exchange Act); *Federal Securities Litigation* at 6-43 to 6-45 (discussing damages under Exchange Act Section 10(b)).

33 *Federal Securities Litigation* at 6-42; *see also* Exchange Act Section 28(a) (limiting recovery for damages in actions under the Exchange Act to *actual damages*).

34 130 S.Ct 2869, 2884 (2010).

35 *See id*. at 2286.

36 *Id*. at 2885.

37 *See,* e.g.*, In re Satyam Computer Services Ltd. Securities Litigation*, 2013 WL 28053, at n.14 and *15-17 (S.D.N.Y. Jan. 2, 2013) (Sections 11, 12(a)(2), and 15); *In re Vivendi Universal, S.A., Sec. Litig*., 842 F. Supp. 2d 522, 529 (S.D.N.Y. 2012) (Sections 11 and 12(a)(2)); *In re Royal Bank of Scot. Grp. PLC Sec. Litig*., 765 F. Supp. 2d 327, 338 & n.11 (S.D.N.Y 2011) (Sections 11 and 12(a)(2)).

38 There are three types of sponsored ADRs. Level I sponsored ADRs represent securities of a foreign issuer that is exempted from registration under the Exchange Act, and are only traded in the US OTC market. Level II and III sponsored ADRs are listed on the US stock exchange, and therefore are subject to the SEC's disclosure and other requirements applicable to foreign registrants. Paul Dudek, *Securities Litigation: Applying Morrison to American Depositary Receip*ts, at 11 (Feb. 2017).

39 *Stoyas v. Toshiba Corp*., 191 F. Supp. 3d 1080, 1091-95 (C.D. Cal. 2016), rev'd, 896 F.3d 933 (9th Cir. 2018).

40 *Stoyas v. Toshiba Corp*., 896 F.3d 933, 952 (9th Cir. 2018) (finding that the complaint failed to "sufficiently allege a domestic violation of the Exchange Act, but that allowing leave to amend would not be futile"). *cert. denied sub nom. Toshiba Corp. v. Auto. Indus. Pension Tr. Fund*, 139 S. Ct. 2766 (2019).

41 *Stoyas v. Toshiba Corp*., 896 F.3d 933, (9th Cir. 2018), *cert. denied sub nom. Toshiba Corp. v. Auto. Indus. Pension Tr. Fund*, 139 S. Ct. 2766 (2019).

42 Section 929P(b) of the Dodd-Frank Act.

43 *SEC v. Scoville*, 913 F.3d 1204, 1218 (10th Cir. 2019), *cert. denied*, 140 S.Ct. 483 (2019).

44 *Id*. at 1215-18.

45 *Id*. at 1224.

46 *Federal Securities Litigation* at 3-1.

47 *See Loss & Seligman* at 4217-18.

48 Note that Section 11 standing is limited to persons who purchased securities pursuant to the registration statement at issue. *See* 15 U.S.C. § 77k(a). In other words, a person must be able to "trace" the shares she purchased to the registration statement alleged to contain the misstatements. This requirement can be difficult to satisfy in a secondary offering. *See also Slack Technologies, LLC v. Pirani*, 598 U.S. ___ (2023) (holding that Section 11 "requires a plaintiff to plead and prove that he purchased securities that were actually registered under the allegedly materially misleading registration statement.").

49 *Federal Securities Litigation* at 3-11 (citing Securities Act Section 6(a)).

50 *Id*. at 3-12.

51 *Id*. at 3-14.

52 Securities Act Sections 11(b)(3)(A) and (B).

53 Securities Act Section 11(b)(3)(C).

54 Securities Act Section 11(e). Note that, under Section 11(e), an underwriter is not liable for Section 11 damages "in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public" unless that underwriter "shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting."

55 *Federal Securities Litigation* at 3-19 to 3-20.

56 *Pinter v. Dahl*, 486 U.S. 622, 644 (1988); *see also In re Royal Ahold N.V. Sec. & ERISA Litig*., 351 F. Supp. 2d 334, 401 (D. Md. 2004).

57 *Gustafson v. Alloyd Co*., 513 US 561, 564, 584 (1995). There is some question whether Section 12(a)(2) liability extends to offshore public offerings under Regulation S. One lower US federal court has held that, despite *Gustafson*, "an offering issued pursuant to Regulation S is subject to" Section 12(a)(2) liability "if it is a public offering." *Sloane Overseas Fund Ltd. v. Sapiens Int'l Corp*., 941 F. Supp. 1369, 1376 (S.D.N.Y. 1996).

58 *Basic*, 485 US at 236 (quoting *TSC Indus., Inc.*, 426 US at 450).

59 *Id.* at 238-41.

60 *Id.* at 238 (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968)).

61 *See,* e.g., *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47-48 (2d Cir. 1976). ("Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions – and this even though the mortality rate of mergers in such formative stages is doubtless high.")

62 Securities Act Rule 405; *see also* Exchange Act Rule 12b-2.

63 *Federal Securities Litigation* at 11-5.

64 *Id.* at 11-5 to 11-7.

65 *See generally id.* at 11-7 to 11-10 (discussing the defense).

66 *See generally Federal Securities Litigation* at 2-1 to 2-31 (discussing the PSLRA).

67 Securities Act Section 27A(c)(1).

68 Securities Act Section 27A(i)(1).

69 Securities Act Section 27A(b)(2).

70 Securities Act Section 27A(c)(1)(A)(i).

71 For a comprehensive discussion of SEC Enforcement practice, *see*, e.g., *The Securities Enforcement Manual: Tactics and Strategies* (Richard M. Phillips, ed. 1997); William R. McLucas, J. Lynn Taylor & Susan A. Mathews, *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 Temp. L. Rev. 53 (1997).

72 *See SEC v. Murphy*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,688 (C.D. Cal. 1983).

73 *Steadman v. SEC*, 450 U.S. 91 (1981).

74 For a discussion of MLATs, *See* Symposium, Mann, Mari & Lavdas, *International Agreements and Understandings for the Production of Information and Other Mutual Assistance*, 29 Int'l Law 780, 781 n.248 and accompanying text (1995).

75 *In the Matter of E.On AG*, Release No. 34-43372 (Sept. 28, 2000).

76 *Id.*

CHAPTER 14

Activities of Non-US Broker-Dealers in the United States

Background

It would seem perfectly logical for a foreign private issuer to engage the services of a financial institution in its own jurisdiction to help it structure and effect its securities offerings, including those involving US markets and US investors. However, under US law, foreign financial institutions must be mindful of the requirements under Section 15(a) of the Exchange Act, which generally requires the registration with the SEC of any person acting as a broker or a dealer that uses US jurisdictional means to effect transactions in, or to induce, or attempt to induce the purchase or sale of, any security.[1] Accordingly, a broker-dealer operating outside the United States that, for example, telephones or sends documents into the United States to contact US persons with respect to securities transactions (whether in the primary or secondary markets or in connection with an M&A transaction), should register as a broker-dealer with the SEC unless an applicable exemption from registration is available.[2] An issuer that uses an entity that is not appropriately registered (or exempt from registration) to help it sell its securities in the United States or to US persons, or to effect a tender offer or other transaction involving the sale of securities in the United States, may itself be subject to liability (including possible rescission by investors) and, if engaged in a public offering, may be required to disclose possible rescission risk relating to prior securities activities by unregistered persons in its prospectus for the current offering.

It is also important to bear in mind that, although Exchange Act Rule 3a4-1 provides an exemption for certain employees of an issuer that wishes to sell its own securities through such employees, the exemption has certain limitations. For example, such persons may not be paid securities transaction-based compensation (such as a bonus based on the success of the transaction), and they generally must have substantial duties other than marketing the securities. Accordingly, it is typical for securities offerings in the United States by both US and non-US issuers to be conducted through SEC-registered broker-dealers. When such broker-dealers are acting in a "principal" capacity with respect to the offering, they are generally termed underwriters;[3] when they act in a purely "agency" capacity, they are generally termed "placement agents."

What Is a "Broker-Dealer"?

The term "broker-dealer" is not itself defined in the Exchange Act, but is commonly used to refer to entities that act as either or both a "broker" and/or a "dealer."

Section 3(a)(4) of the Exchange Act defines a "broker," in general, as "any person engaged in the business of effecting transactions in securities for the account of others."[4] The terms "effecting transactions" and "engaged in the business" are not defined in the Exchange Act or in SEC rules thereunder. Nonetheless, the "broker" definition and its components have been subject to extensive interpretation by the courts and the SEC.[5] In relation to the marketing of primary issuances, courts have held that factors that are relevant to the determination of whether a person is acting as a broker include whether that person (a) is an employee of the issuer of the securities; (b) receives commissions as opposed to a salary; (c) is selling, or has previously sold, securities; (d) is involved in negotiations between the issuer and the investor; (e) makes evaluations as to the merits of the investment or gives advice; and (f) is an active rather than passive finder of investors.[6] SEC Staff has stated more broadly in its no-action guidance that activities that may be deemed (alone or in combination) to confer "broker" status include:

- soliciting clients to enter into securities transactions;

- assisting issuers in structuring prospective securities transactions or helping issuers to identify potential purchasers of securities;
- participating in the order-taking or order-routing process or otherwise bringing buyers and sellers of securities together; and
- receipt of compensation that is contingent on the success of a securities transaction or that is based on the amount or value of a securities transaction.[7]

Section 3(a)(5) of the Exchange Act defines a "dealer," in general, as "any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise."[8] Activities that have been identified (alone or in combination) by the SEC Staff as indicators of "dealer" (rather than "investor" or "trader" status) include:

- participating in a selling group, underwriting securities, or purchasing or selling securities as principal from or to customers rather than from or to only brokers or dealers;
- carrying a dealer inventory or holding oneself out as a dealer or market-maker or as otherwise willing to buy or sell particular securities on a continuous basis;
- quoting a market in securities or publishing any quotations on or through any quotation system used by dealers, brokers, or institutional investors or otherwise quoting prices, other than on a limited basis through a retail screen broker;
- handling money or securities, or executing or clearing securities transactions, for third parties;
- issuing or originating securities;
- extending or arranging for the extension of credit to others in connection with securities; and
- engaging in trading transactions for the benefit of others, rather than consistently with one's own judgment and investment and liquidity objectives.[9]

The Rule 15a-6 Conditional Exemption

Rule 15a-6 under the Exchange Act (Rule 15a-6) provides a conditional exemption from the US registration requirements that permits non-US broker-dealers (Non-US BDs) to conduct certain activities in the United States and with US persons.[10] Pursuant to Rule 15a-6, Non-US BDs may:

- effect "unsolicited" securities transactions with US persons;
- subject to certain conditions, provide research reports to major U.S. institutional investors; and
- subject to certain conditions, solicit and effect securities transactions for certain types of counterparties

In addition, pursuant to a no-action letter issued by the SEC Staff in January 1996 (the 1996 Staff Letter), Non-US BDs may, subject to the conditions detailed in the 1996 Staff Letter, effect certain transactions in non-US securities with US fiduciaries acting for the account of offshore clients.[11]

Although Non-US BDs are permitted to make certain US contacts under Rule 15a-6 without the assistance or intermediation of an SEC-registered broker-dealer, the range of activities in which Non-US BDs are permitted to engage under the Rule is broader for those Non-US BDs that have established an arrangement with an SEC-registered broker-dealer in accordance with paragraph (a)(3) of Rule 15a-6 (such arrangement, a Chaperoning Arrangement; the SEC-registered broker-dealer involved in such arrangement

is the Chaperoning Broker-Dealer). The requirements for establishing a Chaperoning Arrangement are summarized on the following page.

On March 21, 2013, the Staff of the SEC's Division of Trading and Markets published guidance in the form of Frequently Asked Questions on Rule 15a-6 (the Rule 15a-6 FAQs).[12] The Rule 15a-6 FAQs resulted from the efforts of a Task Force assembled by the Trading and Markets Subcommittee of the American Bar Association to discuss and seek clarification from the Staff with respect to certain recurring issues regarding Rule 15a-6. In the Rule 15a-6 FAQs, the Staff affirmed the general applicability of certain previously issued interpretive guidance and addressed certain aspects of the operation of Rule 15a-6, primarily with respect to issues concerning solicitation, the dissemination of research reports, recordkeeping requirements, and chaperoning arrangements between foreign broker-dealers and SEC-registered broker-dealers.

The SEC has historically brought enforcement actions against foreign brokers on numerous occasions for engaging in unregistered broker-dealer activity in the US.[13] Further, the SEC has historically cautioned the industry that broker-dealer registration violations are serious and will be pursued, even where there has been no allegation of fraud or willful misconduct.[14]

Permitted Activities Under Rule 15a-6 – Without a Chaperoning Arrangement

In accordance with Rule 15a-6 and applicable SEC Staff interpretive guidance, a Non-US BD may engage in the following activities without registration as a broker-dealer with the SEC and without entering into a Chaperoning Arrangement:

Unsolicited Transactions[15]

A Non-US BD may effect an "unsolicited" transaction with any US person. Solicitation, however, has traditionally been viewed quite broadly by the SEC and would generally include any action intended to induce securities transactions, develop goodwill, or make the Non-US BD known in the United States.[16] For example, "solicitation" would include, among other things, the following activities:

- telephone calls to US investors encouraging the use of the Non-US BD to effect securities transactions;
- provision of research by the Non-US BD to US investors; and
- attempts by the Non-US BD to make its business known in the United States, including, for example, through (a) seminars or conferences held in the United States or targeted to US investors, (b) individual introductory meetings with US investors, or (c) advertisement of its services, or interviews with senior management regarding particular securities or markets, on a television or radio broadcast into the United States or in a publication of general circulation in the United States.

However, the Staff clarified in the Rule 15a-6 FAQs that, absent any other indicia of solicitation, a Non-US BD may rely on Rule 15a-6(a)(1) to effect more than one unsolicited securities transaction on behalf of a single US investor. The Staff emphasized in this regard that the inquiry is to the nature of the activities of the broker-dealer, as opposed to the number of transactions effected. Nonetheless, the Staff cautioned that a "series of frequent transactions or a significant number of transactions between a Non-US BD and a US investor [may be] indicative of solicitation through the establishment of an 'ongoing securities business relationship.'"[17]

Activities With Certain Specified Counterparties[18]

A Non-US BD may solicit and engage in securities transactions with the categories of persons listed below (Permissible Direct Counterparties):

- *Broker-Dealers and Banks.* An SEC-registered broker-dealer, whether acting as principal for its own account or as agent for others, or a US bank acting in accordance with certain exceptions or exemptions from the definition of "broker" or "dealer" under the Exchange Act.
- *Supranational Organizations*. The African Development Bank, the Asian Development Bank, the Inter-American Development Bank, the International Bank for Reconstruction and Development, the International Monetary Fund, and the United Nations (as well as their agencies, affiliates, and pension funds).
- *Non-US Persons Temporarily Present in the United States*. A non-US person temporarily present in the United States with whom the Non-US BD had a *bona fide* pre-existing relationship before the non-US person entered the United States.[19]
- *Non-US Branches of US Companies*. An agency or branch of a US-organized entity permanently located outside the United States, provided that any resulting securities transactions occur outside the United States.
- *Non-Resident US Citizens*. A US citizen resident outside the United States, provided that the resulting securities transactions occur outside the United States and the Non-US BD does not direct its selling efforts to "identifiable groups" of US citizens residing outside the United States (such as military or embassy personnel).
- *US Fiduciaries Acting for Offshore Clients*. A US resident fiduciary acting for an "offshore client,"[20] provided that the transactions involve only "foreign securities,"[21] written assurances are obtained from the fiduciary and certain other requirements as set forth in the 1996 Staff Letter are met.[22]

Provision of Research Reports to Major US Institutional Investors[23]

A Non-US BD may provide research reports to "major US institutional investors," and effect securities transactions resulting from doing so,[24] provided that (except in the case of research reports sent to Permissible Direct Counterparties) the Non-US BD does *not*:

- recommend that the Non-US BD be used to effect transactions in any security;
- initiate any contact with the recipients to follow up on the research or otherwise attempt to induce securities transactions by such recipients; or
- provide such research pursuant to any express or implied understanding that the recipients will direct commission income (or soft dollars) to the Non-US BD.[25]

Rule 15a-6 defines the term "major US institutional investor" as an entity (i) that either is a "US institutional investor" or an SEC-registered investment adviser, and (ii) that owns or has under management at least $100 million. The term US institutional investor (as defined in Rule 15a-6) includes US-registered investment companies, banks, savings and loan associations, insurance companies, and certain employee benefit plans, charitable organizations, and trusts.

In April 1997, however, the SEC Staff issued a Rule 15a-6 related no-action letter (the 1997 Staff Letter) that, among other things, significantly expanded the definition of major US institutional investor.[26] Pursuant to the 1997 Staff Letter, the term "major US institutional investor" is deemed to include, in addition to the above categories, any entity (including a corporation, partnership, unregistered investment adviser, or hedge fund) that owns or has under management at least $100 million in aggregate financial assets.[27]

Permitted Activities Under Rule 15a-6 – With a Chaperoning Arrangement[28]

If a Non-US BD enters into a Chaperoning Arrangement with an SEC-registered broker-dealer, the Non-US BD would, pursuant to Rule 15a-6(a)(3) applicable SEC Staff interpretive guidance issued in connection therewith, be permitted to engage in the following activities (in addition to the activities discussed above):

Contacts With Major US Institutional Investors From Outside the United States

Qualified employees of the Non-US BD may contact from outside the United States (e.g., by telephone) major US institutional investors *at any time* without an appropriately licensed representative of the Chaperoning Broker-Dealer being present.

Contacts With US Institutional Investors (Non-Majors) From Outside the United States

Qualified employees of the Non-US BD may contact from outside the United States (e.g., by telephone) US institutional investors that are not major US institutional investors:

- *at any time*, if an appropriately licensed representative of the Chaperoning Broker-Dealer participates in such contact, or
- without the participation of a representative of the Chaperoning Broker-Dealer, if such contact takes place outside of the trading hours of the NYSE (currently, 9:30 a.m. to 4:00 p.m. New York time) and no orders to effect transactions *other than those involving foreign securities* are accepted by the Non-US BD employees during such contact.[29]

In-Person US visits

Qualified employees of the Non-US BD may:

- *at any time*, visit major US institutional investors and US institutional investors in the United States if the qualified employee is accompanied on such visits by an appropriately licensed representative of the Chaperoning Broker-Dealer.
- without being accompanied by a representative of the Chaperoning Broker-Dealer, visit major US institutional investors if the number of days on which such unchaperoned visits occur does not exceed 30 per year and the qualified Non-US BD employee does not accept orders to effect any securities transactions (whether involving US securities or non-US securities) while in the United States.[30]

Access to Screen-Based Quotations

Non-US BDs may provide US investors with access to screen-based quotation systems that supply quotations, prices, and other trade reporting information input directly by the Non-US BD, so long as any resulting transactions are effected in accordance with the requirements of Rule 15a-6.[31]

Key Requirements With Respect to the Establishment of a Chaperoning Arrangement

Certain Requirements Applicable to the Non-US BD and Its Personnel

- *Consents to service of process*. A consent to service of process for any civil action brought by, or proceeding before, the SEC or any US self-regulatory organization must be executed by the Non-US BD and each of its personnel engaged in the solicitation of US investors, and such consents must be submitted to and maintained by the Chaperoning Broker-Dealer.

- *Provision of background information to chaperoning broker-dealer.* Each employee of the Non-US BD who engages or proposes to engage in contacts with major US institutional investors and US institutional investors must provide to the Chaperoning Broker-Dealer certain employment and other background information.
- *Provision of information to the SEC*. The Non-US BD must provide to the SEC upon request any information or documents within its possession or control relating to transactions effected by the Chaperoning Broker-Dealer pursuant to the Chaperoning Arrangement and assist the SEC in obtaining testimony of its employees and other persons with respect to such transactions (unless it is prohibited from doing so pursuant to applicable law).

Certain Responsibilities of the Chaperoning Broker-Dealer under the Chaperoning Arrangement

- *Effecting transactions*. The Chaperoning Broker-Dealer must "effect" all securities transactions entered into between the Non-US BD and US investors under the Chaperoning Arrangement.[32] In addition, the Chaperoning Broker-Dealer must take responsibility for, among other things, issuing confirmation statements to the US investor, complying with applicable net capital requirements, and safeguarding, delivering, and receiving funds and securities in connection with such transactions (subject to the ability of the Non-US BD to directly settle certain securities transactions under certain circumstances).[33]
- *Customer relationship*. US investors that are counterparties to transactions entered into with the Non-US BD pursuant to the Chaperoning Arrangement are, for purposes of US regulatory requirements and the Chaperoning Broker-Dealer's policies and procedures, treated as "customers" of the Chaperoning Broker-Dealer. Accordingly, the Chaperoning Broker-Dealer must, among other things, open accounts for such US investors on its books and comply with any applicable suitability, "know your customer," best execution, and other requirements with respect to transactions between the Non-US BD and such US investors.
- *Maintaining books and records*. The Chaperoning Broker-Dealer is responsible for the maintenance of appropriate books and records with respect to transactions between the Non-US BD and US investors entered into under the Chaperoning Arrangement. The Chaperoning Broker-Dealer must also maintain as part of its books and records copies of the consents to service of process and informational questions submitted to it by the Non-US BD and its personnel. Such books and records must be kept in an office of the Chaperoning Broker-Dealer located in the United States and be provided to the SEC upon request.

ENDNOTES

1 Note that this is not limited to capital markets transactions and, for example, could also apply to transactions involving the acquisition or sale of a business if the transaction is effected through the purchase or sale of securities. *But see Merger and Acquisition Activities of Foreign Firms in Reliance on Rule 15a-6*, SEC No-Action Letter (July 12, 2012); Roland Berger Strategy Consultants, SEC No-Action Letter (May 28, 2013) (providing relief from broker-dealer registration requirements for foreign persons engaging in M&A activities subject to certain conditions, including that for any transaction with a US target in reliance on the relief, the foreign person will not represent or advise any US target and will not receive, acquire or hold funds or securities.); and Section 15(b)(13) of the Exchange Act (providing an exemption from broker-dealer registration requirements for certain "M&A brokers" that effect transfers of ownership in eligible privately held target companies, subject to certain conditions).

2 This Chapter addresses only an available exemption from federal broker-dealer registration requirements; it does not address state broker-dealer registration requirements or applicable state law exemptions therefrom. Moreover, it should be noted that Rule 15a-6 exemptions do not preempt state law registration requirements under Rule 15a-6 and accordingly that qualifying for such exemptions do *not* necessarily mean that a non-US broker-dealer will not be subject to state broker-dealer registration requirements.

3 Because the term "underwriter" is typically associated with a public offering, a broker-dealer acting in a similar capacity in connection with a Rule 144A transaction (as described in Chapter 2) is sometimes referred to as an "initial purchaser."

4 15 U.S.C. § 78c(a)(4) (*emphasis added*).

5 Courts and the SEC have determined that a person "effects transactions in securities" if the person participates in such transactions "at key points in the chain of distribution." *See Mass. Fin. Servs., Inc. v. Sec. Investor Prot. Corp.*, 411 F. Supp. 411, 415 (D. Mass.), *aff'd*, 545 F.2d 754 (1st Cir. 1976), cert. denied, 431 U.S. 904 (1977). Courts and the SEC have identified several other factors that indicate that a person is "engaged in the business." These factors include receiving transaction-related compensation and soliciting securities transactions. Transaction-related compensation refers to compensation based, directly or indirectly, on the size, value, or completion of any securities transactions. *See, e.g., BondGlobe, Inc.*, SEC No-Action Letter (Feb. 6, 2001) (SEC declined to issue a no-action letter); *SEC v. Century Inv. Transfer Corp.*, Fed. Sec. L. Rep. (CCH) ¶ 93,232 (S.D.N.Y. Oct. 5, 1971) (defendant "engaged in the broker-dealer business" by soliciting customers through ads in the *Wall Street Journal*).

6 *See SEC v. Hansen*, 1984 U.S. Dist. LEXIS 17835, *26, Fed. Sec. L. Rep. (CCH) P91,426 (S.D.N.Y. Apr. 6, 1984).

7 *See,* e.g., *MuniAuction Inc.*, SEC Staff No-Action Letter (Mar. 13, 2000).

8 15 U.S.C. § 78c(a)(5).

9 *See,* e.g., *Continental Grain Company*, SEC Staff No-Action Letter (Nov. 6, 1987); *Fairfield Trading Corp.*, SEC Staff No-Action Letter (Jan 10, 1988).

10 To be eligible for the safe harbor provisions of Rule 15a-6, the Non-US BD must meet the definition of "foreign broker or dealer" set forth in the Rule. Among other things, that definition requires that the Non-US BD not be a branch or office of an SEC-registered broker-dealer.

11 *See Transactions in Foreign Securities by Foreign Brokers or Dealers with Accounts of Certain Foreign Persons Managed or Advised by U.S. Resident Fiduciaries*, SEC Staff No-Action Letter (Jan. 30, 1996).

12 *See* Frequently Asked Questions Regarding Rule 15a-6 and Foreign Broker-Dealers, *available at* http://www.sec.gov/divisions/marketreg/faq-15a-6-foreign-bd.htm [*Rule 15a-6 FAQs*]. The FAQs have been updated since their original issuance to clarify certain issues and add new guidance.

13 *See, e.g.*, *Securities and Exchange Commission v. MintBroker Int'l, Ltd.,* No. 21-cv-61944 (S.D. Fla. filed Sept. 27, 2021); *In the Matter of Outset Global LLP,* SEC Release No. 34- 87158 (Sept. 30, 2019); *In the Matter of Bank Leum le-Israel B.M., Leumi Private Bank, and Bank Leumi (Luxembourg) S.A.,* SEC Release 34-79113 (Oct. 18, 2016); *In the Matter of HSBC Private Bank (Suisse), SA*, SEC Release No. 34-73681 (Nov. 25, 2014); *In the Matter of Credit Suisse Group AG*, SEC Release No. 34-71593 (Feb. 21, 2014); *In the Matter of CentreInvest, Inc. et al*., SEC Release No. 34-68764 (Jan. 30, 2013); *In the Matter of ABN AMRO Bank, N.V.*, SEC Release No. 33-9437 (July 31, 2013); *In the Matter of Banco Commercial Portugues, S.A*., SEC Release No. 33-9393 (Mar. 18, 2013); *In the Matter of Motilal Oswal Securities Limited*, SEC Release No. 34-68296 (Nov. 27, 2012); *In the Matter of JM Financial Institutional Securities Private Limited*, SEC Release No. 34-68297 (Nov. 27, 2012); *In the Matter of Edelweiss Financial Services Limited*, SEC Release No. 34-68298 (Nov. 27, 2012); *In the Matter of Ambit Capital Private Limited*, SEC Release No. 34-68295 (Nov. 27, 2012); *In the Matter of Banco Espirito Santo S.A*., SEC Release No. 34-65608 (Oct. 24, 2011); *Securities and Exchange Commission v. UBS AG*, 1:09-CV 00316 (JR) (D.D.C. filed Feb. 18, 2009); *In the Matter of CentreInvest, Inc. et al*., SEC Ad. Proc. 3-13304 (Dec. 8, 2008).

14 *See* David W. Blass, Chief Counsel, SEC Division of Trading and Markets, A Few Observations in the Private Fund Space (Apr. 5, 2013), *available at* http://www.sec.gov/news/speech/2013/spch040513dwg.htm. *See also In the Matter of William M. Stephens*, SEC Release No. 34-69090 (Mar. 8, 2013); *In the Matter of Ranieri Partners LLC and Donald W. Phillips*, SEC Release No. 34-69091 (Mar. 8, 2013) (each of the foregoing, involving violations of broker-dealer registration requirements by US-based persons).

15 *See* Exchange Act Rule 15a-6(a)(1).

16 As an indication of how broadly the concept of solicitation is viewed by the SEC, a Non-US BD could be deemed to have solicited a US investor who on his own initiative opened an account with the Non-US BD and became a regular customer. *See* Release No. 34-27017 (July 11, 1989), at n.103 [*Rule 15a-6 Adopting Release*].

17 *See Rule 15a-6 FAQs*, Response to Question 9. Prior to the issuance of the *Rule 15a-6 FAQs*, it also was unclear whether a Non-US BD could directly contact US employees in connection with the administration of a foreign issuer's employee stock option plan (an ESOP), or whether it needed to effect such communications and resulting transactions through an SEC-registered broker-dealer or US bank pursuant to Rule 15a-6(a)(4) or other available exemption (or, alternatively, whether US employees would need to be excluded from participation in the plans). The Staff states in the *Rule 15a-6 FAQs* that certain limited activities engaged in by a Non-US BD relating to its administration of a foreign issuer's ESOP or other employee plan would not be viewed as "solicitation" for purposes of its reliance on the Rule 15a-6(a)(1) exemption. The Staff updated the *Rule 15a-6 FAQs* on Mar. 28, 2013 to clarify that the foregoing position applies equally to situations in which the US plan participants receive, transfer, or hold the foreign issuer's shares pursuant to a sponsored American Depositary Receipt program. *See Rule 15a-6 FAQs*, Responses to Questions 2 and 2.1.

18 *See* Rule 15a-6(a)(4).

19 The Staff states in the *Rule 15a-6 FAQs* that the determination of whether a person is temporarily present in the United States is ultimately dependent on the facts and circumstances of each particular situation, but notes that a foreign person should be deemed "temporarily present" in the United States if such person (1) is not a US citizen and (2) is not a lawful permanent resident of the United States (i.e., a "Green Card holder"). *See Rule 15a-6 FAQs*, Response to Question 1. The Staff has indicated that this FAQ is not meant to preclude other situations in which a non-US person may be shown to be "temporarily present" in the United States for purposes of this exception.

20 An "offshore client" is defined in the 1996 Staff Letter as (i) any entity not organized or incorporated under the laws of the United States and not engaged in a trade or business in the United States for US federal income tax purposes, (ii) any natural person who is not a "US resident," or (iii) any entity not organized or incorporated under the laws of the United States substantially all of the outstanding voting securities of which are beneficially owned by the persons described in (i) and (ii) above. For the purposes of this definition, the term "US resident" includes a US citizen residing outside the United States unless such citizen (x) has $500,000 or more under management with the relevant US resident fiduciary with whom the Non-US BD transacts business, or (y) has, together with his or her spouse, a net worth in excess of $1 million.

21 "Foreign securities" are defined in the 1996 Staff Letter as (i) a security issued by an issuer not organized or incorporated under the laws of the United States when the transaction in such security is not effected on a US securities exchange or through the Nasdaq system (including a depositary receipt issued by a US bank, but only if it is initially offered and sold outside the United States in accordance with Regulation S), (ii) a debt security (including a convertible debt security) issued by an issuer organized or incorporated in the United States in connection with a distribution conducted outside the United States, and (iii) any over-the-counter derivative instrument on an instrument described in (i) or (ii) above; *provided, however*, that debt securities of an issuer organized or incorporated under the laws of the United States do not constitute "foreign securities" if they are offered and sold as part of a "global offering" involving both a distribution of the securities in the United States under a registration statement filed under the Securities Act and a contemporaneous distribution outside the United States.

22 *See* 1996 Staff Letter. Although the no-action position set forth in the 1996 Staff Letter was technically applicable only to those SEC-registered broker-dealers cited in the Letter and their non-US affiliates, the Rule 15a-6 FAQs make clear that other broker-dealers may also rely on the 1996 Staff Letter, so long as all the substantive requirements of the 1996 Staff Letter are met.

23 *See* Rule 15a-6(a)(2). Note that pursuant to SEC Regulation AC, a Non-US BD that is affiliated with an SEC-registered broker-dealer must comply with the certification requirements of Regulation AC with respect to any research reports sent or otherwise made available to US investors, including those reports sent to major US institutional investors in reliance on Rule 15a-6(a)(2). For further information regarding the requirements applicable to Non-US BDs with respect to SEC Regulation AC, *see Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation Analyst Certification* (revised Apr. 26, 2005).

24 If, however, a Non-US BD has established a Chaperoning Arrangement with an SEC-registered broker-dealer, any transactions in securities discussed in the reports sent to major US institutional investors *must* be effected by the SEC-registered broker-dealer. On the other hand, with a Chaperoning Arrangement in place, the Non-US BD would be permitted to engage in follow-up contacts with the recipients of the reports to the extent permitted by Rule 15a-6(a)(3).

25 In the *Rule 15a-6 Adopting Release*, the SEC noted that Non-US BDs could also continue to rely on a prior no-action position taken by the SEC pursuant to which a Non-US BD could provide research reports to *any* US person, so long as (i) an SEC-registered broker-dealer "accepts responsibility" for the content and US distribution of such research reports and this fact is prominently noted on the reports, (ii) the reports state that transactions in securities are to be effected through the SEC-registered broker-dealer (and not through the Non-US BD), and (iii) all resulting transactions are in fact effected through the SEC-registered broker-dealer. Although, in order for a Non-US BD to rely on this no-action position, an SEC-registered broker-dealer is required to "accept responsibility" for research distributed to US persons, this arrangement is not a true Chaperoning Arrangement of the kind discussed below (e.g., among other things, reliance on this position does not require the execution by the Non-US BD of a consent to service of process in the United States) and, accordingly, the Non-US BD would not be permitted to directly contact any US investor (including a major US institutional investor) in reliance on this type of arrangement. Research reports prepared by a Non-US BD that are distributed by an SEC-registered broker-dealer to clients of the SEC-registered broker-dealer must also comply with certain additional requirements imposed by self-regulatory organizations of which the SEC-registered broker-dealer is a member. *See,* e.g., FINRA Rules 2210 and 2241.

[26] *See Securities Activities of U.S.-Affiliated Foreign Dealers*, SEC Staff No-Action Letter (Apr. 9, 1997).

[27] *See Rule 15a-6 FAQs*, Response to Question 7 (confirming that the expanded definition of "major US institutional investor" set forth in the 1997 Staff Letter applies to every provision of Rule 15a-6 in which that term is used) and Response to Question 18 (clarifying that the definition of "major US institutional investor" includes any entity, all the equity owners of which are major US institutional investors).

[28] Although not technically required in order to comply with Rule 15a-6(a)(3), the implementation of a Chaperoning Arrangement is typically documented in the form of a written services agreement between the Non-US BD and the SEC-registered broker-dealer that sets forth the respective roles and responsibilities of, and the limitations on, each of the parties to the arrangement.

[29] *See* 1997 Staff Letter.

[30] *See* 1997 Staff Letter. *See also Rule 15a-6 FAQs*, Responses to Questions 6, 8, and 8.1.

[31] *See* 1997 Staff Letter.

[32] In accordance with the *Rule 15a-6 Adopting Release*, however, the Chaperoning Broker-Dealer may appoint the Non-US BD as its agent in connection with the physical execution of transactions in non-US securities listed on non-US securities exchanges or traded in non-US markets. The Non-US BD may also be appointed to mechanically process records related to the transactions, so long as the Chaperoning Broker-Dealer retains responsibility for, and maintains the originals or copies of, such records, and the records comply with applicable requirements under US law. *See Rule 15a-6 Adopting Release*, text accompanying note 150.

In addition, with respect to the transfer and holding of non-US securities, it should be possible for the Chaperoning Broker-Dealer (assuming that it is subject to the possession and control provisions of Rule 15c3-3 under the Exchange Act and is *not* claiming an exemption therefrom pursuant to paragraph (k)(2) thereunder) to establish an account at the Non-US BD *in the Chaperoning Broker-Dealer's name* for the benefit of the Chaperoning Broker-Dealer's customers, so long as the Chaperoning Broker-Dealer has submitted an application to the SEC (and the SEC has approved such application) for the designation of the account as a "satisfactory control location" in accordance with Rule 15c3-3(c) (a Control Location Application). *See* SEC Release No. 34-10429 (Oct. 12, 1973) [*Control Location Release*]. Pursuant to the Control Location Release, the Control Location Application will be considered accepted unless rejected by the SEC within 90 days of receipt. The Control Location Release also states that, so long as the criteria for designation as a "satisfactory control location" is met, the requested location will be deemed a "satisfactory control location" during the period that the application is being considered by the SEC.

[33] Notwithstanding the requirement in Rule 15a-6(a)(3) that the Chaperoning Broker-Dealer be responsible for "safeguarding, delivering, and receiving funds and securities," pursuant to the 1997 Staff Letter, there are certain circumstances in which clearance and settlement is permitted to occur through the *direct* transfer of funds and securities between a US institutional or major US institutional investor and the Non-US BD. Specifically, such direct settlement is permitted in transactions that involve "foreign securities" (as such term is defined in the 1996 Staff Letter) or US government securities where (i) the transactions have been intermediated by the Chaperoning Broker-Dealer in accordance with Rule 15a-6(a)(3) and (ii) the Non-US BD is *not* (a) acting as custodian of the funds or securities of the US institutional or major US institutional investor or (b) in default to any counterparty on any material financial market transaction. *See* 1997 Staff Letter.

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CHAPTER 15

The US Investment Company Act of 1940

Background

The Investment Company Act and the SEC's rules thereunder establish a comprehensive regulatory scheme for "investment companies." As we discuss below, the definition of investment company is broad, and potentially covers certain foreign private issuers that view themselves primarily as operating companies rather than investment companies (so-called "inadvertent investment companies").

The Investment Company Act prohibits unregistered non-US investment companies from issuing securities to the public in the United States. Foreign private issuers are generally unable to comply with the registration and reporting requirements of the Investment Company Act, which impose significant substantive compliance obligations. This means that a foreign private issuer that intends to offer its securities in the US must:

- fall outside of the definition of investment company under the Investment Company Act;
- structure the offering to fit within an exclusion to or exemption from the Investment Company Act; or
- obtain special exemptive relief from the SEC.

Can an Operating Company Be an Investment Company?

Investment company status is incompatible with an operating business because the Investment Company Act is designed to regulate funds holding portfolios of non-control, typically diversified securities. The Investment Company Act is not simply a disclosure statute – it is an inflexible, substantive federal law of corporations that imposes extensive operating restrictions on investment companies. As a result, an operating company that is also an "investment company" will find itself paralyzed by the array of substantive Investment Company Act requirements. Most notably, these include:

- *Limit on affiliate transactions*. Any transactions and dealings between an investment company and its affiliates are presumptively unlawful. These limits also apply to certain co-investment arrangements. The definition of "affiliate" under the Investment Company Act is very broad.[1]
- *Ethics, compliance, and recordkeeping burdens*. The Investment Company Act sets forth onerous and detailed requirements for investment companies to adopt (i) a code of ethics, (ii) written policies and procedures to ensure compliance with federal securities laws and (iii) a recordkeeping policy. These policies must be reviewed at least annually, and in some cases quarterly, and the entire compliance system is subject to sporadic, in-depth, on-site audit and inspection by the SEC.[2]
- *Limitations on capital structure*. Investment companies must generally maintain (i) 300% asset coverage over debt (and 200% asset coverage over any preferred stock), (ii) only one class of debt, and (iii) only one class of preferred stock.[3]
- *Strict investment policies*. Investment companies must adopt various policies governing investment objectives and concentrations, borrowing money, and issuing "senior securities." These companies must strictly adhere to these policies, which cannot be changed without a shareholder vote. Note that acquiring control of another company risks breaching the investment objectives and would likely require shareholder approval.[4]

- *Limits on directors, officers, underwriters, and others*. The directors, officers, underwriters, and other specified related parties of an investment company are subject to a wide range of "bad boy" disqualifications, with a 10-year look back.[5]
- *Requirements for independent directors*. In general, at least 40% of the board of directors must not have a material business relationship with the investment company, its entities, or certain additional persons. In many cases, boards consist of an even higher number of such "independent" directors. These directors are also subject to heightened scrutiny, as the SEC has repeatedly emphasized that independent directors must act as "watchdogs" on behalf of investors.[6]
- *Required investment adviser*. The investment company would be required to appoint an investment adviser, which in turn needs to be registered under the Investment Advisers Act of 1940 and become subject to its own registration and compliance regime. This process requires shareholder approval and adoption of a written contract (also by shareholder approval), which cannot be assigned or changed without shareholder approval. The contract is subject to strict fee requirements and anti-assignment provisions.[7]
- *Public filings; financial reporting*. The investment company's periodic filings, as well as its annual (audited) and quarterly (unaudited) financial statements are configured significantly differently from the forms used by traditional operating companies and may be subject to separate accounting requirements.[8]
- *Changes in status.* An investment company may not cease to be an investment company without shareholder approval.[9]
- *Effect on MLP taxation*. The Investment Company Act poses particular problems for publicly traded partnerships, also known as master limited partnerships (MLPs). It is critical for MLPs to avoid investment company status at all costs. Specifically, section 7704(a) of the Internal Revenue Code of 1986, as amended (the Code), provides the general rule that a publicly traded partnership will be treated as a corporation for federal income tax purposes. However, Section 7704(c) of the Code provides an exclusion to the general rule for any publicly traded partnership if 90% or more of such publicly traded partnership's gross income for a taxable year consists of "qualifying income," which is defined to include income from a number of activities, the most significant of which are related to certain natural resources. If this exclusion is met, MLPs are not subject to tax at the entity level. Instead, the MLP is treated as a partnership, and its taxable income is allocated to its partners and taxed only at the partner level. Importantly, this exclusion from the publicly traded partnership rules generally does not apply to a publicly traded partnership that would be treated as a regulated investment company as defined in section 851(a) of the Code, if such publicly traded partnership were a domestic corporation.[10] Thus, a publicly traded partnership that is registered under the Investment Company Act is generally taxed as a corporation under the Code. In other words, a registered investment company cannot be an MLP even if it otherwise generates the requisite amount of qualifying income.

The above is not a comprehensive list, but it is enough to highlight the main disadvantages of being inadvertently deemed an investment company. Thankfully, the Investment Company Act provides a wide array of exclusions and exemptions. Thoughtfully applied, these allow most operating companies to avoid becoming an investment company.

Investment Company Definition; the 40% Test

Section 3(a)(1) of the Investment Company Act defines an "investment company" to include any issuer that (1) is "or holds itself out as being engaged primarily ... in the business of investing, reinvesting, or trading in securities" or (2) is "engaged ... in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to own investment securities having a value" exceeding 40% of the value of the issuer's total assets on an unconsolidated basis, excluding US Government securities[11] and certain cash items. We refer to this numerical test of investment security ownership as the 40% Test.

40% Test – What Is an "Investment Security"?

The definition of investment securities is broad, and includes the following items:[12]

- any note, stock, treasury stock, security future, bond, or debenture;
- any evidence of indebtedness (including any loan);
- any certificate of interest or participation in any profit-sharing agreement;
- any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, or certificate of deposit for a security;
- any fractional undivided interest in oil, gas, or other mineral rights;
- any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group of index securities (including any interest therein or based on the value thereof);
- any put, call, straddle, option, or privilege entered into on a US national securities exchange relating to non-US currency;
- any interest or instrument commonly known as a "security;" and
- any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

However, the following are not investment securities:

- US Government securities;
- securities issued by "employees' securities companies" (i.e., entities that are held for the benefit of an issuer's employees and meet certain additional statutory requirements);[13] and
- securities issued by a majority-owned subsidiary that is itself not an investment company (with certain exceptions).[14]

40% Test – Value

The Investment Company Act defines the "value" of an issuer's total assets to be (1) market value at the end of the prior fiscal quarter, in the case of securities owned at that time for which market quotations are readily available, (2) fair value at the end of the prior fiscal quarter (as determined in good faith by the board of directors of the issuer), in the case of all other securities and assets owned at that time, and (3) cost, in the case of securities and assets acquired after the end of the prior fiscal quarter.[15]

In making the calculation of the percentage of investment securities to total assets, cash items are not counted – in other words, they are excluded from both the numerator and the denominator. Note that intangible assets such as goodwill count as "good" (i.e., non-investment security) assets, as do physical assets such as property, plant, and equipment. Likewise, accounts receivable generated by operating companies are generally not considered to be investment securities.

40% Test – Cash Items

Although the Investment Company Act does not define the term, the SEC Staff has stated that the following can be considered "cash items:"[16]

- cash;

- coins;
- paper currency;
- demand deposits with banks;
- cashier checks;
- certified checks;
- bank drafts;
- money orders; and
- letters of credit.

In addition, the SEC Staff generally views as cash items shares held for cash management purposes by an operating company in a registered US money market fund with a stable net asset value of $1.00 per share.[17] This is so, even though those shares are technically securities. It is not clear, however, whether the SEC Staff would consider comparable non-US instruments in the same way.

Certain other liquid instruments typically used by foreign private issuers for treasury management are more problematic. Certificates of deposit, for example, may be viewed as investment securities, depending on such factors as the reasons for which an issuer holds them and the length of time they are held.[18] Similarly, the SEC Staff may take the position that time deposits in a bank are not cash items.[19]

Rule 3a-1 Safe Harbor; 45% Tests

Rule 3a-1 provides a safe harbor to issuers that fail the 40% Test, but are not investment companies in the sense that they are not primarily engaged in an investment business. The rule takes into consideration the nature of an issuer's assets and the sources of its income.

An issuer seeking to rely on Rule 3a-1 must satisfy two 45% tests. More specifically, (1) no more than 45% of the value of the issuer's total assets (excluding US Government securities and cash items) must consist of, and (2) no more than 45% of the issuer's net income after taxes (for the last four fiscal quarters combined) must be derived from, certain investment securities (Rule 3a-1 Investment Securities). Note that, unlike the 40% Test, an issuer is allowed to compute the 45% tests of Rule 3a-1 on a *consolidated* basis with its wholly owned subsidiaries. This can considerably simplify some of the calculation difficulties of the 40% Test, particularly in the case of companies with many subsidiaries.

Rule 3a-1 Investment Securities are for the most part identical to investment securities for purposes of the 40% Test. For example, US Government securities, cash items, investments in US money market funds,[20] securities issued by majority-owned subsidiaries that are not themselves investment companies,[21] and securities issued by employees' securities companies are excluded from the definition of Rule 3a-1 Investment Securities. But the definition of Rule 3a-1 Investment Securities also excludes securities issued by certain companies that are "controlled primarily" by the issuer, and that are not investment companies or companies through which the issuer engages in an investment business.[22]

The percentage of an issuer's investment income is determined by comparing, for the last four fiscal quarters combined, (1) its net income from investment securities (i.e., after-tax investment income *minus* investment expenses) to (2) its total net income (i.e., after-tax income *minus* all business expenses).[23] In the case of net losses, the SEC Staff has stated that Rule 3a-1 requires an issuer to match its investment expenses with investment income to "ensure that only income or loss generated by investment activities are compared to" the issuer's total net income or loss.[24] As a result, the relevant comparison for purposes of the income test

would be (x) net investment loss (i.e., investment expenses *minus* investment income) to (y) total net loss (i.e., expenses *minus* income).[25]

Additional Exclusions and Exemptions

A foreign private issuer that fails the 40% Test and cannot take advantage of Rule 3a-1 despite being an operating company is often referred to as an inadvertent investment company. The Investment Company Act provides a number of statutory exclusions and rule-based exemptions for inadvertent investment companies. Broadly speaking, these exclusions and exemptions are of two types. The first depend on the specific characteristics of the issuer, while the second depend on transaction structure – that is, the specific manner in which a given security offering is conducted.

These exclusions and exemptions include the following.

Exclusions and Exemptions Based on Characteristics of the Issuer

Issuers Primarily Engaged in Non-Investment Activity – Sections 3(b)(1) and 3(b)(2)
Sections 3(b)(1) and 3(b)(2) provide that an issuer that fails the 40% Test is not an investment company if it is primarily engaged in non-investment activity either directly or through wholly owned subsidiaries (Section 3(b)(1)) or through majority-owned subsidiaries and controlled companies[26] (Section 3(b)(2)). An issuer seeking to rely on Section 3(b)(1) or 3(b)(2) "initially must establish that it is engaged in some non-investment business."[27] If a non-investment business exists, the inquiry shifts to whether that non-investment business is the primary business of the issuer.[28] And if that business is found to be primary, the issuer may then be eligible to rely on Section 3(b)(1) or 3(b)(2).[29]

To test whether an issuer is primarily engaged in a non-investment company business for purposes of both Sections 3(b)(1) and 3(b)(2), the SEC has traditionally looked to a five-factor test (laid out in the SEC's 1947 declaratory order in *Tonopah Mining Co.*).[30] The five factors are:

- an issuer's historical development;
- its public representations of policy;
- the activities of its officers and directors;
- the nature of its present assets; and
- the sources of its present income.

The last two factors (nature of the issuer's assets and sources of its income) have traditionally been the most important of the five *Tonopah* factors.[31] Although the SEC has declined to set guidelines, it has stated that an issuer that has no more than 45% of its assets invested in investment securities and derives no more than 45% of its income from investment securities[32] would generally not be considered primarily engaged in an investment business.[33] Bear in mind that this test is essentially identical to the two 45% tests established in Rule 3a-1. But an issuer that cannot rely on the Rule 3a-1 exemption because it exceeds either or both of the 45% tests may still seek to rely on Section 3(b)(1), given that Section 3(b)(1) incorporates three factors in addition to the 45% tests.

The SEC views Section 3(b)(1) as self-operating,[34] and the SEC Staff generally will not issue no-action relief with respect to Section 3(b)(1) because it believes the question whether an issuer is primarily engaged in a non-investment business as an inherently factual matter and because an issuer may apply for an exemptive order under Section 3(b)(2).[35] By contrast, Section 3(b)(2) requires that issuers submit an application to the SEC for an order granting relief, and the SEC has stated that it "ordinarily would be unwilling to issue an order" under Section 3(b)(2) when Section 3(b)(1) "provides an automatic exclusion."[36]

In order to obtain a Section 3(b)(2) exemptive order, an issuer must submit an application to the SEC. Section 3(b)(2) provides that a good-faith filing of an application for exemptive relief by an issuer (other than a registered investment company) exempts the applicant from all provisions of the Investment Company Act for a 60-day period, and the SEC has also been willing to grant temporary orders extending the 60-day exemptive period.

Broker-Dealers – Section 3(c)(2)

Section 3(c)(2) exempts any person "primarily engaged" in the business of underwriting and distributing securities issued by other persons, selling securities to customers, acting as a broker, and acting as a market intermediary (or any combination of these activities). The person's gross income must be "derived principally" from these businesses (and related activities). A "market intermediary" for these purposes is a person that regularly holds itself out as being willing contemporaneously to engage in, and that is regularly engaged in, the business of entering into transactions on both sides of the market for financial contracts.

> PRACTICE POINT
>
> Non-US broker-dealers are not specifically covered by Section 3(c)(2) and (unlike non-US banks and insurance companies discussed below) the SEC has not enacted a rule to extend Section 3(c)(2) to these entities. In practice, however, non-US broker-dealers may be able to take advantage of Section 3(c)(2) if they fit within its other substantive requirements.[37]

Banks and Insurance Companies – Section 3(c)(3) and Rule 3a-6

Section 3(c)(3) exempts US-regulated banks and insurance companies regulated by US States from the definition of investment company. Under Rule 3a-6, the SEC has also exempted non-US banks and insurance companies meeting certain requirements. These include:

- the non-US bank must be regulated as such by the authorities of the country in which it is organized, and must be "engaged substantially in commercial banking activity;" and
- the non-US insurance company must be regulated as such by the authorities of the country in which it is organized, and must be "engaged primarily and predominately" in specified types of insurance business (including writing insurance policies and reinsurance of risks).

> PRACTICE POINT
>
> UK building societies generally qualify for the Rule 3a-6 exemption.[38]

Transient Investment Companies – Rule 3a-2

Rule 3a-2 provides temporary relief from investment company status for "transient investment companies" – i.e., operating companies[39] that temporarily fall within the definition of investment company because of unusual corporate events (e.g., securities issuances or asset dispositions).[40] Under Rule 3a-2, an issuer will not be deemed to be an investment company under the Investment Company Act for a period of time not exceeding one year, provided that the issuer has a *bona fide* intent to be engaged primarily in a non-investment business "as soon as is reasonably possible" and in any event within the one-year period. This intent must be evidenced by (1) the issuer's business activities and (2) an appropriate resolution of the issuer's board of directors or by an appropriate action of the person or persons performing similar functions for any issuer not having a board of directors. A resolution or action of this sort must be recorded contemporaneously in the issuer's minute books or comparable documents.

The one-year period of time begins on the earlier of two dates. The first is the date on which an issuer owns or proposes to own securities and/or cash having a value exceeding 50% of the value of the issuer's total assets, on either a consolidated or unconsolidated basis. The second is the date on which the issuer owns or proposes to own investment securities in an amount that would lead it to fail the 40% Test.

Although Rule 3a-2 provides up to one year of exemptive relief, the rule does not provide a blanket one-year exemption. The SEC has stated that the determination of what constitutes an intent to engage primarily in a non-investment company activity "as soon as is reasonably possible" will "depend on all the facts and circumstances of each particular case, including the nature of the business in which the issuer intends to become primarily engaged."[41]

> PRACTICE POINT
>
> Rule 3a-2 only provides a temporary exemption, and an issuer can rely on the rule only once in any three-year period. In addition, the SEC Staff generally refuses to grant no-action relief under this rule.[42]

Finance Subsidiaries – Rule 3a-5

Rule 3a-5 exempts certain finance subsidiaries from being considered investment companies under the Investment Company Act and provides that the securities of those finance subsidiaries held by parent companies or parent-controlled companies are not investment securities for purposes of the 40% Test. In order to be considered a finance subsidiary under the rule, all outstanding securities of the subsidiary, other than parent-guaranteed debt securities and non-voting preferred stock, must be owned by the parent (or a parent-controlled company), and in turn the parent (or parent-controlled company) must itself not be an investment company. The finance subsidiary must also meet each of the following requirements:

- the primary purpose of the subsidiary must be to finance the business operations of its parent company (or parent-controlled companies);
- any publicly held debt securities and non-voting preferred stock of the subsidiary must be unconditionally guaranteed by the parent company, and that guaranty must give guaranteed security holders the right to institute legal proceedings directly against the parent company to enforce the guaranty without first proceeding against the subsidiary in the event of default in payment;[43]
- all convertible or exchangeable securities of the subsidiary must be convertible or exchangeable only for (1) securities issued by the parent company or (2) guaranteed debt securities or non-voting preferred stock of the subsidiary meeting the requirements set out in the bullet point above;
- the finance subsidiary must invest in or loan to its parent company (or parent-controlled company) 85% of any cash or cash equivalents raised by the subsidiary through an offering of debt securities, non-voting preferred stock, or other borrowings "as soon as practicable" and in any event not later than six months after the subsidiary receives those funds; and
- the subsidiary must not invest, reinvest, own, hold, or trade in securities other than (1) US Government securities,[44] (2) securities of its parent company (or a parent-controlled company) or (3) certain commercial paper exempt from registration under the Securities Act.

> PRACTICE POINT
>
> Rule 3a-5 covers only commercial paper that is exempt from registration under Section 3(a)(3) of the Securities Act. A finance subsidiary accordingly may not hold commercial paper issued under other exemptions from Securities Act registration, such as Section 4(a)(2).

Research and Development Companies – Rule 3a-8

Rule 3a-8 is a safe harbor from investment company status for *bona fide* R&D companies. In particular, under the rule, an issuer is not an investment company if:

- its "research and development expenses" (as defined in ASC 730) for the last four fiscal quarters combined, are a "substantial percentage"[45] of its total expenses for the same period;
- its net income derived from investments in securities, for the last four fiscal quarters combined, does not exceed twice the amount of its research and development expenses for the same period;
- its expenses for investment advisory and management activities, investment research and custody, for the last four fiscal quarters combined, do not exceed 5% of its total expenses for the same period;
- its investments in securities are "capital preservation investments" – i.e., an investment made to conserve capital and liquidity until the funds are used in the issuer's primary business – except that:
  - no more than 10% of its total assets may consist of other investments; or
  - no more than 25% of its total assets may consist of other investments, provided that at least 75% of those other investments are investments made pursuant to a collaborative research and development arrangement;
- it does not hold itself out as being primarily engaged in an investment business;
- it is primarily engaged, directly or through majority-owned subsidiaries or companies it primarily controls, in a non-investment business (based on certain indicia); and
- its board of directors has adopted a written investment policy with respect to its capital preservation investment.

Exclusions and Exemptions Based on Transaction Structure

100 Holders – Section 3(c)(1)

Section 3(c)(1) – often referred to as the "100-holder exclusion" – provides an exclusion from the definition of investment company for any issuer "whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons (or, in the case of a qualifying venture capital fund,[46] 250 persons) and which is not making and does not presently propose to make a public offering of its securities."[47] Section 3(c)(1)'s prohibition on public offerings means that an issuer cannot register its securities with the SEC for sale in the United States.

The SEC Staff has taken the position that, as a general matter, a foreign private issuer relying on Section 3(c)(1) must limit only the initial US purchasers of securities (and their subsequent US transferees) to 100 beneficial owners, and is not required to limit the number of non-US offerees or to take steps to prevent US persons from acquiring securities in valid secondary market transactions offshore (provided certain requirements are met).[48] To take advantage of Section 3(c)(1), a foreign private issuer accordingly should issue securities only to US investors who provide certifications (in investor letters) as to the number of beneficial

owners of their securities, and must require similar certifications to be made in connection with subsequent transfers by US investors.

Qualified Purchasers – Section 3(c)(7)

Section 3(c)(7) of the Act (sometimes referred to as the QP exclusion) provides an exclusion from the definition of investment company for any issuer "the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities."

Section 3(c)(7) requires investors to be "qualified purchasers" at the time of acquisition of the issuer's securities. Unlike the Section 3(c)(1) exclusion, Section 3(c)(7) does not limit the number of investors so long as all investors are qualified purchasers (including investors in the issuer's short-term paper). But the requirement that the Section 3(c)(7) entity's securities be held only by qualified purchasers lasts for the life of the issuer. This generally means that, as in Section 3(c)(1) transactions, investor letters must be obtained from the initial purchasers of securities and transfer restrictions must be put in place to limit secondary market sales to qualified purchasers.

The term "qualified purchaser" includes:

- any natural person who owns not less than $5 million in investments;[49]
- any company that owns not less than $5 million in investments and is owned by two or more natural persons related to each other as family members;
- any trust that was not formed for the specific purpose of acquiring the securities offered as to which the trustee and each settlor is a qualified purchaser; and
- any person acting for its own account or the accounts of other qualified purchasers, who own and invest on a discretionary basis at least $25 million in investments.[50]

The SEC Staff has interpreted Section 3(c)(7) in a similar manner to Section 3(c)(1). Accordingly, foreign private issuers can generally conduct simultaneous offshore public offerings and private offerings in the United States so long as initial US purchasers of securities (and their subsequent US transferees) are qualified purchasers.[51]

Exemptive Orders

The SEC has authority (for example, pursuant to Section 6(c)) to exempt companies and transactions from the Investment Company Act. Accordingly, a foreign private issuer that is unable to take advantage of one of the exclusions or exemptions under the Investment Company Act can consider applying to the SEC for an exemptive order.

An application for an exemptive order typically involves a detailed written submission to the Staff of the Division of Investment Management of the SEC. Depending on the complexity of the relief sought, the process will generally take anywhere from six months to one year or more.

ENDNOTES

1 *See* Investment Company Act Section 17.

2 *See* Investment Company Act Sections 17, 31, and 38 and related Investment Company Act rules.

3 *See* Investment Company Act Section 18. Business development companies, a type of pooled investment vehicle regulated under the Investment Company Act, are subject to more flexible leverage requirements subject to certain regulatory requirements.

4 *See* Investment Company Act Sections 8 and 13.

5 *See* Investment Company Act Section 9.

6 *See* Investment Company Act Section 10. Certain investment companies that elect to be regulated as business development companies can be internally managed and do not have to hire a third-party investment manager.

7 *See* Investment Company Act Sections 10 and 15.

8 *See* Investment Company Act Section 30.

9 *See* Investment Company Act Section 13.

10 To the extent provided by US Treasury Department regulations, the exclusion from the publicly traded partnership rules will still apply to such a partnership if a principal activity of that partnership is the buying and selling of commodities (other than stock in trade or similar property described in section 1221(a)(1) of the Code), or options, futures, or forwards with respect to commodities.

11 "Government securities" are defined in Section 2(a)(16) to include "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by Congress" or a certificate of deposit for any of the foregoing.

12 *See* Section 2(a)(36) (defining "security") and Section 3(a)(2) (defining "investment securities" as all "securities" with certain exceptions).

13 An "employees' securities company" is an investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned (a) by the employees or persons on retainer of a single employer or of two or more employers each of which is an affiliated company of the other; (b) by former employees of such employer or employers; (c) by members of the immediate family of such employees, persons on retainer, or former employees; (d) by any two or more of the foregoing classes of persons; or (e) by such employer or employers together with any one or more of the foregoing classes of persons. *See* Section 2(a)(13).

14 Securities issued by a majority-owned subsidiary that is not an investment company by virtue of the statutory exclusion provided by Section 3(c)(1) or Section 3(c)(7) would nevertheless be considered investment securities. *See* Section 3(a)(2)(C)(ii). A "majority-owned subsidiary" of a person means "a company 50 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a majority-owned subsidiary of such person." *See* Section 2(a)(24).

15 Section 2(a)(41). The definition of value contained in Section 2(a)(41), read literally, refers to "registered investment companies." *But see SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3, 27 n.13 (S.D.N.Y. 1968), *aff'd*, 435 F.2d 510 (2d Cir. 1970), stating that value in Section 2(a)(41) also applies to companies which are not registered under the Act.

16 *Willkie Farr & Gallagher*, SEC Staff No-Action Letter (Oct. 23, 2000) [*Willkie Farr*].

17 *See id.*

18 *See Proposed Rule: Certain Prima Facie Investment Companies*, Release No. IC-10937, n.4 (Nov. 13, 1979) [*Rule 3a-1 Proposing Release*] ("Whether certificates of deposit are to be considered cash items or investment securities, for purposes of determining whether an issuer holding them is an investment company under [Section 3(a)(1)(c)], depends on the purpose for which such interests are held, the circumstances under which they were acquired, the length of the period for which they are held, the amount held in comparison with the company's other assets, and any other 'special circumstances.' … For example, certificates of deposit purchased as an integral part of an operating business – such as during a transition between lines of business or as a result of seasonal liquidity requirements – may be treated as cash items. When it cannot be shown conclusively that the operating business requires substantial liquid assets, however, such deposits may be considered investment securities for purposes of [Section 3(a)[(1)(c)].").

19 The SEC has stated that time deposits "typically would not be considered cash items absent convincing evidence of no investment intent." *Rule 3a-1 Proposing Release*, n.29.

20 *See Willkie Farr*.

21 The exclusion for securities of majority-owned subsidiaries in the definition of Rule 3a-1 Investment Securities varies slightly from the comparable exclusion for purposes of the 40% Test. Rule 3a-1(b) provides that the definition of Rule 3a-1 Investment Securities includes securities of a majority-owned subsidiary if, among other things, that subsidiary is excluded from the definition of an investment company under Section 3(c)(1). By contrast, under the 40% Test, securities of a majority-owned subsidiary that is not an investment company by virtue of Section 3(c)(1) are counted as investment securities. Section 3(a)(2)(C)(ii).

22 Rule 3a-1(a)(4). The SEC Staff has stated that "a company is not 'controlled primarily' by an issuer within the meaning of the rule unless (1) the issuer has control over the company within the meaning of [Section 2(a)(9)] and (2) the degree of the issuer's control is greater than that of any other person." *Health Communications Services, Inc.*, SEC Staff No-Action Letter (Apr. 26, 1985). Section 2(a)(9), in turn, provides that "control" is assumed if 25% or more of the subsidiary's outstanding voting securities are held by the issuer.

23 *Final Rule: Certain Prima Facie Investment Companies*, Release No. IC-11551 (Jan. 14, 1981).

24 *DRX, Inc.*, SEC Staff No-Action Letter (Jan. 28, 1988) [*DRX*].

25 *Id*. The SEC Staff recognized in DRX that not all expenses can be clearly earmarked as investment or operating, and that some "reasonable method of allocation" must be used.

26 Section 2(a)(9) defines "control" as the power "to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." Section 2(a)(9) also provides that a person who owns more than 25% of a company's outstanding voting securities is presumed to control that company. In order to qualify for a Section 3(b)(2)(B) exclusion, any controlled company must be involved in a similar type of business as the issuer. Section 3(b)(2)(B).

27 *Proposed Rule: Certain Research and Development Companies*, Release No. IC-19566 (Jul. 8, 1993).

28 *Id*.

29 *Id*.

30 26 S.E.C. 426 (1947) [*Tonopah*].

31 *Final Rule: Certain Research and Development Companies*, Release No. IC-26077, text at n.10 (June 16, 2003) [*Rule 3a-8 Adopting Release*].

32 *See* Section 2(a)(36) (defining "security") and Section 3(a)(2) (defining "investment securities" as all "securities" with certain exceptions).

33 *See* Rule 3a-1 Proposing Release.

34 *Id*. n.17.

35 *Compact Video, Inc.*, SEC Staff No-Action Letter (Apr. 13, 1998).

36 *ICOS Corp.: Order Granting Exemption*, Investment Company Act Release No. 19,334 (Mar. 16, 1993), 58 Fed. Reg. 15,392, at 15,393 (Mar. 22, 1993).

37 *Cf. Charterhouse Tilney*, SEC Staff No-Action Letter (July 15, 1993) (although the SEC Staff has taken the position that the exclusion of broker-dealers from the definition of investment advisers in Section 202(a)(11)(C) of the US Investment Advisers Act of 1940 is meant to apply solely to SEC-registered broker-dealers, the Staff has extended the exclusion to non-US broker-dealers if resulting transactions with US investors are conducted in accordance with the exemption from broker-dealer registration provided by Exchange Act Rule 15a-6) [*Charterhouse Tilney*].

38 Rule 3a-6(b)(1)(ii)(B).

39 An issuer that holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities may not take advantage of Rule 3a-2. *Final Rule: Transient Investment Companies*, Release No. IC-11552, at n.9 (Jan. 14, 1981).

40 *Id*.

41 *Id*. at n.7.

42 *Cooper Development Company*, SEC Staff No-Action Letter (Dec. 12, 1988).

43 Rule 3a-5(a)(1)-(3). The defaults to be covered in the parent guaranty include (1) in the case of debt securities, defaults arising from failure to pay principal, interest, or premium and (2) in the case of non-voting preferred stock, defaults arising from failure to pay dividends, liquidation preference, and payments to be made under a sinking fund. Rule 3a-5(a)(1)-(2). Although the parent guaranty must be unconditional, it may be subordinated in right of payment to other debt of the parent company. *Id*. Note that where the parent company is a non-US bank, it may issue an irrevocable letter of credit in lieu of a guaranty, subject to certain additional requirements. Rule 3a-5(a)(7).

44 "Government securities" are defined in Section 2(a)(16).

45 The SEC deliberately left the term "substantial" undefined. *See Rule 3a-8 Adopting Release*, text at n.20 (Aug. 2003).

46 Under Section 3(c)(1)(C)(i), the term ''qualifying venture capital fund'' means a venture capital fund that has not more than $10,000,000 in aggregate capital contributions and uncalled committed capital, with such dollar amount to be indexed for inflation once every 5 years by the Commission, beginning from a measurement made by the Commission on a date selected by the Commission, rounded to the nearest $1,000,000. The term "qualifying venture capital fund" has the meaning given the term in Rule 203(l)-1 under the Investment Advisers Act of 1940. On August 21, 2024, the Securities and Exchange Commission updated the dollar threshold for a fund to qualify as a "qualifying venture capital fund" to $12 million in aggregate capital contributions and uncalled committed capital, up from the original threshold of $10 million.

47 Beneficial ownership by a company is deemed to be beneficial ownership by one person except that, if the company owns more than 10% of the issuer's outstanding voting securities and would be an investment company but for the exclusion of Section 3(c)(1) or 3(c)(7), beneficial ownership is deemed to be that of all of the holders of the company's securities. Section 3(c)(1)(A).

48 *Investment Funds Institute of Canada*, SEC Staff No-Action Letter (Mar. 4, 1996) [IFIC], interpreting *Touche Remnant & Co.*, SEC Staff No-Action Letter (Aug. 27, 1984). The requirements of *IFIC* include that the non-US issuer has not made a public offering of securities in the United States; that the non-US issuer (or persons acting on its behalf) has not engaged in "directed selling efforts" or other attempts to condition the market for the securities in the United States, and has not taken steps to facilitate secondary market trading in the United States (e.g., listing its securities in the United States, arranging for dealers to make a secondary market in the United States, or creating an ADR facility); the non-US issuer has not directly or indirectly sold securities offshore to US residents; and the non-US issuer's activities with respect to its securities holders are limited. *IFIC*.

49 The term "investments" is defined in Rule 2a51-1.

50 Section 2(a)(51)(A).

51 *Goodwin, Procter & Hoar*, SEC Staff No-Action Letter (Feb. 28, 1997).

CHAPTER 16

US Sanctions and Financial Compliance Framework

Foreign Corrupt Practices Act

The US Foreign Corrupt Practices Act (FCPA) potentially applies to foreign private issuers in several different ways.[1] There is a key distinction in this context between reporting foreign private issuers on the one hand – i.e., foreign private issuers that have registered a transaction with the SEC under the Securities Act or a class of securities under the Exchange Act and accordingly have an Exchange Act reporting obligation under Exchange Act Section 13(a) or 15(d) – and non-reporting foreign private issuers. A reporting foreign private issuer would include an NYSE- or Nasdaq-listed foreign private issuer, while a foreign private issuer that has only issued Rule 144A bonds in the United States or whose ADRs were traded only over the counter in the United States would typically be a non-reporting foreign private issuer.

- A reporting foreign private issuer is subject to:
  - the FCPA's books-and-records provisions, which require the issuer to maintain and keep books, records, and accounts that "accurately and fairly reflect" the transactions and dispositions of assets of the foreign private issuer, and design and maintain "a system of adequate internal accounting controls;"[2] and
  - the FCPA's limitations on corrupt payments to foreign officials, foreign political parties, or their intermediaries.[3]
- A *non-reporting foreign private issuer* is not subject to either the FCPA's books-and-records or its internal controls provisions. A foreign private issuer may, however, be subject to the FCPA's anti-bribery provision. The FCPA's anti-bribery provision, which is codified outside the securities laws, applies to US "domestic concerns."[4] That term covers any US citizen, national, or resident, or any entity (such as a corporation or a partnership) that has its principal place of business in the United States or which is organized under the laws of a US state or territory.[5] So, a foreign private issuer's subsidiaries that are domestic concerns, or its US officers or directors, would be subject to the anti-bribery aspects of the FCPA. In addition, the FCPA's anti-bribery provision applies to entities, individuals, and conduct located within the jurisdiction of the United States. Historically, this concept has been interpreted broadly. As a result, foreign entities and their personnel can both be subject to the FCPA's anti-bribery provisions if they engage in conduct within the US (including through use of US banks or internet servers) in furtherance of an offer, promise, authorization, or provision of anything of a value to a foreign official in order to corruptly obtain or retain a business advantage.

OFAC; US Sanctions; Outbound Investment Rules

The US Treasury Department's Office of Foreign Assets Control (OFAC) administers and enforces a range of comprehensive and targeted economic and trade sanctions programs. OFAC maintains country- or territory-wide sanctions programs against Cuba, Iran, North Korea, Syria, the Crimea region of Ukraine, the so-called Donetsk People's Republic, and the so-called Luhansk People's Republic (commonly referred to as "embargoes").

On May 23, 2025, OFAC issued General License 25 (GL 25), which effectively suspends most OFAC sanctions targeting Syria. That said, OFAC's Syria sanctions program technically remains in place, and GL 25 could be revoked at the discretion of the President. In addition, GL 25 does not impact long-standing export control prohibitions administered by the Department of Commerce (discussed below) on the export or reexport to Syria of almost all US-regulated items.

In addition to comprehensive embargoes, OFAC administers targeted sanctions against certain parties involved in illicit activities, such as weapons proliferation, international terrorism, narcotics trafficking, and other activities that undermine US national security or US foreign policy objectives. These parties are identified on the Treasury Department's list of Specially Designated Nationals and Blocked Persons, or "SDN List," which is available on the OFAC website. OFAC takes the position that any entity owned in the aggregate, directly or indirectly, 50% or more by one or more blocked persons is itself considered a blocked person by operation of law, and the property and interests in property of such an entity are blocked, even if the entity itself is not identified on the SDN list.

OFAC has imposed extensive sanctions in connection with certain countries not subject to a comprehensive embargo, including Russia, Belarus, Myanmar, Afghanistan, and Venezuela, including by adding individuals and entities associated with each country and its government to the SDN List, and imposing certain other sanctions. For instance, the Government of Venezuela – defined broadly to include "any political subdivision, agency, or instrumentality thereof," all state-owned or state-controlled entities, as well as any person acting for or on behalf of the Maduro regime – is the target of US sanctions.

With respect to Russia and Belarus, OFAC and the White House, in coordination with the European Union, the United Kingdom, and other allies, have imposed a series of significant sanctions and export controls following Russia's invasion of Ukraine in February 2022. These include a prohibition on the importation into the United States of certain oil, gas, coal, gold, aluminum, copper, nickel, diamond, and fish and seafood products of Russian Federation origin; restrictions on dealings in Russia's sovereign debt; restrictions on providing accounting, trust and corporate formation, management consulting, architecture and engineering, and information technology and software services to persons in Russia; and other debt and equity restrictions with respect to certain listed Russian entities. The United States, as part of an international coalition, has implemented a "price cap policy" that prohibits a broad range of services relating to the maritime transport of crude oil and petroleum products of Russian Federation origin unless such crude oil or petroleum products are purchased at or below a specified price cap. The covered services include trading/commodities brokering, financing, shipping, insurance, flagging, and customs brokering. OFAC and the US Department of State have also added a significant number of persons to the SDN list, including major Russian (and Belarussian) banks, government entities, natural resources companies, and political elites, as well as third-country entities for having materially assisted, sponsored, or provided financial, material, or technological support for, or goods or services to or in support of an SDN.

Executive Order 14071 (April 6, 2022) prohibited "new investment" in Russia by US persons. According to a series of "Frequently Asked Questions" (FAQs) issued by OFAC on June 6, 2022, regarding this investment prohibition, "investment" in this context means "the commitment of capital or other assets for the purpose of generating returns or appreciation."[6] In this guidance, OFAC explains that it would generally consider a prohibited "new investment" by a US person to include, among other things: (1) the purchase or acquisition of real estate in Russia, other than for noncommercial, personal use; (2) the purchase of an equity interest in an entity located in Russia; and (3) the lending of funds to persons located in Russian for commercial purposes, including when such funds are intended to be used to fund a new or expanded project or operations in Russian. According to OFAC FAQ 1055[7] OFAC would not regard the purchase by a US person of a debt or equity interest in an entity located outside of the Russian Federation as a "new investment" in Russia if (i) such funds are "not specifically intended for new projects or operations in the Russian Federation and (ii) the entity derives less than 50% of revenues from its investments in the Russian Federation. The FAQs also confirm that the new investment ban does not, as a general matter, prohibit divestment of Russian investments or maintenance of pre-existing Russian investments. US persons whose divestment of assets in Russia involve a payment of an "exit tax" imposed by the Government of the Russian Federation, however, need to seek a specific license from OFAC prior to the payment of such tax. FAQ 1118, updated on May 19, 2023, indicates that OFAC will expedite its review of such requests for authorization.[8]

The US Department of Commerce's Bureau of Industry and Security (BIS) has also implemented stringent sanctions under the Export Control Regulations and refinements to existing controls designed to "impose powerful and coordinated restrictions on Russia."[9] BIS has expanded restrictions on the export, reexport, or transfer (in-country) of certain EAR99 items to or within Russia or Belarus and added a significant number of entities to its Entity List due to their activities in support of Russia's defense industrial sector and war effort. The US Departments of Commerce and Justice also announced the launch of the Disruptive Technology Strike Force, designed to target illicit actors, strengthen supply chains, and protect critical technological assets from being acquired or used by nation-state adversaries.[10]

The enhanced Russia-related sanctions program follows previous escalations of sanctions dating, in primary part, back to 2014, which, among other restrictions, imposed so-called "sectoral" sanctions on certain entities that operate in the finance, energy, and defense sectors of the Russian economy. As with its more recent actions, the United States imposed these measures in conjunction with comparable sanctions maintained by the European Union and other governments in response to events in Ukraine in early 2014. Such entities are identified on OFAC's Sectoral Sanctions Identifications (SSI) list, which is also available on the OFAC website. US persons are prohibited from participating in or supporting specified types of financial transactions (relating to debt and, in some cases, equity) or certain energy-related projects involving SSI-listed parties. These restrictions also extend to entities that are owned 50% or more by entities on the SSI list.

With respect to China, the United States has enacted trade restrictions targeted at the human rights abuses occurring in Xinjiang, the political crisis in Hong Kong, and other US interests, such as protecting semiconductor manufacturing equipment, advanced computing chips, communications networks, sensitive personal data, and trade relations. The Uyghur Forced Labor Prevention Act establishes an effective ban on imports from the Xinjiang Uyghur Autonomous Region by creating a rebuttable presumption that the importation of any goods originating in whole or part from that region, or produced by certain entities, is prohibited by Section 307 of the Tariff Act of 1930.[11] Executive Order 14032 (June 3, 2021) prohibits US persons from engaging in the purchase or sale of publicly traded securities of companies designated as Chinese Military-Industrial Complex Companies (CMICs) or any publicly traded securities that are derivative of such securities or are designed to provide investment exposure to such securities.

All of the OFAC-administered sanctions programs apply to the conduct of US persons. For these purposes, the term "US person" includes:

- all US legal entities and and their foreign branches (including their employees wherever located and regardless of nationality);
- all US citizens and US lawful permanent residents (i.e., so-called "Green Card" holders), wherever located or employed; and
- any individual or entity located in the United States (regardless of nationality or duration of time in the United States).

Note that the OFAC sanctions programs against Cuba and Iran are broader, in that they apply to "US persons" as well as to foreign-incorporated entities that are "owned or controlled" by a US person (i.e., foreign subsidiaries of US corporations).

OFAC sanctions are strictly enforced, and the consequences for violations can be significant and include both criminal and civil penalties. For most sanctions programs, criminal violations, which must be premised on a showing of willfulness, may be punished by fines of up to $1,000,000 per violation plus up to 20 years' imprisonment. Most civil violations of the OFAC sanctions program do not require a showing of intent or knowledge, and are punishable by penalties of up to $377,700 per violation or twice the value of the transaction, whichever is greater.

Finally, the US government also maintains so-called "secondary" sanctions. While the "primary" sanctions described above apply to the activities of US persons, secondary sanctions are designed to deter and penalize certain activities of non-US persons where there is no jurisdictional nexus to the United States. Under present law, the United States can impose secondary sanctions on non-US persons that engage in certain categories of activities or transactions involving Iran, Syria, North Korea, sanctioned Russian parties, or certain sectors of the Venezuelan economy (currently, the gold, oil, financial, and defense and security sectors). The US Department of State, as well as OFAC, typically play a role in administering secondary sanctions programs. Penalties under secondary sanctions can take various forms, but they generally focus on denying certain privileges of conducting business in the United States, such as access to the US financial system, government procurement, and export licensing. Secondary sanctions can also include the designation of offending non-US persons on the OFAC SDN list.

Separate and apart from US primary and secondary sanctions, SEC-reporting companies are also subject to SEC reporting requirements relating to certain activities, including activities of affiliates, with certain Iranian (and other) entities under Exchange Act Section 13(r).[12] The Exchange Act requires issuers to disclose any transactions or dealings (regardless of materiality) that the issuer or its affiliates have knowingly conducted during the relevant reporting period with the Government of Iran (other than transactions or dealings conducted with authorization "of a US Federal department or agency" or with certain parties on the SDN List (i.e., those designated under certain sanctions programs related to weapons proliferation and terrorism).

Outbound Investment Security Program

On October 28, 2024, the US Department of the Treasury issued final regulations (Outbound Investment Rules)[13] to implement Executive Order 14105, "Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern" (August 9, 2023),[14] and address the national security threat posed by certain US investments that may accelerate the development of sensitive technologies and products in "countries of concern," currently defined as China and the Special Administrative Regions of Hong Kong and Macau. These Outbound Investment Rules became effective on January 2, 2025.

The Outbound Investment Rules prohibit or require notification by "US persons" of certain investments in a "covered foreign person," which includes entities with a connection to a country of concern that are engaged in, or associated with parties engaged in, activities involving semiconductors and microelectronics, quantum information technologies, or artificial intelligence (AI).

Violations of the Outbound Investment Rules may result in civil penalties of up to $377,700 per violation (adjusted annually for inflation) or twice the value of the transaction, whichever is greater; or a criminal fine up to $1 million, a prison sentence of up to 20 years, or both, for willful violations. The US Department of the Treasury may also compel the divestment of a prohibited transaction.

Anti-Money Laundering; PATRIOT Act

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, or PATRIOT Act,[15] was adopted by the United States Federal government in part to combat activities such as money laundering and terrorist financing that are conducted through banking channels and other parts of the financial system. The PATRIOT Act amended[16] another federal statute called the Bank Secrecy Act.[17] Generally, the PATRIOT Act amendments to the Bank Secrecy Act are applicable to financial institutions[18] that are located in or have operations within the United States. Among other things, the Bank Secrecy Act (as amended by the PATRIOT Act) requires US financial institutions and foreign financial institutions that conduct business in the United States to have appropriate anti-money laundering, or AML, compliance programs in place. The PATRIOT Act also enhances the provisions of the Bank Secrecy Act by requiring financial institutions:

- to have appropriate risk-based customer identification programs;
- to not engage in business with foreign shell banks;
- to enhance their due diligence procedures concerning types of accounts, including foreign correspondent and private banking accounts; and
- to report certain information to the US government (for example, certain transactions over $10,000 and suspicious activity that might signify money laundering, tax evasion, or other criminal activities).

In general, a non-US company that is not a financial institution with a presence in the US is not subject to the requirements of the AML provisions of the PATRIOT Act. However, if such a non-US company establishes an account with or engages in transactions with any financial institution in the United States that is subject to the Bank Secrecy Act (as amended by the PATRIOT Act), then such company will be required to provide information to the financial institution that the financial institution determines is necessary for it to comply with its customer identification, due diligence, and other obligations under the Bank Secrecy Act. In addition, if such a non-US company has an account with a foreign financial institution that maintains a correspondent account with a US bank, the US Departments of Justice and the Treasury have the power to compel the production of certain records from the foreign bank, even if located outside of the United States. The Anti-Money Laundering Act of 2020 (AML Act) expanded this authority by allowing the government to access records related to any account at the foreign bank if the records are the subject of an investigation of a criminal violation of US law, a violation of the Bank Secrecy Act, or a civil forfeiture action.[19]

The AML Act will also require many US companies — including certain foreign companies registered to do business in the United States — to report to the US government certain beneficial ownership information. Specifically, covered companies will be required to submit such information to the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), which will be responsible for creating and maintaining a database to house information on beneficial ownership. The AML Act defines beneficial owners to include any individual who, directly or indirectly, either exercises "substantial control" over a reporting company or owns or controls not less than 25% of the ownership interests of a reporting company.

ENDNOTES

1 On June 9. 2025, Deputy Attorney General Todd Blanche issued a memorandum on "Guidelines for Investigations and Enforcement of the Foreign Corrupt Practices Act (FCPA) by the U.S. Department of Justice" (the Guidelines). The Guidelines follow President Trump's February 10, 2025 executive order directing DOJ to, among other things, cease initiation of any new FCPA investigations unless the Attorney General determines that an individual exception should be made. In a statement announcing the Guidelines, Deputy Attorney General Blanche indicated that the aim of the Guidelines was to ensure that enforcement efforts "advance American interests" by "shifting prosecutorial resources to cases that clearly implicate U.S. national security and competitiveness." Adding further perspective, the Head of DOJ's Criminal Division, Matthew Galeotti, stated on May 12, 2025, that DOJ's Criminal Division views corporate enforcement as a priority and will continue to "vigorously pursue" white collar investigations. Exactly how the Guideline will be implemented, and the extent to which future enforcement will depart from the past, remains to be seen. It is also unclear what impact, if any, the Guidelines will have on the SEC's enforcement of the FCPA. The FCPA remains a lawful statute, which has a 5-year statute of limitations, and which can only be repealed by the US Congress. In addition, many foreign governments have anti-bribery laws. Companies should carefully monitor their anti-bribery compliance to avoid violating other international laws.

2 Exchange Act Sections 13(b)(2)-(7); Exchange Act Regulation 13B 2; *see also* Exchange Act Rules 13a-15(a), 15d-15(a) (reporting issuer must maintain "internal control over financial reporting").

3 Exchange Act Section 30A. In addition, any "domestic concern" whether or not registered with the SEC is subject to substantially identical anti-bribery provisions. 15 U.S.C. § 78dd-2(a). A domestic concern for these purposes means any US citizen, national, or resident, or any entity (such as a corporation or a partnership) that has its principal place of business in the United States or which is organized under the laws of a US state or territory. 15 U.S.C. § 78dd-2(h)(1).

4 *See* 15 U.S.C. § 78dd-2(a).

5 *See* 15 U.S.C. § 78dd-2(h)(1).

6 *See* FAQ 1049, https://home.treasury.gov/policy-issues/financial-sanctions/faqs/1049.

7 *See* FAQ 1055, https://ofac.treasury.gov/faqs/1055.

8 *See* FAQ 1118, https://ofac.treasury.gov/faqs/1118.

9 *See* https://www.bis.doc.gov/index.php/documents/about-bis/newsroom/press-releases/3273-2023-05-19-bis-press-release-russia-rules-and-joint-bis-fincen-alert/file.

10 *See* https://www.justice.gov/opa/pr/justice-and-commerce-departments-announce-creation-disruptive-technology-strike-force.

11 Pub. L. 117-78.

12 15 U.S.C. § 78m.

13 *See* 89 Fed. Reg. 90398.

14 *See* https://www.federalregister.gov/documents/2023/08/11/2023-17449/addressing-united-states-investments-in-certain-national-security-technologies-and-products-in.

15 Pub. L. 107-56.

16 Title III of the PATRIOT Act is the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001.

17 12 U.S.C. § 1829b, 12 U.S.C. §§ 1951-1960, 31 U.S.C. §§ 5311-5314, 5316-5336.

18 Defined in 31 U.S.C. § 5312, "financial institution" includes banking organizations (including commercial banks, trust companies, savings banks, savings and loan associations, credit unions, private banks, and US branches and agencies of foreign banks), and a wide range of other types of entities that engage in financial activities, including broker-dealers, insurance companies, and investment companies.

19 Pub. L. 116-283.

ANNEX A

NYSE Quantitative Listing Criteria and Corporate Governance Standards

The NYSE's requirements for initial listing and listing maintenance are set out below. Foreign private issuers may satisfy either the general NYSE listing standards applicable to domestic US issuers or the NYSE's Alternate Listing Standards for foreign private issuers. They apply only to foreign private issuers with a broad, liquid market for their securities in their country of origin.[1]

Quantitative Initial Listing Standards[2]

Under the NYSE initial listing standards, an issuer typically must meet the following minimum distribution and market value criteria[3] and must also meet one of the two financial standards described below.[4]

Minimum Distribution Requirements

- *IPOs*: An IPO issuer must have 400 holders of 100 shares or more[5] and 1.1 million publicly held shares.[6]
- *Transfer or quotation*: An issuer seeking to transfer to the NYSE or list its existing securities on the NYSE must have either:
  - 400 holders of 100 shares or more;[7] or
  - 2,200 total stockholders, together with average monthly trading volume of 100,000 shares for the most recent six months;[8] or
  - 500 total stockholders, together with average monthly trading volume of 1 million shares for the most recent 12 months and 1.1 million publicly held shares.[9]

Market Value of Publicly Held Shares

The aggregate market value of publicly held shares must be at least $40 million for IPO issuers[10] or $100 million for issuers seeking to transfer to the NYSE or list their existing securities.[11] In addition, a company must have a closing price or, if listing in connection with an IPO, an IPO price per share of at least $4 at the time of initial listing.

Financial Standards

A company seeking to list must meet the requirements of either the Earnings Test or the Global Market Capitalization Test:

- *Earnings Test*: An issuer's pre-tax earnings (from continuing operations and after minority interest, amortization, and equity in the earnings or losses of investees, subject to certain adjustments) must total:
  - at least $10 million in the aggregate for the last three fiscal years including a minimum of $2 million in each of the two most recent fiscal years and positive amounts in all three years;
  - at least $12 million in the aggregate for the last three fiscal years together with a minimum of $5 million in the most recent fiscal year and $2 million in the next most recent fiscal year;[12] or

- if the issuer is an EGC[13] and it avails itself of the Securities Act and Exchange Act provisions permitting EGCs to report only two years of financial statements, it may meet the final prong of this test if it has at least $10 million in aggregate pre-tax earnings for the last two years with at least $2 million in both years.

- *Global Market Capitalization Test*: An issuer must have at least $200 million in global market capitalization.[14]

Alternate Listing Standards for Foreign Private Issuers Only

The NYSE provides Alternate Listing Standards for foreign private issuers that do not list under the standards listed for domestic issuers listed above. These alternative minimum distribution, market value criteria, and financial standards are described below.[15]

FPI Minimum Distribution Requirements

A foreign private issuer must have:

- 5,000 worldwide holders of 100 shares or more; and
- 2.5 million shares held publicly worldwide.[16]

FPI Market Value of Publicly Held Shares

The aggregate worldwide market value of publicly held shares of the foreign private issuer must be at least $100 million. In addition, an issuer must have a closing price or, if listing in connection with an IPO, an IPO price per share of at least $4 at the time of listing.

Financial Standards

A foreign private issuer seeking to list must satisfy the requirements of either the Earnings Test or the Valuation/Revenue Tests:

- *Earnings Test:*
  - The pre-tax earnings (from continuing operations and after minority interest, amortization, and equity in the earnings or losses of investees, subject to certain adjustments) of the foreign private issuer must be at least $100 million in the aggregate for the last three fiscal years, including a minimum of $25 million in each of the most recent two fiscal years;[17] or
  - If the issuer is an EGC and it avails itself of the Securities Act and Exchange Act provisions permitting EGCs to report only two years of financial statements, it may meet the final prong of this test if it has at least $100 million in aggregate pre-tax earnings for the last two years with at least $25 million in each year.
- *Valuation/Revenue Tests:*
  - *Valuation/Revenue with Cash Flow Test:*[18]
    - At least $500 million in global market capitalization, at least $100 million in revenues during the most recent 12-month period, and $100 million in the aggregate cash flows for the last three fiscal years, including $25 million in each of the two most recent fiscal years (subject to certain adjustments); or
    - If the issuer is an EGC and it avails itself of the Securities Act and Exchange Act provisions permitting EGCs to report only two years of financial statements, it may meet the final prong of this test if it has at least $100 million aggregate cash flows in the last two fiscal years with at least $25 million in each year.

– *Pure Valuation/Revenue Test:*[19]

  - At least $750 million in global market capitalization and $75 million in revenues during the most recent fiscal year.

Quantitative Maintenance Requirements

To maintain its listing on the NYSE, a domestic US issuer or foreign private issuer must meet certain quantitative maintenance standards, which are summarized below.

Minimum Distribution Requirements

The NYSE may promptly initiate suspension and delisting procedures against an issuer if:

- the total number of stockholders is less than 400; or
- the total number of stockholders is less than 1,200 and the average monthly trading volume for the most recent 12 months is less than 100,000 shares; or
- the number of publicly held shares is less than 600,000.[20]

Minimum Financial Standards

The NYSE will consider an issuer to be below compliance (and so eligible for suspension and delisting) if an issuer's average global market capitalization over a consecutive 30 trading-day period is less than $50 million[21] and, at the same time, total stockholders' equity is less than $50 million. An issuer that falls below an average global market capitalization of $15 million over a consecutive 30 trading-day period will be subject to prompt suspension and delisting procedures.[22]

When determining an issuer's ability to meet the market capitalization test in any of the financial standard tests above, include the total number of outstanding shares of common stock (excluding treasury shares, if any) along with any shares of common stock issuable upon conversion of any other outstanding equity security. All such shares should be included in the calculation of market value so long as the security is the "substantial equivalent" of the issuer's common stock. All securities included in the calculation must be either publicly traded (or quoted) or convertible into a publicly traded (or quoted) security.

Price Criteria

An issuer will be considered to be below compliance standards and accordingly may be subject to suspension and delisting if the average closing price of its listed security is less than $1.00 over a consecutive 30 trading-day period. The NYSE will grant the issuer six months to cure the deficiency as long as the issuer (1) files a press release disclosing the deficiency within four days following notification; and (2) notifies the NYSE that it intends to return its share price and average share price to more than $1.00 within 10 business days following NYSE notification. A foreign private issuer has 30 days following notification to issue a press release disclosing that it has fallen below the continued listing standards. In the event that an issuer does not comply with the press release requirement, the NYSE will issue a press release noting the issuer's failure to meet the continued listing requirements. If, on the final trading day of any calendar month during the six-month cure period, the issuer's shares have a closing price of at least $1.00 and an average closing price of $1.00 over the prior 30 trading days, then the issuer will be deemed to be in compliance. However, if the six-month cure period expires without the securities meeting these requirements, then the NYSE will initiate the suspension and delisting of the securities.[23]

Other Maintenance Requirements

An issuer may also be subject to suspension and delisting on a number of additional grounds, including:

- a substantial reduction in operating assets and/or scope of operations;
- the failure of an issuer to make timely, adequate, and accurate disclosures of information to its shareholders and the investing public; and
- the failure to observe good accounting practices in reporting of earnings and financial position.[24]

NYSE Corporate Governance Requirements

In addition to the quantitative and maintenance listing standards detailed above, an issuer must meet certain corporate governance standards for an initial listing, with two key exceptions:

- *Foreign Private Issuers:* Foreign private issuers are permitted to follow home-country practice in lieu of the NYSE's corporate governance standards, other than the NYSE's requirements that it must: (1) have an audit committee that meets the requirements of Exchange Act Rule 10A-3; (2) provide prompt notification from its CEO of non-compliance with the applicable provisions of the NYSE's corporate governance rules, and (3) comply with the requirements regarding erroneously awarded compensation.[25] Whether a listed foreign private issuer follows the NYSE corporate governance standards or its home-country practice, it must disclose any ways in which its corporate governance practices differ from those followed by domestic US issuers under NYSE listing standards.[26]
- *Controlled Companies*: A "controlled company" is an issuer in which more than 50% of the voting power for the election of directors is held by an individual, a group, or another company. Master Limited Partnerships (MLPs) often qualify as controlled companies. A "controlled company" is not required to comply with the NYSE's requirements to have a majority of independent directors, a nominating/corporate governance committee, or a compensation committee.[27]

Majority of Independent Directors

A majority of the issuer's board of directors must consist of independent directors.[28] A director will qualify as independent only if the board affirmatively determines that the director does not have any material relationships with the company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company).[29] In making its determination, the board of directors must consider a candidate's commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships, among others. The NYSE notes that a director's stock ownership, even if significant, should not in and of itself negate a determination of independence.[30]

A director would not be independent if:

- currently or during the previous three years, either the director was an employee of the company or an immediate family member of the director was an executive officer of the company;[31]
- during any 12-month period within the last three years, the director (or any of the director's immediate family members) has received more than $120,000 in direct compensation from the company (other than in the form of director and committee fees, pension, or other forms of deferred compensation for prior service, provided such compensation is not contingent in any way on continued service);[32]
- (A) the director is a current partner or employee of a firm that is the company's internal or external auditor; (B) the director has an immediate family member who is a current partner of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and personally works on the

company's audit; or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the company's audit within that time;[33]

- the director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee;[34] or
- the director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues.[35]

An "immediate family member" is defined broadly to include a person's spouse, parents, children, and siblings, as well as mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone who shares that person's home (other than a domestic employee). "Listed company" or "company" for the purpose of determining independence includes any parent or subsidiary in a consolidated group with the company.[36]

Furthermore, with respect to service on the compensation committee, the board of directors must affirmatively conclude that the director is able to be independent from management after consideration of all relevant factors, including, but not limited to:[37]

- the director's compensation, including any consulting, advisory, or other compensatory fees paid by the listed company; and
- any affiliation between such director and the listed company, any of its subsidiaries, or any affiliates of its subsidiaries.

Executive Session

The listed company must hold regularly scheduled meetings of non-management directors without management present. Furthermore, a listed company that chooses to include all non-management directors at such meetings should also hold an executive session solely for independent directors at least once a year.[38]

Recovery of Erroneously Awarded Compensation ("Claw Back" Rules)

The listed company must adopt a written policy that provides for the reasonably prompt recovery of erroneously awarded incentive-based compensation received by executive officers and comply with the policy if the listed company is required to prepare an accounting restatement due to a material noncompliance by the listed company with any financial reporting requirement under the securities laws. This includes any such restatement required to correct any material errors in previously issued financial statements or errors that would result in a material misstatement if such errors were corrected in the current period or left uncorrected in the current period.[39]

Each listed company must also file disclosures with respect to such erroneously awarded compensation recovery policy as required by the federal securities laws and any applicable SEC rules.[40]

Nominating/Corporate Governance Committee

The listed company must have a fully independent nominating/corporate governance committee,[41] which is governed by a written charter that:

- addresses the committee's purpose and responsibilities, which must include identifying and selecting or recommending director nominees, developing, and recommending corporate governance principles, and overseeing the evaluation of the board and management;[42] and

- provides for an annual performance evaluation of the committee.[43]

The nominating/corporate governance committee charter should also address how the committee:

- qualifies its members;
- appoints and removes its members;
- is structured and operates (including the authority to delegate to subcommittees); and
- reports to the board.[44]

Finally, the committee charter should also specify that the committee has the sole authority over the retention and termination of any company engaged to identify director candidates, including the terms and fees relating to such search.

Compensation Committee

Companies must have a fully independent compensation committee,[45] which is governed by a written charter that:

- addresses its purpose and responsibilities, including, at a minimum, direct responsibility for:
  - setting corporate goals and objectives relevant to CEO compensation, evaluating CEO performance, and determining and approving CEO compensation levels in light of such evaluation;[46]
  - recommending compensation, incentive-compensation plans, and equity-based plans for non-CEO executives that are subject to board approval to the board;[47] and
  - producing a report on executive compensation as required by the SEC to be included in the company's annual proxy statement or annual report filed with the SEC;[48]
- provides for an annual performance evaluation of the compensation committee;[49] and
- sets forth the following rights and responsibilities with respect to the use of compensation consultants, legal counsel, or other advisers by the compensation committee:[50]
  - the ability, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, or other adviser upon consideration of all of the factors relevant to that person's independence from management, including the following:
    - any other services to be provided to the issuer by the employer of the compensation consultant, legal counsel, or other adviser;
    - any fees to be received from the issuer by the employer of the compensation consultant, legal counsel, or other adviser taken as a percentage of the total revenue of such employer;
    - the policies and procedures of the employer of the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest;
    - any business or personal relationships between any member of the compensation committee and the proposed compensation consultant, legal counsel, or other adviser;
    - whether such compensation consultant, legal counsel, or other adviser owns any stock of the listed company;

- any business or personal relationship of the compensation consultant, legal counsel, other adviser, or the person employing the adviser with an executive officer of the listed company;[51] and
- responsibility for the appointment, compensation, and oversight of the work of any such compensation consultant, independent legal counsel, or other adviser.[52] The listed company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to such compensation consultant, independent legal counsel, or other adviser.[53]

The compensation committee charter should also address committee member qualifications, committee member appointment and removal, committee structure and operations (including authority to delegate to subcommittees), and committee reporting to the board.[54]

Audit Committee

Composition

Companies must have an audit committee composed of at least three members that meet all of the NYSE independence requirements as well as the independence and other requirements of Exchange Act Rule 10A-3 (implementing Section 301 of Sarbanes-Oxley).[55] The NYSE does not mandate a minimum number of members for foreign private issuers.

The audit committee members must be "financially literate," and at least one member must have accounting or financial management expertise, as determined by the company's board based on its business judgment. For any audit committee member that serves on the audit committees of more than three public companies at the same time, the board must determine that such service would not impact such member's ability to serve effectively on its audit committee, and it must disclose its determination on or through the company's website or in the company's annual proxy statement or, if the company does not file an annual proxy statement, in its annual report filed with the SEC.[56]

Charter

The audit committee must have a written charter that addresses:

- the committee's purpose, which at a minimum must be to:
  - assist the board with oversight of: (1) the integrity of the company's financial statements; (2) the company's compliance with legal and regulatory requirements; (3) the independent auditor's qualifications and independence; and (4) the performance of the company's internal audit function and independent auditors;[57] and
  - prepare an audit committee statement as required by the SEC to be included in the company's annual proxy statement or annual report filed with the SEC;[59]
- an annual performance evaluation of the audit committee;[59] and
- the duties and responsibilities of the audit committee, which at a minimum must include those set out in Exchange Act Rule 10A-3(b)(2), (3), (4) and (5) (concerning responsibilities relating to: (1) registered public accounting firms; (2) complaints relating to accounting, internal accounting controls or auditing matters; (3) authority to engage advisers; and (4) funding as determined by the audit committee),[60] as well as to:
  - at least annually, obtain and review a report by the independent auditor describing: (1) the firm's internal quality-control procedures; (2) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by government or professional

bodies, within the preceding five years respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (3) all relationships between the independent auditor and the company (to assess the auditor's independence);[61]

- meet to review and discuss the company's annual audited financial statements;[62] quarterly unaudited financial statements with management and the independent auditor, including the company's MD&A disclosures;[63] earnings press releases;[64] financial information and earnings guidance provided to analysts and rating agencies;[65] and policies with respect to risk assessment and risk management;[66]
- meet separately, periodically, with management, with internal auditors and with independent auditors;[67]
- review with the independent auditors any audit problems or difficulties and management's response;[68]
- set clear hiring policies for employees or former employees of the independent auditors;[69] and
- report regularly to the board.[70]

Internal Audit

Companies must have an internal audit function that evaluates the company's risk management processes and internal control systems, and reports its findings to management and the audit committee. This function may be provided by a third party other than the company's independent auditor.[71]

Shareholder Meetings

Each fiscal year, a listed company must hold an annual meeting of its shareholders.[72]

Shareholder Approval of Certain Transactions

Shareholder approval is required for each of the following material transactions, with certain exceptions:

- the implementation of equity-compensation plans and material revisions thereto[73] (any sale of stock to an employee, director, or services provider is also subject to the equity compensation rules in Section 303A.08[74]);
- prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, in any transaction or series of related transactions to a related party (that is, directors, officers, or substantial security holders of the issuer) if such transaction is a cash sale for a price that is less than the Minimum Price,[75] and the number of shares of common stock to be issued, or if the number of shares of common stock into which the securities may be convertible or exercisable, exceeds either 1% of the number of shares of common stock or 1% of the voting power outstanding before the issuance.[76]
- prior to the issuance of common stock, or of securities convertible into or exercisable for common stock, where such securities are issued as consideration in a transaction or series of transactions in which a Related Party has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction or series of related transactions and the present or potential issuance of common stock, or securities convertible into common stock, could result in an issuance that exceeds either 5% of the number of shares of common stock or 5% of the voting power outstanding before the issuance.[77]
- an issuance of more than 20% of the outstanding common stock of the issuer (measured either by amount of shares or voting power);[78] and
- an issuance that will result in a change of control of the issuer.[79]

Related Party Transactions

A company's audit committee or another independent body of the board of directors, is required to conduct a reasonable prior review and oversight of all related party transactions for potential conflicts of interest and will need to prohibit such a transaction if it determines it to be inconsistent with the interests of the company and its shareholders.[80]

Corporate Governance Guidelines

Companies must adopt and disclose corporate governance guidelines that must address:

- director qualification standards;
- director responsibilities;
- director access to management and, as necessary and appropriate, independent advisers;
- director compensation;
- director orientation and continuing education;
- management succession; and
- annual performance evaluation of the board.

The company must make its corporate governance guidelines available on its website, and it must state in its annual proxy statement or, if the company does not file an annual proxy statement, in its annual report filed with the SEC, that the guidelines are available on its website and provide the website address.[81]

Code of Business Conduct and Ethics

Companies must adopt and disclose a code of business conduct and ethics for directors, officers, and employees.

This code should address, among other things:

- conflicts of interest;
- corporate opportunities;
- confidentiality;
- fair dealing;
- protection and use of company assets;
- compliance with laws, rules, and regulations (including insider trading laws); and
- encouraging the reporting of illegal or unethical behavior.

The code must contain compliance standards and procedures to facilitate its effective operation and must require that only the board or a board committee may waive any provision of the code for executive officers or directors, and that any such waiver be disclosed to shareholders within four business days.

The company must make the code available on its website, and it must state in its annual proxy statement or, if the company does not file an annual proxy statement, in its annual report filed with the SEC, that this information is available on its website and provide the website address.[82]

Certification Requirements

Each year the CEO must certify to the NYSE that they are not aware of any violation by the company of NYSE corporate governance listing standards. In addition, the CEO must promptly notify the NYSE in writing after any executive officer of the company becomes aware of any non-compliance with any NYSE corporate governance listing standard.[83]

Written Affirmation

In addition to the CEO certification mentioned above, a foreign private issuer must provide to the NYSE, within 30 days of the date the foreign private issuer files its annual report with the SEC, a wide-ranging "written affirmation" with exhibits that describe the issuer's compliance or non-compliance with the NYSE's corporate governance requirements. Besides the annual written affirmation, a foreign private issuer must submit an interim written affirmation when:

- an audit committee member who was deemed independent is no longer independent;
- a member has been added to the audit committee;
- the issuer or a member of its audit committee is eligible to rely on and is choosing to rely on a Rule 10A-3 exemption;
- the issuer or a member of its audit committee is no longer eligible to rely on or is choosing to no longer rely on a previously applicable Rule 10A-3 exemption;
- a member has been removed from the issuer's audit committee resulting in the issuer no longer having a Rule 10A-3 compliant audit committee;
- the issuer determined that it no longer qualifies as a foreign private issuer and will be considered a domestic company under Section 303A.[84]

NYSE Communication and Notification Requirements

The NYSE requires that any listed company promptly notify the public of any information that it might reasonably expect to materially affect the market for its securities. A listed company should also act promptly to dispel unfounded rumors that produce unusual market activity or price variations.[85]

If the company will announce a material event or make a statement regarding a rumor between 7:00 a.m. and 4:00 p.m. Eastern Standard Time, it must notify the NYSE by telephone at least 10 minutes before it releases the announcement. The company must also provide the text of any written announcement to the NYSE at least 10 minutes prior to releasing the announcement. This will allow the NYSE to determine if a trading halt should be imposed.[86]

Corporate Governance Requirements for Foreign Private Issuers

As noted above, foreign private issuers are permitted to follow home-country practice in lieu of the NYSE's corporate governance standards, other than the NYSE's requirements that it must: (1) have an audit committee that meets the requirements of Exchange Act Rule 10A-3; and (2) provide prompt notification from its CEO of non-compliance with the applicable provisions of the NYSE's corporate governance rules. As described earlier, a foreign private issuer must also provide an annual written affirmation as well as an interim written affirmation to the NYSE.[87]

Whether a listed foreign private issuer follows the NYSE corporate governance standards or its home-country practice, it must disclose any ways in which its corporate governance practices differ from those followed by domestic US issuers under NYSE listing standards.[88] A detailed and cumbersome analysis is not required; a brief, general summary of differences is enough. A foreign private issuer that is required to file an annual report on Form 20-F with the SEC must include the statement of significant differences in that annual report. All other foreign private issuers may either (i) include the statement of significant differences in an annual report filed with the SEC or (ii) make the statement of significant differences available on or through the listed company's website. If the statement of significant differences is made available on or through the listed company's website, the listed company must disclose that fact in its annual report filed with the SEC and provide the website address.[89]

ENDNOTES

1 *See generally* NYSE Listed Company Manual, § 103.00 (*NYSE Manual*).

2 Both affiliated companies and companies listing following emergence from bankruptcy have different listing standards.

3 When considering a listing application from a company organized under the laws of Canada, Mexico, or the US (North America), the NYSE will include all North American holders and trading volume in applying the minimum stockholder and trading volume requirements. When listing a company from outside North America, the Exchange may, in its discretion, include holders and trading volume in the company's home country or primary trading market outside the United States in applying the applicable listing standards, provided that such market is a regulated stock exchange. In exercising this discretion, the Exchange will consider all relevant factors including: (i) whether the information is derived from a reliable source, preferably either a government- regulated securities market or a transfer agent that is subject to governmental regulation; (ii) whether there exist efficient mechanisms for the transfer of securities between the company's non-US trading market and the United States; and (iii) the number of shareholders and the extent of trading in the company's securities in the United States prior to the listing. For securities that trade in the format of American Depositary Receipts (ADRs), volume in the ordinary shares will be adjusted to be on an ADR-equivalent basis. *See* NYSE Manual § 102.01.

4 *See NYSE Manual* § 102.01. In addition, in certain circumstances, the NYSE will take into account certain other qualitative factors, including: the company must be a going concern or the successor to a going concern, the degree of national interest in the company, the character of the markets for its products, its relative stability and position in its industry, and whether it is engaged in an expanding industry with prospects for maintaining its position. Higher minimum standards might apply if there is a lack of public interest in the securities of a company as evidenced, for example, by low trading volume on another exchange, lack of dealer interest in the over-the-counter market, unusual geographic concentration of holders of shares, slow growth in the number of shareholders, and a low rate of transfers. *See NYSE Manual* § 102.01C. A company formed by a reverse merger is subject to additional initial listing requirements. *See NYSE Manual* 102.01F. In order to qualify for initial listing a reverse merger company must also: (i) have been trading for at least one year on the US over-the-counter market, on another national securities exchange, or on a regulated foreign exchange, and, in the case of a domestic issuer, have filed a Form 8-K containing all required information under Item 2.01(f), including audited financial statements or, in the case of a foreign private issuer, have filed all such information on Form 20-F; (ii) have maintained a minimum closing price of $4 per share for at least 30 of the most recent 60 trading days preceding the filing of the initial listing application; and (iii) have filed all periodic financial reports required by the SEC or other regulatory authority during the year preceding the initial listing, including one annual report containing audited financial statements for a full fiscal year after the filing of the initial Form 8-K or 20-F, as applicable. In addition, in order to qualify for listing, the reverse merger company must (i) have timely filed all periodic financial reports required by the SEC or other regulatory authority during the year preceding the listing date, including one annual report containing audited financial statements for a full fiscal year; and (ii) have maintained a minimum closing price of $4 per share for at least 30 of the most recent 60 trading days prior to the listing date. However, a reverse merger company will not be required to meet the above additional conditions if it lists in connection with a firm-commitment underwritten public offering with gross proceeds of at least $40 million.

5 *See NYSE Manual* § 102.01A. If the issuer has less than 100 shares, the requirement relating to the number of publicly held shares will be reduced proportionately.

6 *See id*. If the unit of trading is less than 100 shares, the requirement relating to the number of publicly held shares will be reduced proportionately. Shares held by directors, officers, or their immediate families and other concentrated holdings of 10% or more are excluded in calculating the number of publicly held shares.

7 *See NYSE Manual* § 102.01A. If the issuer has less than 100 shares, the requirement relating to the number of publicly held shares will be reduced proportionately.

8 *See id.*

9 *See id.* If the unit of trading is less than 100 shares, the requirement relating to number of publicly held shares will be reduced proportionately. Shares held by directors, officers, or their immediate families and other concentrated holdings of 10% or more are excluded in calculating the number of publicly held shares.

10 *See NYSE Manual* § 102.01B. For IPOs, the NYSE will rely on a written commitment from the underwriter regarding the anticipated value of the offering.

11 *See NYSE Manual* § 102.01B. For IPOs, the NYSE will rely on a written commitment from the underwriter regarding the anticipated value of the offering. Under certain limited circumstances, the NYSE may allow an issuer to list without conducting a public offering (a "direct listing"). For a selling shareholder direct listing, the exchange will determine whether the company has met the $100 million market value requirement based on the lesser of (i) the value calculable based on the valuation and (ii) the value calculable based on the most recent trading price in a private placement market. In the absence of recent trading in a private placement market, the NYSE will determine that the company has met the market value of publicly-held shares requirement if the company provides a valuation showing a market value of publicly-held shares of at least $250 million. For a primary direct listing, the NYSE will determine that the company has met the market value of publicly-held shares requirement if the company will sell at least $100 million in market value of shares in the opening auction on the first day of trading on NYSE. For this purpose, market value will be calculated using a price per share equal to the lowest price of the price range in the registration statement minus an amount equal to 20% of the highest price of such price range.

12 *See NYSE Manual* § 102.01C(I).

13 As defined in Section 2(a)(19) of the Securities Act and Section 3(a)(80) of the Exchange Act.

14 *See NYSE Manual* § 102.01C(II).

15 In addition, a foreign private issuer listing its equity securities in the form of ADRs must sponsor its ADRs and enter into an agreement with a US depository bank to provide such services as cash and stock dividend payments, transfer of ownership, and distribution of company financial statements and notices, such as shareholder meeting material. *See generally NYSE Manual* § 103.04.

16 *See NYSE Manual* § 103.01A. Shares held by directors, officers, or their immediate families, and other concentrated holdings of 10% or more are excluded in calculating the number of publicly held shares. If an issuer either has a significant concentration of stock, or if changing market forces have adversely impacted the public market value of an issuer which otherwise would qualify for listing on the NYSE such that its public market value is no more than 10% below $100 million, the NYSE will generally consider $100 million in stockholders' equity as an alternate measure of size and therefore, as an alternative basis to list the issuer.

17 *See NYSE Manual* § 103.01B(I).

18 *See NYSE Manual* § 103.01B(II)(a). For IPOs, the company's underwriters must provide a written representation that demonstrates the company's ability to meet the global market capitalization requirement based upon the completion of the offering.

19 *See NYSE Manual* § 103.01B(II)(b). For IPOs, the company's underwriters must provide a written representation that demonstrates the company's ability to meet the global market capitalization requirement based upon the completion of the offering. For all other companies, market capitalization valuation will be determined over a six-month average.

20 *See NYSE Manual* § 802.01A. If the unit of trading is less than 100 shares, the requirement relating to the number of shares publicly held will be reduced proportionately. Shares held by directors, officers, or their immediate families, and other concentrated holdings of 10% or more are excluded in calculating the number of publicly held shares.

21 *See NYSE Manual* § 802.01B(I).

22 *See generally NYSE Manual* § 802.01B.

23 *See NYSE Manual* § 802.01C. For any curative actions requiring the approval of the issuer's shareholders, the issuer must include such approval requirement in its notification to the NYSE, seek and obtain such approval by the next annual meeting, and then effect such action without delay. Note that the NYSE may exercise discretion with respect to the minimum price criteria after evaluating the financial status of the issuer if the security that has fallen below compliance is other than the issuer's primary trading common stock (for example, a tracking stock or a preferred class).

24 *See generally NYSE Manual* § 802.01D for additional enumerated criteria.

25 *See NYSE Manual* §§ 303A.00, 303A.06, 303A.12; 303A.14.

26 *See NYSE Manual* § 303A.11.

27 *See NYSE Manual* §§ 303A.00, 303A.01, 303A.04, 303A.05.

28 *See NYSE Manual* § 303A.01. Issuers listing in connection with an IPO have one year following the initial listing date to meet the majority independent board of directors requirement and may phase in independent committees as follows: at least one independent director per committee at the time of listing, a majority of independent directors within 90 days following listing, and fully independent committees, as required, within one year. *See NYSE Manual* § 303A.00.

29 *See NYSE Manual* § 303A.02.

30 *See* Commentary to *NYSE Manual* § 303A.02.

31 *See NYSE Manual* § 303A.02(b)(i).

32 *See NYSE Manual* § 303A.02(b)(ii).

33 *See NYSE Manual* § 303A.02(b)(iii).

34 *See NYSE Manual* § 303A.02(b)(iv).

35 *See NYSE Manual* § 303A.02(b)(v).

36 *See* Commentary to *NYSE Manual* § 303A.02(b).

37 *See NYSE Manual* § 303A.02(a)(ii).

38 *See NYSE Manual* § 303A.03.

39 *See NYSE Manual* § 303A.14 and https://www.nyse.com/publicdocs/nyse/markets/nyse/rule-filings/filings/2023/SR-NYSE-2023-12_Am._1.pdf. The policy must be applied to compensation received after October 2, 2023.

40 *See NYSE Manual* § 303A.14.

41 *See NYSE Manual* § 303A.04(a).

42 *See NYSE Manual* § 303A.04(b)(i).

43 *See NYSE Manual* § 303A.04(b)(ii).

44 *See* Commentary to *NYSE Manual* § 303A.04.

45 *See NYSE Manual* § 303A.05(a). As of July 1, 2013, compensation committee members must satisfy additional independence requirements as set forth in § 303A.02(a)(ii). In determining the independence of a director who will serve on an issuer's compensation committee, the board of directors must consider all factors specifically relevant to determining whether that director has a relationship to the issuer that is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to (i) any sources of compensation of such director, including any consulting, advisory, or other compensatory fee paid by the issuer; and (ii) whether such director is affiliated with the issuer, any of its subsidiaries, or any affiliates of its subsidiaries. Smaller reporting companies (as defined in Exchange Act Rule 12b-2) are not required to comply with § 303A.02(a)(ii) or the second paragraph of the Commentary to § 303A.02(a). *See* § 303A.00.

46 *See NYSE Manual* § 303A.05(b)(i)(A).

47 *See NYSE Manual* § 303A.05(b)(i)(B).

48 *See NYSE Manual* § 303A.05(b)(i)(C).

49 *See NYSE Manual* § 303A.05(b)(ii).

50 *See NYSE Manual* § 303A.05(b)(iii).

51 *See NYSE Manual* § 303A.05(c)(iv).

52 *See NYSE Manual* § 303A.05(c)(ii).

53 *See NYSE Manual* § 303A.05(c)(iii)

54 *See* Commentary to *NYSE Manual* § 303A.05.

55 *See NYSE Manual* §§ 303A.06, 303A.07(a).

56 *See NYSE Manual* § 303A.07(a); *see also* Commentary to *NYSE Manual* § 303A.07(a). While the NYSE does not require that an audit committee include a person who satisfies the definition of audit committee financial expert as set out in Item 407(d)(5)(ii) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise. Foreign private issuers are not required to comply with § 303A.07.

57 *See NYSE Manual* § 303A.07(b)(i)(A).

58 *See NYSE Manual* § 303A.07(b)(i)(B).

59 *See NYSE Manual* § 303A.07(b)(ii).

60 *See NYSE Manual* § 303A.07(b)(iii).

61 *See NYSE Manual* § 303A.07(b)(iii)(A).

62 *See NYSE Manual* § 303A.07(b)(iii)(B).

63 *See id.*

64 *See NYSE Manual* § 303A.07(b)(iii)(C).

65 *See id.*

66 *See NYSE Manual* § 303A.07(b)(iii)(D).

67 *See NYSE Manual* § 303A.07(b)(iii)(E).

68 *See NYSE Manual* § 303A.07(b)(iii)(F).

69 *See NYSE Manual* § 303A.07(b)(iii)(G).

70 *See NYSE Manual* § 303A.07(b)(iii)(H).

71 *See NYSE Manual* § 303A.07(c); *see also* Commentary to *NYSE Manual* § 303A.07(c).

72 *See NYSE Manual* § 302.00. This Section 302 is not applicable to companies whose only securities listed on the Exchange are non-voting preferred and debt securities, passive business organizations (such as royalty trusts), or securities listed pursuant to 5.2(j)(2) (Equity Linked Notes), 5.2(j)(3) (Investment Company Units), 5.2(j)(4) (Index-Linked Exchangeable Notes), 5.2(j)(5) (Equity Gold Shares), 5.2(j)(6) (Equity-Index Linked Securities, Commodity- Linked Securities, Currency-Linked Securities, Fixed Income Index-Linked Securities, Futures-Linked Securities and Multifactor Index-Linked Securities), 5.2(j)(8) (Exchange-Traded Fund Shares), Rule 8.100 (Portfolio Depositary Receipts), 8.200 (Trust Issued Receipts), 8.201 (Commodity-Based Trust Shares), 8.202 (Currency Trust Shares), 8.203 (Commodity Index Trust Shares), 8.204 (Commodity Futures Trust Shares), 8.300 (Partnership Units), 8.400 (Paired Trust Shares), 8.600 (Managed Fund Shares), 8.601 (Active Proxy Portfolio Shares), 8.700 (Managed Trust Securities), and 8.900 (Managed Portfolio Shares). Foreign private issuers may follow home-country practice with respect to shareholder meetings. *See NYSE Manual* § 103.00.

73 *See NYSE Manual* § 312.03(a); *see also* Commentary to *NYSE Manual* § 303A.08.

74 *See NYSE Manual* § 312.03(b)(iii): For example, a sale of stock to any of such parties at a discount to the then market price would be treated as equity compensation under Section 303A.08, notwithstanding that shareholder approval may not be required under Sections 312.03(b) or 312.03(c). Consequently, the company would be required to either: (i) obtain shareholder approval of such sale, or (ii) issue such shares under an equity compensation plan that had previously been approved by shareholders and for which shareholder approval under Section 303A.08 is not otherwise required. Moreover, shareholder approval is required if any of the subparagraphs of Section 312.03 require such approval, notwithstanding the fact that the transaction does not require approval under this subparagraph or one or more of the other subparagraphs.

75 *See NYSE Manual* § 312.04(h); Minimum Price" means a price that is the lower of: (i) the Official Closing Price immediately preceding the signing of the binding agreement; or (ii) the average Official Closing Price for the five trading days immediately preceding the signing of the binding agreement.

76 *See NYSE Manual* § 312.03(b)(i). Shareholder approval will not be required if such transaction is a cash sale that meets the Minimum Price requirement.

77 *See NYSE Manual* § 312.03(b)(ii).

78 *See NYSE Manual* § 312.03(c). Shareholder approval will not be required for any issuance involving: (1) any public offering for cash; or (2) any other private financing (that is not a public offering for cash) in which the issuer is selling securities for cash, if it involves a sale of common stock, or securities convertible into or exercisable for common stock, at a price at least equal to the lesser of either the stock's official closing price or the average official closing price for the five trading days immediately preceding entry into the binding agreement, provided that if these securities are issued in connection with an acquisition of the stock or assets of another company, shareholder approval will be required if the issuance of such securities alone or when combined with any other present or potential issuance of common stock or securities convertible into common stock in connection with such acquisition, is equal to or exceeds either 20% of the number of shares of common stock or 20% of the voting power outstanding before the issuance.

79 *See NYSE Manual* § 312.03(d).

80 *See NYSE Manual* § 314.00. For purposes of this rule, the term "related party transaction" refers to transactions required to be disclosed pursuant to Item 404 of Regulation S-K under the Securities Exchange Act. In the case of foreign private issuers, the term "related party transactions" refers to transactions required to be disclosed pursuant to Form 20-F, Item 7.B.

81 *See NYSE Manual* § 303A.09; *see also* Commentary to *NYSE Manual* § 303A.09.

82 *See NYSE Manual* § 303A.10; *see also* Commentary to *NYSE Manual* § 303A.10.

83 *See NYSE Manual* §§ 303A.12(a), 303A.12(b).

84 *See NYSE Manual* § 303A.12(c), NYSE Instructions for Submission of Foreign Private Issuer Section 303A Written Affirmations.

85 *See NYSE Manual* § 202.05.

86 *See NYSE Manual* § 202.06(B).

87 *See NYSE Manual* §§ 303A.00, 303A.12(b), 303A.12(c).

88 *See NYSE Manual* § 303A.11.

89 *See NYSE Manual* § 303A.11.

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ANNEX B

Nasdaq Quantitative Listing Criteria and Corporate Governance Standards

There are three distinct markets within Nasdaq: the Nasdaq Global Market (NGM), the Nasdaq Global Select Market (NGSM), and the Nasdaq Capital Market (NCM). The NGSM mandates the highest initial listing requirements, while its maintenance requirements are identical to those of the NGM. The NGM, in turn, has more stringent quantitative listing and maintenance requirements than the NCM.[1]

Except as noted below, the quantitative listing and maintenance criteria applicable to non-Canadian foreign private issuers for the NGM, NGSM, and NCM are identical to those of domestic US issuers and Canadian issuers.[2] However, all foreign private issuers (including Canadian issuers) may elect to follow home-country practice in lieu of compliance with certain Nasdaq corporate governance requirements.[3] An issuer of a security listed on either the NGM or NCM may, at any time, apply to transfer the respective security to the NGSM as long as it satisfies all of the requirements for listing on the NGM and it meets the additional financial and liquidity requirements described below.[4]

NGM Quantitative Listing and Maintenance Standards

NGM Quantitative Initial Listing Standards

An issuer, whether a domestic US issuer or a foreign private issuer, generally must meet one of the following standards to be listed on the NGM.[5]

	Entry Standard 1	Entry Standard 2	Entry Standard 3/4
	Income Standard	**Equity Standard**	**Market Value or Total Assets/Total Revenue Standard**
Minimum bid price[6]	At least $4 per share	At least $4 per share	At least $4 per share
Unrestricted publicly held shares[7]	At least 1.1 million	At least 1.1 million	At least 1.1 million
Number of round lot holders[8]	At least 400	At least 400	At least 400
Stockholders' equity	At least $15 million[9]	At least $30 million[10]	—
Number of registered and active market-makers	At least three[11]	At least three[12]	At least four[13]
Market value of unrestricted publicly held shares (for an issuer listing in connection with IPO, including ADRs, this must be satisfied from the offering proceeds)	At least $8 million[14]	At least $18 million[15]	At least $20 million[16]

	Entry Standard 1	Entry Standard 2	Entry Standard 3/4
	Income Standard	**Equity Standard**	**Market Value or Total Assets/Total Revenue Standard**
Annual pre-tax income from continuing operations in the most recently completed fiscal year or in two of the last three most recently completed fiscal years	At least $1 million[17]	—	—
Operating history	—	Two-year operating history[18]	—
Market value of listed securities	—	—	$75 million for Market Value Standard[19]
Total assets and total revenue	—	—	$75 million, each in total assets and total revenue, for the most recently completed fiscal year or two of the last three most recently completed fiscal years for Total Assets/Total Revenue Standard[20]

NGM Quantitative Maintenance Standards

Once an issuer has been listed on the NGM, it must continue to satisfy one of the following maintenance standards.

	Maintenance Standard 1	Maintenance Standard 2/3
	Equity Standard	**Market Value Standard or Total Assets/Total Revenue Standard**
Minimum bid price[21]	$1 per share	$1 per share
Total Holders[22]	At least 400	At least 400
Stockholders' equity	At least $10 million[23]	—
Market value of publicly held shares	At least $5 million[24]	At least $15 million[25]
Number of publicly held shares	At least 750,000[26]	At least 1.1 million[27]
Registered and active market-makers	At least two[28]	At least four[29]
Market value of listed securities	—	$50 million for Market Value Standard[30] (No requirement for Total Assets/Total Revenue Standard)

	Maintenance Standard 1	Maintenance Standard 2/3
Total assets and total revenue	—	$50 million each, in total assets and total revenue, for the most recently completed fiscal year or two of the last three most recently completed fiscal years for Total Assets/Total Revenue Standard[31] (No requirement for Market Value Standard)

NGSM Quantitative Listing and Maintenance Standards

NGSM Quantitative Initial Listing Standards

The issuer must meet one of the following financial standards:

Financial Requirement	Standard 1: Earnings	Standard 2: Capitalization with Cash Flow	Standard 3: Capitalization with Revenue	Standard 4: Assets with Equity
Aggregate income from continuing operations before income taxes	At least $11 million over the prior three fiscal years[32]	—	—	—
Positive income from continuing operations before income taxes in each of the prior three fiscal years	Required[33]	—	—	—
Income from continuing operations before income taxes	At least $2.2 million in each of the two most recent fiscal years[34]	—	—	—
Aggregate cash flows	—	At least $27.5 million over the prior three fiscal years[35]	—	—
Positive cash flows in each of the prior three fiscal years	—	Required[36]	—	—
Market capitalization	—	Average of at least $550 million over prior 12 months[37]	Average of at least $850 million over prior 12 months[38]	At least $160 million[39]

Financial Requirement	Standard 1: Earnings	Standard 2: Capitalization with Cash Flow	Standard 3: Capitalization with Revenue	Standard 4: Assets with Equity
Total revenue in the previous fiscal year	—	At least $110 million[40]	At least $90 million[41]	—
Total assets	—	—	—	At least $80 million[42]
Stockholders' equity	—	—	—	At least $55 million[43]
Minimum bid price[44]	$4 per share	$4 per share	$4 per share	$4 per share

Liquidity Requirements

An issuer must also meet the following liquidity requirements:

- 2,200 total holders[45] or 450 round lot holders;[46] and
- 1.25 million unrestricted publicly held shares[47] with a $45 million minimum market value.[48]

In computing the number of unrestricted publicly held shares, Nasdaq will not consider shares held by an officer, director, or 10% or greater shareholder of the company.[49]

In addition, where the issuer meets the requirements of the NGM Income Standard or the NGM Equity Standard (as detailed above), it must have at least three registered and active market-makers.[50] Otherwise, the issuer must have at least four registered and active market-makers.[51]

NGSM Quantitative Maintenance Requirements

Once an issuer has been listed on the NGSM, it is subject to the same maintenance standards as issuers listed on the NGM, as described above.[52]

NCM Quantitative Listing and Maintenance Standards

NCM Quantitative Initial Listing Standards

For initial listing on the NCM, an issuer must meet one of the following standards:

	Standard 1: Equity	Standard 2: Market Value of Listed Securities	Standard 3: Net Income
Stockholders' equity	At least $5 million[53]	At least $4 million[54]	At least $4 million[55]
Market value of unrestricted publicly held shares (for an issuer listing in connection with IPO, including ADRs, this must be satisfied from the offering proceeds)	At least $15 million[56]	At least $15 million[57]	At least $5 million[58]

	Standard 1: Equity	Standard 2: Market Value of Listed Securities	Standard 3: Net Income
Two-year operating history	Required[59]	—	—
Market value of listed securities	—	At least $50 million[60]	—
Net income	—	—	At least $750,000 in the most recently completed fiscal year or in two of the last three most recently completed fiscal years[61]

Additionally, each issuer must satisfy the following requirements:

- at least 300 round lot shareholders;[62]
- at least 1 million unrestricted publicly held shares;[63]
- a minimum bid price of $4 a share;[64]
- at least three registered and active market-makers;[65] and
- in the case of ADRs, at least 400,000 must be issued.[66]

NCM Maintenance Requirements

For continued listing on NCM, an issuer must maintain:

- either: (1) stockholders' equity of at least $2.5 million (Equity Standard); (2) a market value of listed securities of at least $35 million (Market Value of Listed Securities Standard); or (3) net income of at least $500,000 in the most recently completed fiscal year or in two of the last three most recently completed fiscal years (Net Income Standard);[67]
- at least 300 public shareholders;[68]
- at least 500,000 publicly held shares;[69]
- a market value of publicly held shares of at least $1 million;[70]
- a minimum bid price of $1 a share;[71] and
- at least two registered and active market-makers, one of which may be a market-maker entering a stabilizing bid.[72]

Failure to Meet Continuing Listing Requirements (NGM, NGSM, and NCM)

The Listing Qualifications Department will immediately notify any company that fails to meet a maintenance requirement. Depending on the type of deficiency, the Listings Qualifications Department will issue one of the following four types of notifications: (i) a Staff Delisting Determination, which is a notification that, unless appealed, will subject the company to immediate suspension and delisting; (ii) a notification of deficiency for

which the company may submit a plan of compliance to the Listing Qualifications Department for review; (iii) a notification of deficiency, which automatically grants the company a cure or compliance period; or (iv) a letter of public reprimand.[73]

Nasdaq Corporate Governance Requirements

In addition to the quantitative listing criteria set out above, listed companies must comply with the Nasdaq rules relating to corporate governance described below, with two key exceptions:

- *Foreign Private Issuers*: A listed foreign private issuer is permitted to follow home-country practice in lieu of Nasdaq's corporate governance standards, other than the Nasdaq's requirements that it must (1) provide Nasdaq with notification of any non-compliance by the issuer with Nasdaq corporate governance requirements; (2) have an audit committee that meets the requirements (including independence requirements) of Exchange Act Rule 10A-3; (3) disclose board diversity information; and (4) abide by the Nasdaq voting rights requirements. A foreign private issuer making its IPO or first US listing on Nasdaq that follows home-country practice in lieu of the Nasdaq corporate governance requirements must disclose in its registration statement or on its website each requirement which it does not follow and describe the home-country practice followed by it in lieu of such requirements.[74]
- *Controlled Companies:* A controlled company is one in which more than 50% of the voting power for the election of directors is held by an individual, a group or another company. Master Limited Partnerships (MLPs) often qualify as controlled companies. A controlled company is not required to comply with Nasdaq requirements to have a majority of independent directors or a compensation committee, or requirements relating to independent director oversight of director nominations.[75]

Majority of Independent Directors

A majority of the issuer's board of directors must consist of independent directors.[76] The board of directors must affirmatively determine that the director has no relationship with the issuer that would impair his or her independence,[77] and the issuer must disclose in its annual proxy (or, if it does not file a proxy, on its annual report on Form 10-K – or Form 20-F for foreign private issuers, if applicable – filed with the SEC) those directors that the board of directors has determined to be independent.[78]

Ownership of an issuer's stock, by itself, is not a bar to an independence finding.[79] The Nasdaq rules define an independent director to mean a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship that, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.[80]

A director cannot be independent if he or she:

- is, or at any time in the past three years was, employed by the issuer or any parent or subsidiary (as defined below) of the issuer;[81]
- has accepted, or has a family member (as defined below) who has accepted, any compensation from the issuer or any parent or subsidiary of the issuer in excess of $120,000 during any period of 12 consecutive months within the three years preceding the determination of independence,[82] other than:
  - compensation for board or board committee service;[83]
  - compensation paid to a family member who is a non-executive employee of the issuer or a parent or subsidiary of the issuer;[84] or
  - benefits under a tax-qualified retirement plan, or non-discretionary compensation;[85]

- is a family member of an individual who is, or at any time during the past three years was, employed by the issuer or any parent or subsidiary of the issuer as an executive;[86]
- is, or has a family member who is, a partner in, or controlling shareholder or executive officer of, any organization to which the issuer made, or from which the issuer received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or $200,000, whichever is more,[87] other than:
  - payments arising solely from investments in the issuer's securities;[88] or
  - payments under non-discretionary charitable contribution matching programs;[89]
- is, or has a family member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the issuer serves on the compensation committee of such other entity;[90] or
- is, or has a family member who is, a current partner of the issuer's outside auditor, or was a partner or employee of the issuer's outside auditor who worked on the issuer's audit at any time during any of the past three years;[91] or
- in the case of an investment company, in lieu of the above paragraphs, a director who is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.[92]

For these purposes, a "parent or subsidiary" covers entities that the issuer controls and consolidates with its financial statements as filed with the SEC (but not if the issuer reflects such entity solely as an investment in its financial statements).[93] A "family member" is defined to include a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home.[94]

Meetings of Independent Directors

Independent directors must have regularly scheduled meetings at which only independent directors are present.[95] Those meetings should occur not less than twice a year.[96]

Recovery of Erroneously Awarded Compensation ("Claw Back" Rules)

The listed company must adopt a written policy that provides for the reasonably prompt recovery of erroneously awarded incentive-based compensation received by executive officers and comply with such policy if the listed company is required to prepare an accounting restatement due to a material noncompliance by the listed company with any financial reporting requirement under the securities laws. This includes any such restatement required to correct any material errors in previously issued financial statements or errors that would result in a material misstatement if such errors were corrected in the current period or left uncorrected in the current period.[97]

Each listed company must also file disclosures with respect to such erroneously awarded compensation recovery policy as required by federal securities laws and any applicable SEC rules.[98]

Director Nominees

Director nominees must be selected, or recommended for the board of directors' selection, either by a majority of the independent directors in a vote in which only independent directors participate or by a nominations committee comprised solely of independent directors.[99] Each issuer must certify that it has adopted a formal

written charter or board resolution addressing the nominations process (and such related matters as may be required under the federal securities laws).[100] In certain circumstances a single non-independent director, who is not a current officer or employee (or family member of an officer or employee), may serve for up to two years on an independent nominations committee composed of at least three members.[101]

Compensation Committee

An issuer must have, and certify that it has and will continue to have, a compensation committee composed of at least two independent directors.[102] In order to serve as a member of the listed company's compensation committee, the board of directors must affirmatively determine that the director does not have a relationship to the company that is material to that director's ability to be independent from management. Relevant factors in this determination include, but are not limited to:

- the source of any compensation received by such director, including any consulting, advisory, or other compensatory fee paid by the company to such director; and
- any affiliations between the director and the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.[103]

Under certain limited circumstances, if the compensation committee is composed of at least three members, one director who does not otherwise meet the independence requirements and who is not currently an executive officer or employee or a family member of an executive officer may serve on the compensation committee for up to two years if the board of directors determines it is required by the best interests of the issuer and its shareholders. Such an exception must be disclosed on the company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its Form 10-K or 20-F), and such disclosure must include the nature of the relationship and the reasons for the determination. In addition, the issuer must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception.[104]

The compensation committee must have a written charter that:[105]

- addresses the scope of the committee's responsibilities, including structure, process, and membership requirements;
- addresses the committee's responsibility for determining, or recommending to the board for determination, the compensation of the chief executive officer and all other executive officers of the company (the chief executive officer may not be present during voting or deliberations on his or her compensation); and
- sets forth the following rights and responsibilities with respect to the use of compensation consultants, legal counsel, or other adviser by the compensation committee:
  - the ability, in its sole discretion, to retain or obtain the advice of a compensation consultant, legal counsel, or other adviser. The compensation committee will be directly responsible for the appointment, compensation, and oversight of the services provided by any such compensation consultant, legal counsel, or other adviser. The compensation committee must provide for appropriate funding for payment of reasonable compensation. The compensation committee may retain or obtain the advice of such consultant, legal counsel, or other adviser only after considering the following:
    - any other services provided to the issuer by the employer of such compensation consultant, legal counsel, or other adviser;
    - any other fees paid by the issuer to the employer of the compensation consultant, legal counsel, or other adviser as a percentage of the total revenue of that employer;

- the policies and procedures of the employer of the compensation consultant, legal counsel, or other adviser with respect to the prevention of conflicts of interest;
- any business or personal relationships between any member of the compensation committee and such compensation consultant, legal counsel, or other adviser;
- any ownership of the issuer's equity by such compensation consultant, legal counsel, or other adviser; and
- any business or personal relationship between the compensation consultant, legal counsel, or other adviser or such person's employer and any of the issuer's executive officers.

Audit Committees

Sarbanes-Oxley

An issuer's audit committee must satisfy the independence and other requirements of Exchange Act Rule 10A-3 (implementing Section 301 of Sarbanes-Oxley).[106]

Charter

Each issuer must certify that it has a written audit committee charter and that the audit committee will review and assess the adequacy of the audit committee charter on an annual basis.[107] The charter must specify:

- the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements;[108]
- the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the issuer, and the audit committee's responsibility for engaging in a dialogue with the auditor with respect to any disclosed relationships or services that might impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor;[109]
- the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer;[110] and
- the specific audit committee responsibilities and authority necessary to comply with the audit committee requirements of Sarbanes-Oxley concerning responsibilities relating to: (1) registered public accounting firms; (2) complaints relating to accounting, internal accounting controls or auditing matters; (3) authority to engage advisers; and (4) funding as determined by the audit committee.[111]

Composition

The issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must:

- be independent, within the meaning of the Nasdaq director independence rules discussed above;
- meet the requirements for audit committee independence, set out in Exchange Act Rule 10A-3(b)(1), that, subject to certain limited exceptions:[112] (1) such member be a member of the board of directors of the issuer; (2) such member (other than in his or her capacity as a member of the board of directors, the audit committee, or another board committee) not accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof; and (3) such member not be an affiliated person of the issuer or any subsidiary thereof;[113]

- not have participated in the preparation of the financial statements of the issuer or any current subsidiary of the issuer at any time during the past three years; and
- be able to read and understand fundamental financial statements, including an issuer's balance sheet, statement of comprehensive income, and cash flow statement, at the time of appointment.[114]

In addition, each issuer must certify that it has, and will continue to have, one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or other comparable experience or background which results in financial sophistication.[115] Note that a director who qualifies as an audit committee financial expert under Item 407(d)(5)(ii) and (iii) of Regulation S-K will be presumed to meet this financial sophistication requirement.[116] Under certain circumstances a single director who meets the independence requirements of Exchange Act Rule 10A(m)(3) but not the independence requirements of the Nasdaq rules, who is not a current officer or employee (or family member of an officer or employee), may serve for up to two years on an audit committee. Such a person may not, however, chair the audit committee.[117]

Responsibility and Authority

The audit committee must have the specific responsibilities and authority needed to satisfy Exchange Act Rule 10A-3(b)(2), (3), (4) and (5) (concerning responsibilities relating to: (1) registered public accounting firms; (2) complaints relating to accounting, internal accounting controls, or auditing matters; (3) authority to engage advisers; and (4) funding as determined by the audit committee).[118]

Cure Periods

The Nasdaq rules provide for certain cure periods if an audit committee member ceases to be independent for reasons outside the member's reasonable control, or if there is a vacancy on the audit committee.[119]

Shareholder Meetings

An issuer must hold an annual meeting of shareholders no later than one year after the end of the issuer's fiscal year-end.[120] A newly listed company that was not previously subject to a requirement to hold an annual meeting is required to hold its first meeting within one year after its first fiscal year-end following listing.[121]

Quorum

An issuer must provide for a quorum as specified in its bylaws for any meeting of the holders of its common stock; provided that in no case shall such quorum be less than 33$^1/_3$% of the outstanding shares of the issuer's common voting stock.[122] Issuers organized as limited partnerships are required to have a quorum of at least 33$^1/_3$% of the outstanding limited partnership interests.[123]

Proxy Solicitation

An issuer must solicit proxies and provide proxy statements for all meetings of shareholders and must provide copies of such proxy solicitation to Nasdaq.[124] Note, however, that foreign private issuers are not subject to the US proxy rules.[125]

Conflicts of Interest and Related-Party Transactions

An issuer must have its audit committee or another independent committee of the board of directors review all related-party transactions for potential conflicts of interest on an ongoing basis. A "related-party transaction" for this purpose means those transactions required to be disclosed pursuant to Item 404 of Regulation S-K (and includes transactions and loans between management and the issuer for amounts over $120,000) or, in

the case of foreign private issuers, pursuant to Item 7.B of Form 20-F (and includes transactions and loans between the issuer and enterprises under common control of the issuer, associates, and individuals owning an interest in the voting power of the company that gives them significant influence or key management).[126]

Shareholder Approval of Certain Transactions

An issuer must obtain shareholder approval prior to the issuance of securities:

- when a stock option or purchase plan is to be established or materially amended or other equity compensation arrangement made or materially amended, pursuant to which stock may be acquired by officers, directors, employees, or consultants,[127] subject to limited exceptions;[128]
- when the issuance or potential issuance will result in a change of control of the issuer;[129]
- in connection with the acquisition of the stock or assets of another company: (1) if any director, officer, or substantial shareholder of the issuer has a 5% or greater interest (or such persons collectively have a 10% or greater interest), directly or indirectly, in the company or assets to be acquired or in the consideration to be paid in the transaction or series of related transactions and the present or potential issuance of common stock, or securities convertible into or exercisable for common stock, could result in a 5% or greater increase in outstanding common shares or voting power;[130] or (2) where, other than in a public offering for cash: (a) the common stock to be issued has or will have upon issuance voting power equal to 20% or more of the voting power outstanding before the issuance of the stock or convertible securities, or (b) the number of shares of common stock to be issued is or will be 20% or more of the number of shares of common stock outstanding before the issuance of the stock or convertible securities;[131] or
- in connection with a transaction other than a public offering involving the sale, issuance, or potential issuance by the issuer of common stock (or securities convertible into or exercisable for common stock) at a price below the lesser of either the closing price or the average closing price for the previous five days on nasdaq.com, which together with sales by certain affiliates of the issuer equals 20% or more of the common stock or voting power outstanding before the issuance.[132]

An exception may be made upon application to Nasdaq when a delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise and the audit committee (or other comparable body of the board of directors comprised solely of independent, disinterested directors) expressly approves reliance on this exception.[133]

Only shares actually issued and outstanding (excluding treasury shares or shares held by a subsidiary) are to be used for any calculation under the shareholder approval requirement. Shareholder approval must be obtained prior to the issuance of certain private financing instruments, generally in the form of convertible securities under which the number of shares that will be issued is uncertain until the conversion occurs, unless the instrument contains certain features (potentially a cap on the number of shares that can be issued upon conversion or a floor on the conversion price) and the issuance will not result in a change of control.[134]

Shareholder approval is not required for a public offering. Generally, any securities offering registered with the SEC and which is publicly disclosed and distributed in the same general manner and extent as a firm-commitment underwritten securities offering will be considered a public offering for purposes of the shareholder approval rules.[135]

Auditor Registration

An issuer must be audited by an independent public accountant that is registered as a public accounting firm with the Public Company Accounting Oversight Board, as provided for in Section 102 of Sarbanes-Oxley.[136]

Code of Conduct

An issuer must adopt a code of conduct applicable to all directors, officers, and employees and make it publicly available. A code of conduct satisfying this requirement must comply with the definition of a "code of ethics" set out in Section 406(c) of Sarbanes-Oxley and any regulations promulgated thereunder. Also, the code must provide for an enforcement mechanism. Any waivers of the code for directors or executive officers must be approved by the issuer's board and must be disclosed on a Form 8-K or, where a Form 8-K is not required, must be distributed via press release (foreign private issuers shall disclose such waivers either by distributing a press release or including disclosure in a Form 6-K). Alternatively, an issuer, including a foreign private issuer, may disclose waivers on its website in a manner that satisfies the requirements of Item 5.05(c) of Form 8-K.[137]

Notification of Non-Compliance

An issuer must promptly notify Nasdaq as soon as an executive officer of the issuer discovers any non-compliance by the issuer with the Nasdaq corporate governance standards.[138]

Corporate Governance Certification

After the initial certification, an updated certification form is required only if a change in the company's status results in the prior certification no longer being accurate. A foreign private issuer that relied on an exemption in its certification would have to file a new certification if the company ceased to be a foreign private issuer.[139]

Nasdaq Communication and Notification Requirements

Except in "unusual circumstances," Nasdaq requires an issuer to make prompt disclosure to the public through any Regulation FD-compliant method of disclosure of material information that would reasonably be expected to affect the value of its securities or influence investors' decisions.[140]

The issuer must notify Nasdaq prior to the release of certain types of information (and should make that notification at least 10 minutes prior to the release if the release is made during Nasdaq market hours or prior to 6:50 a.m. Eastern Standard Time if the release is made outside of Nasdaq market hours), including:

- financial-related disclosure (including earnings releases and restatements);
- corporate reorganizations and acquisitions;
- new products or discoveries, or developments regarding customers or suppliers;
- material senior management changes or a change in control;
- resignation or termination of independent auditors or withdrawal of a previously issued audit report;
- events regarding its securities (e.g., defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, or public or private sales of additional securities);
- significant legal or regulatory developments; and
- any event requiring the filing of a Form 8-K.[141]

An issuer (other than an issuer solely of ADRs) must notify Nasdaq on the appropriate form not later than 15 calendar days prior to certain events, including:

- establishing or materially amending a stock option plan, purchase plan, or other equity compensation arrangement pursuant to which stock may be acquired by officers, directors, employees, or consultants without shareholder approval;[142]

- issuing securities that may result in a change of control of the issuer;[143]
- issuing any common stock (or security convertible into common stock) in connection with the acquisition of the stock or assets of another company, if an officer, director, or substantial shareholder of the issuer has a 5% or greater interest (or if such persons collectively have a 10% or greater interest) in the company to be acquired;[144] or
- entering into a transaction that may result in the potential issuance of common stock (or securities convertible into common stock) greater than 10% of either the total shares outstanding or the voting power outstanding on a pre-transaction basis.[145]

An issuer must also file a form prescribed by Nasdaq within 10 days after any aggregate increase or decrease of any class of shares listed on Nasdaq that exceeds 5% of the amount of securities of the class outstanding.[146]

Corporate Governance Requirements for Foreign Private Issuers

A listed foreign private issuer is permitted to follow home-country practice in lieu of Nasdaq's corporate governance standards, other than the Nasdaq's requirements that it must:[147]

- provide Nasdaq with notification of any non-compliance by the issuer with Nasdaq corporate governance requirements;[148] and
- have an audit committee that meets the requirements (including independence requirements) of Exchange Act Rule 10A-3.[149]

A listed foreign private issuer that follows home-country practice in lieu of the Nasdaq corporate governance requirements must disclose in its annual report on Form 20-F each requirement that it does not follow and describe the home-country practice followed by it in lieu of such requirements (if the listing foreign issuer is not required to file its annual report on Form 20-F, it may make this disclosure only on its website).[150] In addition, a foreign private issuer making its IPO or first US listing on Nasdaq must make the same disclosure in its registration statement or on its website.[151]

ENDNOTES

1 *See generally* Nasdaq Rule 5300 Series, 5400 Series, 5500 Series.

2 *See* Nasdaq Rule 5225(b)(2).

3 *See* Nasdaq Rule 5615(a)(3).

4 *See* Nasdaq Rules 5305(c)-(d).

5 A company formed by a reverse merger is subject to additional initial listing requirements. *See* Nasdaq Rule 5110(c). In order to apply for listing, a reverse merger company must also (i) have been trading for at least one year in the US over-the-counter market, on another national securities exchange, or on a regulated foreign exchange, following the filing with the SEC or other regulatory authority of all required information about the transaction, including audited financial statements for the reverse merger company; and (ii) have maintained a minimum closing price of $4 per share for at least 30 of the most recent 60 trading days. In order to be approved for listing, at the time of approval, the reverse merger company must (i) have timely filed all periodic financial reports required by the SEC or other regulatory authority during the year preceding the initial listing, including one annual report containing audited financial statements for a full fiscal year; and (ii) have maintained a minimum closing price of $4 per share for at least 30 of the most recent 60 trading days. However, a reverse merger company will not be required to meet the above additional conditions if it lists in connection with a firm-commitment underwritten public offering with gross proceeds of at least $40 million.

6 *See* Nasdaq Rule 5405(a)(1).

7 *See* Nasdaq Rule 5405(a)(2). Note: Effective August 2019, Nasdaq's initial listing criteria were revised to exclude securities subject to resale restrictions for any reason from the calculation of publicly held shares, market value of publicly held shares and round lot shareholders.

8 *See* Nasdaq Rule 5405(a)(3). A "round lot" or "normal unit of trading" is defined as 100 shares of a security. See Nasdaq Rule 5005(a)(35). Note: Effective August 2019, the round lot shareholder requirements were revised to also require that at least 50% of the minimum required number of round lot holders must each hold unrestricted securities with a minimum value of $2,500.

9 *See* Nasdaq Rule 5405(b)(1)(B).

10 *See* Nasdaq Rule 5405(b)(2)(A).

11 *See* Nasdaq Rule 5405(b)(1)(D).

12 *See* Nasdaq Rule 5405(b)(2)(D).

13 *See* Nasdaq Rules 5405(b)(3)(C), 5405(b)(4)(C).

14 *See* Nasdaq Rule 5405(b)(1)(C).

15 *See* Nasdaq Rule 5405(b)(2)(C).

16 *See* Nasdaq Rules 5405(b)(3)(B), 5405(b)(4)(B).

17 *See* Nasdaq Rule 5405(b)(1)(A).

18 *See* Nasdaq Rule 5405(b)(2)(B).

19 *See* Nasdaq Rule 5405(b)(3)(A). Current publicly traded companies must meet this criteria and the $4 bid price requirement for 90 consecutive trading days prior to applying for listing if qualifying to list only under the Market Value Standard.

20 *See* Nasdaq Rule 5405(b)(4)(A).

21 *See* Nasdaq Rule 5450(a)(1).

22 *See* Nasdaq Rule 5450(a)(2).

23 *See* Nasdaq Rule 5450(b)(1)(A).

24 *See* Nasdaq Rule 5450(b)(1)(C).

25 *See* Nasdaq Rules 5450(b)(2)(C), 5450(b)(3)(C).

26 *See* Nasdaq Rule 5450(b)(1)(B).

27 *See* Nasdaq Rules 5450(b)(2)(B), 5450(b)(3)(B).

28 *See* Nasdaq Rule 5450(b)(1)(D).

29 *See* Nasdaq Rules 5450(b)(2)(D), 5450(b)(3)(D).

30 *See* Nasdaq Rule 5450(b)(2)(A).

31 *See* Nasdaq Rule 5450(b)(3)(A).

[32] *See* Nasdaq Rule 5315(f)(3)(A)(i).

[33] *See* Nasdaq Rule 5315(f)(3)(A)(ii).

[34] *See* Nasdaq Rule 5315(f)(3)(A)(iii).

[35] *See* Nasdaq Rule 5315(f)(3)(B)(i).

[36] *See* Nasdaq Rule 5315(f)(3)(B)(ii).

[37] *See* Nasdaq Rule 5315(f)(3)(B)(iii).

[38] *See* Nasdaq Rule 5315(f)(3)(C)(i).

[39] *See* Nasdaq Rule 5315(f)(3)(D)(i).

[40] *See* Nasdaq Rule 5315(f)(3)(B)(iii). Average market capitalization of at least $550 million over the prior 12 months and total revenue of at least $110 million in the previous fiscal year.

[41] *See* Nasdaq Rule 5315(f)(3)(C)(ii).

[42] *See* Nasdaq Rule 5315(f)(3)(D)(ii).

[43] *See* Nasdaq Rule 5315(f)(3)(D)(iii).

[44] *See* Nasdaq Rule 5315(e)(1). The issuer also must have at least 1,250,000 in unrestricted publicly held shares. *See* Nasdaq Rule 5315(e)(2).

[45] *See* Nasdaq Rule 5315(f)(1)(B). Companies affiliated with another company listed on NGSM and those with common stock or equivalents currently trading may, in the alternative, have a minimum of 550 beneficial shareholders and an average monthly trading volume over the prior 12 months of at least 1.1 million shares a month. *See* Nasdaq Rule 5315(f)(1)(A).

[46] *See* Nasdaq Rule 5315(f)(1)(C). At least 50% of such round lot holders must each hold unrestricted securities with a market value of at least $2,500.

[47] *See* Nasdaq Rule 5315(e)(2).

[48] *See* Nasdaq Rule 5315(f)(2)(C). “Seasoned companies” (those with common stock or equivalents trading) will be required to have a market value of at least $110 million or $100 million and a stockholders’ equity of $110 million. *See* Nasdaq Rules 5315(f)(2)(A) and (B). A closed-end management investment company registered under the Investment Company Act of 1940 will be required to have a market value of at least $70 million. *See* Nasdaq Rule 5315(f)(2)(D).

[49] *See* Nasdaq Rule 5310(d).

[50] *See* Nasdaq Rule 5315(e)(3).

[51] *See* Nasdaq Rule 5315(e)(3).

[52] *See* Nasdaq Rule 5305(e).

[53] *See* Nasdaq Rule 5505(b)(1)(A).

[54] *See* Nasdaq Rule 5505(b)(2)(B).

[55] *See* Nasdaq Rule 5505(b)(3)(B).

[56] *See* Nasdaq Rule 5505(b)(1)(B).

[57] *See* Nasdaq Rule 5505(b)(2)(C).

[58] *See* Nasdaq Rule 5505(b)(3)(C).

[59] *See* Nasdaq Rule 5505(b)(1)(C).

[60] *See* Nasdaq Rule 5505(b)(2)(A). Current publicly traded companies must meet this requirement and the $4 bid price requirement for 90 consecutive trading days prior to applying for listing if qualifying to list only under the Market Value of Listed Securities Standard.

[61] *See* Nasdaq Rule 5505(b)(3)(A).

[62] *See* Nasdaq Rule 5505(a)(3). At least 50% of such round lot holders must each hold unrestricted securities with a market value of at least $2,500.

[63] *See* Nasdaq Rule 5505(a)(2).

[64] *See* Nasdaq Rule 5505(a)(1). In certain circumstances, an issuer that meets either the Equity (Nasdaq Rule 5505(b)(1)) or Net Income (Nasdaq Rule 5505(b)(3)) Standards may have a minimum closing price of $3 per share and an issuer that meets the Market Value of Listed Securities Standard (Nasdaq Rule 5505(b)(2)) may have a minimum closing price of $2 per share. In each case, the issuer must have: (i) net tangible assets over $2 million (if the issuer has been in continuous operation for at least three years); (ii) net tangible assets over $5 million (if the issuer has been in continuous operation for less than three years); or (iii) average revenue of at least $6 million for the last three years; and the security meets such applicable closing price for at least five days prior to approval.

65 *See* Nasdaq Rule 5505(a)(4).

66 *See* Nasdaq Rule 5505(a)(6).

67 *See* Nasdaq Rule 5550(b).

68 *See* Nasdaq Rule 5550(a)(3).

69 *See* Nasdaq Rule 5550(a)(4).

70 *See* Nasdaq Rule 5550(a)(5).

71 *See* Nasdaq Rule 5550(a)(2).

72 *See* Nasdaq Rule 5550(a)(1).

73 *See* Nasdaq Rule 5810.

74 *See* Nasdaq Rules 5615(a)(3), 5605(c), 5606, 5625, 5640. *See also* Nasdaq IM-5615-3.

75 *See* Nasdaq Rules 5615(c)(1)-(2), 5605(b), 5605(e), 5606(d).

76 *See* Nasdaq Rule 5605(b)(1).

77 *See* Nasdaq IM-5605.

78 *See* Nasdaq Rule 5605(b)(1).

79 *See* Nasdaq IM-5605.

80 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2); *see also* Nasdaq IM-5605.

81 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(A).

82 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(B).

83 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(B)(i).

84 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(B)(ii).

85 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(B)(iii).

86 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(C).

87 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(D).

88 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(D)(i).

89 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(D)(ii).

90 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(E).

91 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(F).

92 *See* Nasdaq Rules 5005(a)(20), 5605(a)(2)(G); Nasdaq IM-5605.

93 Nasdaq IM-5605.

94 *See* Nasdaq Rules 5005(a)(18), 5605(a)(2).

95 *See* Nasdaq Rule 5605(b)(2) (the rule refers to these meetings as *executive sessions*).

96 *See* Nasdaq IM-5605-2.

97 *See* Nasdaq Rule 5608(a)-(b). The policy must be applied to any incentive-based compensation granted after October 2, 2023.

98 *See* Nasdaq Rule 5608(b)(2).

99 *See* Nasdaq Rule 5605(e)(1)(A)-(B).

100 *See* Nasdaq Rule 5605(e)(2).

101 *See* Nasdaq Rule 5605(e)(3). Independent director oversight of director nominations does not apply in cases where the right to nominate a director belongs legally to a third party (although certain committee composition requirements remain). *See* Nasdaq Rule 5605(e)(4). Note that this rule also does not apply if the issuer is subject to a binding obligation inconsistent with the rule, and such obligation predates November 2003. *See* Nasdaq Rule 5605(e)(5).

102 *See* Nasdaq Rule 5605(d)(2)(A).

103 *Id.*

104 *See* Nasdaq Rule 5605(d)(2)(B). Rule 5605(d)(4) provides for a cure period for companies that fall out of compliance with these requirements. Rule 5650(d)(5) includes certain exceptions for smaller reporting companies.

105 *See* Nasdaq Rules 5605(d)(1), 5605(d)(3).

106 *See* Nasdaq Rule 5605(c)(2); Nasdaq IM-5605, Nasdaq IM-5605-3, Nasdaq IM-5605-4, Nasdaq IM-5605-5.

107 *See* Nasdaq Rule 5605(c)(1).

108 *See* Nasdaq Rule 5605(c)(1)(A).

109 *See* Nasdaq Rule 5605(c)(1)(B).

110 *See* Nasdaq Rule 5605(c)(1)(C).

111 *See* Nasdaq Rules 5605(c)(1)(D), 5605(c)(3).

112 *See* Nasdaq Rule 5605(c)(2)(A). As noted above, foreign private issuers are not required to meet most of these requirements (including the minimum number of members of the audit committee). *See* IM-5615-3.

113 *See generally* Exchange Act Rule 10A-3(b)(1). In the case of investment company issuers, the term "affiliated person" is replaced with "interested person," as defined in Section 2(a)(19) of the Investment Company Act of 1940.

114 *See* Nasdaq Rule 5605(c)(2)(A).

115 *Id.*

116 *See* Nasdaq IM-5605-4.

117 *See* Nasdaq Rule 5605(c)(2)(B).

118 *See* Nasdaq Rule 5605(c)(3). Audit committees for issuers that are investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting-related services for the issuer, as well as the issuer's employees.

119 *See generally* Nasdaq Rule 5605(c)(4).

120 *See* Nasdaq Rule 5620(a). An issuer organized as a limited partnership is only required to hold an annual meeting of the limited partners if such meeting would otherwise be required under state law or the issuer's partnership agreement. *See* Nasdaq Rule 5615(a)(4)(D).

121 *See* Nasdaq IM-5620.

122 *See* Nasdaq Rule 5620(c). Non-US companies that are not foreign private issuers may rely on home-country practice if home-country law mandates a quorum requirement that prohibits the company from establishing a quorum requirement provided by Nasdaq. Any company relying on this exception must provide a statement from independent home-country counsel regarding such restriction and disclose such reliance publicly. Foreign private issuers may follow home-country practice with respect to shareholder meetings. *See* Nasdaq Rule 5615(a)(3).

123 *See* Nasdaq Rules 5615(a)(4)(E), 5620(c)(i).

124 *See* Nasdaq Rule 5620(b). Note that foreign private issuers are not subject to the US proxy rules. *See* Nasdaq Rule 5615(a)(3). An issuer organized as a limited partnership will only be required to solicit a proxy if a meeting of the limited partners will be held where a vote will be required. *See* Nasdaq 5615(a)(4)(F).

125 *See* Nasdaq Rule 5615(a)(3).

126 *See* Nasdaq Rule 5630(a).

127 *See* Nasdaq Rule 5635(c). *See also* Nasdaq IM-5635-1 paragraph (2). "Material amendments" to an equity compensation arrangement include any material increase in the number of shares to be issued under the plan (other than to reflect a reorganization, stock split, merger, spin-off, or similar transaction), any material increase in benefits to participants, any material expansion of the class of participants eligible to participate in the plan, and any expansion in the types of options or awards provided under the plan.

128 *See* Nasdaq Rule 5635(c). The exceptions include: (1) warrants or rights issued generally to all security holders of the issuer or stock purchase plans available on equal terms to all security holders of the issuer; (2) certain tax-qualified, non-discriminatory employee benefit and parallel non-qualified plans; (3) plans or arrangements involving mergers or acquisitions, either when conversions, replacements, or adjustments of outstanding options or other equity compensation awards are necessary to reflect the transaction, or when shares available under certain plans acquired in acquisitions or mergers are to be used for certain post-transaction grants; and (4) employment inducements to new employees. The items described under (2) and (4) above must be approved by the issuer's independent compensation committee or a majority of independent directors. *See* Nasdaq Rule 5635(c)(1)-(4).

129 *See* Nasdaq Rule 5635(b).

130 *See* Nasdaq Rule 5635(a)(2).

131 *See* Nasdaq Rule 5635(a)(1)(A)-(B).

132 *See* Nasdaq Rule 5635(d)(1)-(2).

133 *See* Nasdaq Rule 5635(f).

134 *See* Nasdaq Rule 5635(e)(1); *see also* Nasdaq IM-5635-4.

135 *See* Nasdaq IM-5635-3.

136 *See* Nasdaq Rule 5210(b); *see also* 15 U.S.C. Section 7212.

137 *See* Nasdaq Rule 5610.

138 *See* Nasdaq Rule 5625.

139 *See Nasdaq Frequently Asked Questions: – Non-US Companies (Identification Number 400); see generally* Nasdaq Rule 5600.

140 *See* Nasdaq Rule 5250(b)(1); *see also* Nasdaq IM-5250-1.

141 *See* Nasdaq IM-5250-1.

142 *See* Nasdaq Rule 5250(e)(2)(A)(i).

143 *See* Nasdaq Rule 5250(e)(2)(B).

144 *See* Nasdaq Rule 5250(e)(2)(C).

145 *See* Nasdaq Rule 5250(e)(2)(D).

146 *See* Nasdaq Rule 5250(e)(1).

147 *See* Nasdaq Rule 5615(a)(3).

148 *See* Nasdaq Rules 5615(a)(3), 5625; *see also* Nasdaq IM-5615-3.

149 *See* Nasdaq Rule 5615(a)(3); *see also* Nasdaq IM-5615-3.

150 *See* Nasdaq Rule 5615(a)(3)(B)(i).

151 *See* Nasdaq Rule 5615(a)(3)(B)(ii).

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