# Demystifying US Securities Laws

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# Overview of Presentation

- The Regulatory Framework
  - The Securities Act of 1933;
  - The Securities Exchange Act of 1934; and
  - The Investment Company Act of 1940
- Exemptions and Safe harbors from Registration
  - Regulation D
  - Rule 144A
  - Regulation S (Category 1, Category 2 and Category 3)
- Due diligence and liability issues in US offerings of securities
  - 10b-5 Letter
  - Comfort
- TEFRA C and D

# Introduction to US Securities Regulatory Framework (1)

The US Federal Securities Laws of primary applicability to a Foreign Private Issuer (referred to herein as the "Company") and its directors, officers and principal shareholders are:

- The Securities Act of 1933, as amended (the "Securities Act");
- The Securities Exchange Act of 1934, as amended (the "Exchange Act");
- The Trust Indenture Act of 1939; and
- The Investment Company Act of 1940 (the "Investment Company Act").

There are also US state securities laws, often referred to as "blue sky" laws, but these are mostly applicable to small, regional or intrastate transactions.

# Introduction to US Securities Regulatory Framework (2)

- The US Federal Securities Laws are enforced by the US Securities and Exchange Commission (SEC) pursuant to express (and, in some cases, implied) authority granted by the US Congress. The SEC has promulgated numerous rules and regulations under each of the Securities Act and the Exchange Act, which have the force and effect of law.
- In addition to US Federal Securities Laws, if the Company has Ordinary Shares listed on the New York Stock Exchange (NYSE) or the NASDAQ Stock Market (NASDAQ), the Company will also be subject to their respective listing rules.

# The Securities Act Overview (1)

The purpose of the Securities Act is to enable investors to receive full and fair disclosure in connection with securities offerings in the US capital markets. The Securities Act generally governs the offer and sale of securities (i.e. ordinary shares or notes) into the public marketplace either by the Company itself or by certain persons who, because of their relationship with the Company, are deemed for purposes of the Securities Act to stand in the shoes of the Company. Thus, it applies not only to the Company when it is issuing ordinary shares or registered notes in an exchange offer, but also to:

- any person who may have acquired ordinary shares or notes directly from the Company rather than in open market transactions;
- persons who may have acquired ordinary shares or notes from any of the foregoing persons in a private transaction (such as a family member to whom one of such persons may have transferred ordinary

# The Securities Act Overview (2)

- all directors, executive officers and principal shareholders in respect of any ordinary shares or notes they have acquired or may acquire in any manner (i.e. regardless of whether from the Company or in the open market).

The Securities Act provides, among other things, that it is unlawful for the Company or any of the foregoing persons to offer or sell securities unless either:

- (a) there is a Securities Act registration statement then in effect (and a Prospectus available) with respect to that offer and sale; or
- (b) one of several possible exemptions from registration is complied with.

# The Exchange Act Overview

Generally, the Exchange Act governs trading of securities within (as distinguished from into) the public (or so-called "secondary") marketplace. It is designed to assure that (a) the public marketplace has an adequate and continuing flow of current information concerning the Company; (b) "insiders" (such as the Company's directors, executive officers and principal shareholders) do not take unfair advantage of their positions and internal sources of information to profit from trading in the ordinary shares or notes, and the SEC and the investing public be kept informed by such "insiders" as to their holdings of, transactions in, and plans and proposals with respect to, the ordinary shares or notes; (c) public (i.e. "non-insider") security holders are assured of true and complete disclosure when being asked to vote or make investment decisions with regard to their securities; (d) the Company's of true and complete disclosure when being asked to vote or make investment decisions with regard to their securities; (e) the Company's books and records are properly maintained; and (f) there is full and prompt disclosure of accumulations of large blocks of securities by certain purchasers.

# The Exchange Act Overview cont'd …

The Exchange Act also regulates "change-in-control transactions" (such as takeovers, election contests and tender offers), securities exchange matters, the conduct of brokers and dealers, and other matters not directly relevant to the scope of this presentation.

# The Securities Act and the Exchange Act (1)

Both the Securities Act and the Exchange Act are broad in scope. They are couched primarily in prohibitory language (*i.e.* it shall be unlawful to …) accompanied by various exceptions and exemptions. Both statutes authorize the SEC to promulgate interpretive rules, to conduct investigations of possible violations, to take administrative action and impose sanctions for violations, and to recommend (in appropriate cases) criminal prosecution of violators by the US Department of Justice.

The statutes prescribe various penalties (including fines and imprisonment) for violations and, in certain cases, expressly or impliedly permit private citizens to sue violators (including directors and officers of the Company) and recover monetary damages. Indeed, it is the potential for lawsuits by private citizens (including so-called "class actions") that constitutes perhaps the most dramatic mechanism for enforcement of these laws.

# The Securities Act and the Exchange Act (2)

It is important to note that, although a Company has authority and has often adopted provisions in its Articles of Association to indemnify its directors and officers from liabilities they may incur as a consequence of their serving in these positions, the SEC takes the position (as have some US Federal and State courts) that a Company's undertakings to indemnify its directors and officers for violations of the federal securities laws are contrary to public policy and, therefore, are unenforceable.

Accordingly, the Company's directors and officers must be aware that their conduct not only may subject the Company to corporate liability (and possible civil or criminal penalties) but also may (and, in certain situations discussed elsewhere in this presentation) subject them to direct personal liability for which there may be no exculpation or indemnification available.

# The Trust Indenture Act of 1939

The Trust Indenture Act of 1939 establishes requirements for trustees and indentures (primarily those relating to fiduciary responsibilities of trustees) for Securities Act-registered debt securities, other than securities issued by non-US governmental issuers.

# The Investment Company Act of 1940 (the "Investment Company Act")

The Investment Company Act and SEC regulations are designed to regulate investment companies such as mutual funds. Any issuer 40 per cent or more of whose assets are "investment securities" (which includes ownership interests in less than 50 per cent owned subsidiaries) may be deemed to be an investment company. Issuers and their finance subsidiaries should seek to avoid having to register under the Investment Company Act where possible because the Investment Company Act embodies a broad regulatory scheme intended primarily for mutual funds, unit investment trusts and closed-end investment companies. It contains requirements that are not consistent with conducting normal business operations.

# Other US Laws or Regulations Which May Be Relevant to Securities Offerings

- Federal tax laws, including the Internal Revenue Code and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA);
- The Employee Retirement Income Security Act of 1974 (ERISA); and
- The rules of the various stock exchanges (NYSE, AMEX) and NASDAQ.

# The Securities Act – Registration of Securities

- Section 5 of the Securities Act prohibits offers or sales of securities involving interstate commerce or mail unless such securities are registered with the SEC (unless otherwise exempt).
- Registration Process
  - Red Herring; and
  - Final Prospectus.
- Contents of a Prospectus for a Registered Offering:
  - detailed description of business;
  - MD&A;
  - description of related party transactions;
  - extensive description of risk factors;
  - disclosure of executive compensation; and
  - complete financial statements, reconciled to US GAAP.

# Securities Act – Exemptions from Registration – Overview

**Exemptions from Registration**

- Security Exemptions, including:
  - 3(a)(2) - any security representing obligations of or guaranteed by the US government or by a state or local government; and
  - 3(a)(3) - commercial paper with a term of not more than 9 months.
- Transaction Exemptions, including:
  - Section 4(1) - exempts transactions by any person other than an issuer, underwriter or dealer - this allows ordinary investors to resell their securities in the normal trading markets;
  - Section 4(2) - exempts transactions by an issuer not involving a public offering - this is the so called “private placement” exemption;
  - Section 4(3) and 4(4) generally exempt brokers and dealers in ordinary trading activities; and
  - So called “Section 4(1½) Exemption” - exempts private re-sales that are effected in a manner similar to private placements by issuers under Section 4(2).

# Securities Act – Exemptions from Registration – Private Placements and Offshore Offerings

- Section 4(2) of the Securities Act allows issuers to offer their securities in the US without registration if the securities are privately placed in transactions that do not involve a public offering. Most private placements under Section 4(2) are structured to comply with one of two safe harbours: Regulation D or Rule 144A.
- Regulation D Private Placement - provides a set of non-exclusive guidelines for determining whether a private placement of securities qualifies for the Section 4(2) exemption.
- Rule 144A Private Placement - Rule 144A is technically a re-sale exemption for buyers of restricted securities. However Rule 144A has become a major vehicle by which issuers place unregistered securities, by selling such securities to "qualified institutional buyers" (QIBs).
- Regulation S Offshore Offering - offshore sales are outside the reach of the registration requirements of the Securities Act - an interpretation of Section 5.

# Securities Act – Exemptions from Registration – Regulation D Private Placement

Regulation D of the Securities Act provides a set of non-exclusive guidelines for determining whether a private placement of securities qualifies for the Section 4(2) exemption. The general guidelines for a private placement are as follows:

- No General Solicitation or Advertising;
- Number of Purchasers;
- Information Requirements; and
- Notice Requirements.

# Securities Act – Exemptions from Registration – Regulation D Private Placement Requirements (1)

## No General Solicitation or Advertising

– Neither the issuer or any person acting on its behalf (including selling agents) may offer or sell the securities by any form of general solicitation or general advertising.

## Number of Purchasers

– Regulation D does not limit the number of accredited investors who may purchase the securities, but it does limit the number of non-accredited investors to 35.

# Securities Act – Exemptions from Registration – Regulation D Private Placement Requirements (2)

## Information Requirements

- If the securities are sold only to accredited investors Regulation D does not require the issuer to provide investors with specific information. However even if a private placement is limited to accredited investors a private placement memorandum will usually be prepared and circulated to prospective purchasers both for marketing reasons and to reduce the potential liabilities of participants in the offering.
- Where non-accredited investors are involved Regulation D provides guidelines for disclosure that vary depending upon:
  - whether the issuer is or is not a reporting company under the Exchange Act; and
  - the dollar value of the securities offered.

# Securities Act – Exemptions from Registration – Regulation D Private Placement Requirements (3)

## Notice Requirements

– If the offering is made pursuant to Regulation D the issuer must file copies of Form D with the SEC within 15 days of the first sale of securities in the offering. Form D is a relatively short, fill in the blank type form which requires basic information about the issuer and the offering.

# Securities Act – Exemptions from Registration – Rule 144A Private Placement

- Rule 144A was adopted in 1990 and is premised on the theory that re-sales to large institutions that are sophisticated investors who can fend for themselves do not need the protections of the registration requirements. Rule 144A is technically a re-sale exemption for buyers of restricted securities. However Rule 144A has become a major vehicle by which issuers place unregistered securities by selling such securities to "qualified institutional buyers" (QIBs). To qualify for an exemption under Rule 144A the following matters must be satisfied:
  - Sales Must Be Made to QIBs;
  - Information Delivery Requirement;
  - Fungibility; and
  - Notice.

# Securities Act – Exemptions from Registration – Rule 144A Private Placement Requirements (1)

## Sales Must be Made to QIBs

- A QIB is generally defined as:
  - an institution 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 issuer, provided that any bank must have a net worth of at least $25 million; or
  - dealers with $10 million or more to invest on a discretionary basis acting for their own accounts or for the account of other QIBs.
- The seller of the securities must reasonably believe that the purchaser is a QIB and should obtain certification of the purchaser's status as a QIB.

# Securities Act – Exemptions from Registration – Rule 144A Private Placement Requirements (2)

## Information Delivery Requirement

- If requested by the purchaser or prospective purchaser, the issuer must provide:
  - a brief description of the issuer's business, products and services; and
  - financial statements for the last three years or such lesser time as the issuer has been in operation.
- The information delivery requirement is not applicable if the issuer is:
  - a reporting company under the Exchange Act;
  - exempt under Rule 12g3-2(b) of the Exchange Act; or
  - a foreign government.
- It should be noted that due to marketing considerations and liability concerns an offering document is usually prepared that is in substantial compliance with SEC disclosure rules. A timetable for a Rule 144A transaction must therefore encompass the preparation of such a document. The extent of deviation of the Rule 144A offering document from US disclosure rules is a subject for consideration by the issuer, the investment banks, and their respective counsel in light of the investment banks' internal policies, counsel's policies regarding the issuance of a 10b-5 opinion and comparable offering documents for similar transactions involving similar issuers.

# Securities Act – Exemptions from Registration – Rule 144A Private Placement Requirements (3)

## Fungibility

– The securities offered cannot be of the same class as securities of the issuer listed in a US exchange or quoted on the NASDAQ. American Depositary Receipts (ADRs) issued in the US are not fungible with the underlying securities listed abroad.

## Notice

– Seller to take reasonable steps to ensure the purchaser is aware that the seller is relying on Rule 144A. Notice is presumed for trades through PORTAL.

# Securities Act – Exemptions from Registration – Regulation S Offshore Offerings

Regulations S provides issuers, affiliates and underwriters with a safe harbor from the registration requirements and also provides a safe harbor for re-sales. Regulation S is not technically an exemption from the Securities Act filing requirements. Instead it provides safe harbour guidelines for determining when an offering of securities will be deemed to have occurred outside the United States (and therefore not be subject to registration under the Securities Act). For Regulation S to apply the following is required:

- the presence of an offshore transaction (i.e. the buyer is outside the US when the buy order is originated or the transaction is executed on the physical trading floor of a foreign securities exchange); and
- the absence of "directed selling efforts" in the United States.

# Securities Act – Exemptions from Registration – Regulation S Requirements (1)

"Offshore Transaction"

– the purchase order originates outside the US and either:
  - the buyer is outside the US when the buy order is originated; or
  - the transaction is executed on the physical trading floor of a foreign securities exchange.

# Securities Act – Exemptions from Registration – Regulation S Requirements (2)

"Directed Selling Efforts"

- Are defined as activities undertaken for the purpose of conditioning the United States market for any of the securities offered in reliance on Regulation S. Activities that could reasonably be expected to have this conditioning effect are also considered directed selling efforts. Directed selling efforts include:
  - advertisements in any publications printed primarily for distribution in the US or with a general circulation in the US of more than 15,000 copies; and
  - mailing printed material to prospective investors in the US.
- However the following will not be classified as directed selling efforts:
  - selling activities to QIBs in connection with a concurrent unregistered US offering of securities of the same class; and
  - routine product advertising and corporate communications.
- Note that the determination of whether US editions of international publications and research reports are or are not directed selling efforts is a grey area.

# Securities Act – Exemptions from Registration – Regulation S Requirements (3)

- Regulation S divides issuers into three categories:
  - Category 1 issuer;
  - Category 2 issuer (40-day distribution compliance period); and
  - Category 3 issuer (one-year distribution compliance period – equity).
- Category application for an issuer seeking to rely on Regulation S depends on:
  - the likelihood that the securities, once issued, will "flow back" to US investors in the secondary market;
  - whether the issuer is US (Category 3) or non-US (Category 1 or Category 2); and
  - whether the issuer already files reports with the SEC.
- Measured by "Substantial US Market Interest" (SUSMI) for Category 2.

# Securities Act – Exemptions from Registration – Regulation S, Category 2

Regulation S, Category 2 – Definition off “Substantial US Market Interest” (SUSMI)

- For equity securities there is SUSMI if:
  - The US is the issuer’s largest market; or
  - In the issuer’s prior fiscal year 20% or more of all trading took place in the United States and less than 55% of such trading occurred on a single foreign country's market.
- For debt securities there is SUSMI if:
  - Debt securities are held of record by 300 or more US persons;
  - $1 billion or more in the principal amount is held of record by US persons; and
  - At least 20% is held of record by US persons.

# Securities Act – Exemptions from Registration – Regulation S, Category 3 (1)

## One Year Distribution Compliance Period

The offer or sale, if made prior to the expiration of the one year distribution compliance period, must be made pursuant to the following conditions: (a) the offer may not be made to a US person; (b) certification by the purchaser that, among other things, it is not a US person, that it will resell the shares only in accordance with Regulation S and other US securities laws; (c) legends on shares with appropriate language regarding Regulation S and other US securities laws; and (d) the company must refuse to register any transfer of the shares not made in accordance with Regulation S and other US securities laws.

## Electronic Settlement (CREST) After One Year Distribution Compliance Period

There was debate as to whether shares can be electronically traded in the second year post IPO – developing market practice towards adequate procedures that need to be put in place to ensure that buyers are aware that shares are “restricted securities” for US securities law purposes. Market practice strengthened by February 2008 revisions to Rule 144 regulating restricted securities.

Liquidity may be affected by certificated settlement as institutional investors use CREST, UK electronic settlement system. Electronic settlement platforms are under development, and are evolving – watch this space (London Stock Exchange/CREST).

# Securities Act– Exemptions from Registration – Regulation S, Category 3 (2)

## Publicity Guidelines

Publicity guidelines prior to and during one year post IPO distribution compliance period:

- In order to rely on Regulation S, Category 3 exemption from registering shares in the US, a Company needs to be very careful about publicity.
- A Company cannot give any interviews, release any publicity material or contact any securities analysts in the United States concerning the offering or the shares either before IPO and for one year post IPO.
- A Company must vet information on its website to ensure that it is only dealing with the business not the offering.
- The investor relations page of a Company's website should only be accessible by non US persons (click through windows and/or IP detector).

## US Reporting Requirements

Reporting company and Sarbanes-Oxley:

- Common misapprehension that AIM protects a US company from Sarbanes-Oxley.
- Under the Exchange Act if a US Company has over 500 shareholders of record globally (regardless of whether it is listed in the United States) it becomes a reporting company.
- Once a reporting company under the Exchange Act, Sarbanes-Oxley applies.

# Securities Act – Exemptions from Registration – Regulation S, Category 3 (3)

## Definition of "US Issuer" under Regulation S

Can you get around Regulation S, Category 3 restrictions by putting a non US company on top of an existing company? No!

If the majority of shares of a company (wherever incorporated) are held by US persons or residents and either:

- a majority of the directors and officers are US persons or residents; or
- a majority of the group's assets are in the United States; or
- the business of the company is principally managed from the United States;

then you are a US issuer for purposes of Regulation S regardless of where the company is incorporated.

## Additional Considerations

Other considerations - special requirements apply to:

- Institutional investors based in the United States (144A/QIBs);
- Pre-IPO holders (including employees); and
- Affiliates (including directors/officers).

# Liability - Securities Act (1)

- Liability for SEC-registered transactions.
- Section 11
  - strict liability for issuers and its executives, managers, experts.
  - liability for registration statements.
  - due diligence defense available, but not for issuer.
- Section 12(a)(1)
  - liability for offers or sales of unregistered securities that are required to be registered.
  - successful plaintiff entitled to rescission (purchase price plus interest).

# Liability - Securities Act (2)

- Section 12(a)(2)
  - liability for prospectuses or oral communications (cf. Registration statements).
  - due diligence defense available.
- Section 15
  - liability of controlling persons.
  - joint and several with the issuer unless controlling person can show that he/she had no knowledge or reasonable ground for belief.

# Liability - Securities Exchange Act

- Any offer or sale of a security - both public and private - are subject to Rule 10b-5 liability.
- Takes the form of private plaintiff (including class-action) lawsuits for misleading offering materials.

Rule 10b-5

- In connection with a purchase or sale, it is unlawful to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

# Due Diligence and 10b-5 Letter (1)

The due diligence process and delivery of the 10b-5 letter:

- Because of the risk of liability, managers usually request 10b-5 letters from their law firm and issuer's counsel.
- A 10b-5 letter is a negative comfort letter (not a legal opinion) where the law firm states that the law firm, in the course of due diligence, did not find any untrue statement of material fact or any omission of material fact that would make the offer document misleading.

# Due Diligence and 10b-5 Letter (2)

- Reason for extensive due diligence:
  - under Section 11 of the Securities Act, underwriters for registered deals can establish a due diligence defense unavailable to the issuer.
  - for Rule 144A and other offerings, underwriters may also establish a due diligence defense.
  - practice has developed such that, as part of the underwriters' due diligence process, a 10b-5 letter is obtained from their and/or the issuer's lawyers.
  - while market practice, the role of a 10b-5 letter has not been addressed in case law.
- Important additional considerations:
  - Auditor comfort letter (SAS 72); and
  - Your own due diligence.

# TEFRA C and D

**The Tax Equity and Fiscal Responsibility Act of 1982**

- was introduced to limit tax evasion by US taxpayers by discouraging the issue of bearer debt securities in the US and to encourage US investors to hold debt securities in registered form.
- in general, TEFRA requires that (i) the issuer of bearer debt instruments should ensure that "reasonable arrangements" are in place to prevent bearer debt instruments being sold to US persons in connection with a primary offering, (ii) a specified legend must be carried on the instruments, and (iii) there can be no payment of interest in the US.
- TEFRA C and TEFRA D are alternative sets of rules adopted by the IRS, compliance with which ensures that an issue of bearer debt satisfies the reasonable arrangements requirement. There are collectively known as the ‘C’ and ‘D’ Rules. The D Rules are generally preferred because compliance with its rules provides a safe harbour from the potential sanctions imposed under TEFRA.

# TEFRA C and D (2)

## The C Rules and D Rules

- The C Rules provide an alternative method for satisfying the "arrangements reasonably designed" requirement, and imposes fewer procedural restrictions than the D Rules on the issuance by a foreign issuer of bearer debt obligations. They do not, however, provide safe harbour protection against a distributor's inadvertent non-compliance.
- The D Rules provide that an issuer (or, subject to the safe harbour rule discussed below, a distributor) of bearer form debt obligations may not offer or sell such obligations to a US person or to a person within the US during an applicable "restricted period".
- A distributor is (i) any person who offers or sells the obligation during the restricted period pursuant to a written contract with the issuer; (ii) any person who offers or sells the obligation during the restricted period pursuant to a written contract with a person described in (i); or (iii) any person who acquires the obligation from an affiliate for purposes of offering or selling the obligation during the restricted period, if that affiliate is the issuer or distributor described in (i) or (iii).

# TEFRA C and D (3)

## The D Rules

- Safe harbour requirements will be satisfied if the distributor (i) agrees to comply with the offering and sale restrictions of the D Rules and (ii) has in effect procedures reasonably designed to ensure that its employees or agents who are directly engaged in selling the obligation are aware that the obligation cannot be offered or sold during the restricted period to a US person or to a person within the US.
- Over time, market participants have established policies to ensure that the safe harbour requirements are satisfied.
- The main benefit of using the D Rules is that if a distributor complies with the D Rules safe harbour, inadvertent sales to US persons will not result in the imposition of issuer sanctions.

# Summary and Overview

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# Contact details

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Daniel is a US securities partner in the international corporate practice of the London office of CMS Cameron McKenna LLP and has over 12 years-experience practising in the London and New York markets. Daniel has significant experience in representing US, UK, European and Asian investment banks and corporate issuers on a wide range of international securities transactions, including: Rule 144A and Regulation S equity and debt offerings; Regulation S, Category 3 transactions for US companies listing in the United Kingdom; rights offerings; exchange offers; equity-linked securities offerings; initial public offerings and secondary and follow-on offerings of equity securities, including SEC-registered transactions. Daniel also advises the London Stock Exchange on US securities issues, including Rule 144A and Regulation S. Daniel was named in Chambers and Partners Directory 2009 for Equity Capital Markets. Daniel was recognised by *The Lawyer* as one of the Hot 100 legal practitioners for 2008.

Daniel is the founder of the Forum for US Securities Lawyers in London (the "Forum"), a trade association representing over 1,500 US-qualified lawyers practising at a number of law firms and financial institutions in the London capital markets, as well as market participants including securities exchanges, settlement systems and registrars. Founded in 2006, the Forum is an independent, self-funded organisation dedicated to addressing issues of, application of and compliance with, US securities laws in the London and international capital markets. The Forum's recent projects have included the submission of comment letters to the US Securities and Exchange Commission (the "SEC") on its proposed changes on its proposed amendments to Rule 12g3-2(b) under the Exchange Act, on its proposed amendments to the cross-border exemptions for business combination transactions and on its proposals on exemptions for foreign broker-dealers), as well as publishing a set of procedures for the electronic settlement of Regulation S, Category 3 shares during the one-year period following the Distribution Compliance Period (the "Year Two Project"). The Forum is currently developing a set of procedures for the application of the 3(c)(7) exemption under the Investment Company Act to equity securities offerings on the London Stock Exchange.