

Chapter 1

Why an Exempt Offering or a Hybrid Offering?

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§ 1:1 Introduction

Our clients include domestic and foreign companies eager to finance their growing businesses by raising capital as well as the investment banks that assist these companies with their financing plans. Generally, both domestic and foreign companies seek to access the U.S. markets. While the capital markets have become more interconnected and many foreign capital markets now rival the U.S. equities market, the United States is still home to the deepest and the largest equities market in the world. Until not too long ago, a company's financing life cycle was almost pre-determined and could be described in well-defined stages. An emerging company typically sought to finance its business through investments from first, friends and family, then perhaps from angel investors, then, if it were successful, from venture capital firms. A venture or private equity investment was seen as a seal of approval. In the United States, given the application of section 5 of the Securities Act of 1933, as amended (the "Securities Act")¹ to offerings of securities, a company was required to limit itself to conducting smaller rounds of financing, relying on various available exemptions from the registration requirements of the Securities Act, and to target principally sophisticated institutional investors. The securities that a company sold in these private or exempt offerings were "restricted securities," which means that the securities had never been offered pursuant to a registration statement. Restricted securities are not freely transferable and must be resold only pursuant to an effective registration statement or in an exempt securities offering.

After any number of private financing rounds, the company's founder, management, and venture investors would begin to consider an initial public offering (IPO). An IPO, as discussed below, provides a company with valuable "currency" in the form of a publicly traded security, which could be used for stock-based compensation awards

1. Securities Act of 1933, 48 Stat. 74 (May 27, 1933), codified at 15 U.S.C. § 77a *et seq.*

and for acquisitions.² An IPO often is also the first step toward providing existing security holders with an opportunity for liquidity. Following an IPO, existing security holders would be able to resell their securities into an active trading market.

Once a company was a public reporting issuer, it became subject to a comprehensive regulatory framework governing, among other things, all of its ongoing disclosures. Although the regulatory framework may have imposed requirements that seemed onerous (at the time), being a public company offered distinct benefits. Once public, a company generally had many more financing opportunities. By and large, already public companies relied on raising additional capital to finance their growth through follow-on public offerings, underwritten by one or more investment banks. From time to time, an already public company also might conduct a private placement or other exempt offering as part of an overall financing plan.

But that was then, and this is now. That orderly process with its well-defined steps is mostly a thing of the past. Given significant changes in market dynamics, emerging companies have a broader array of financing alternatives. For venture and private equity investors, going public may not be the ultimate or the most desirable liquidity event for a number of reasons, including:

1. *Costs and Disclosures.* For both domestic and foreign issuers, the costs associated with going public and the additional disclosure, corporate governance, and other requirements that are applicable to a U.S. reporting issuer have made an IPO far less appealing.
2. *Directors and Officers Scrutiny and Liability.* Foreign issuers may be reluctant to subject themselves and their officers and directors to the scrutiny and heightened liability risks associated with being a U.S. reporting issuer.
3. *Financing Alternatives.* Now, there are a number of foreign capital markets that may offer foreign issuers opportunities. A company that chooses to defer an IPO may find that it has more financing alternatives than in years past. Private secondary markets have emerged that provide existing security-holders of private companies with liquidity opportunities. Regulatory reforms have brought greater certainty to private placements and exempt offerings. These changes have improved capital formation for smaller and emerging companies. Smaller and emerging companies have found that a broader

2. See *infra* section 1:5.

array of investors are interested in investing in private companies, especially in late-stage financing rounds.

For larger already reporting issuers, the “conventional” choice for raising additional capital traditionally was a follow-on public offering. This is no longer the case. Although securities law reforms have made the public offering process more efficient, other developments have led reporting issuers to turn to private placements and other exempt and hybrid offerings as an alternative to, or along with, follow-on public offerings. In recent years, more capital has been raised in private or exempt offerings than in registered offerings, as discussed further below.

§ 1:2 Exempt Offerings and Hybrid Offerings

It is no longer that easy to distinguish among offering types. Throughout this treatise, we focus our attention on “exempt offerings.” Even when reporting issuers turn to registered follow-on offerings to raise additional capital, the dynamic for these offerings has changed in recent years. Most follow-on public offerings are conducted on an accelerated basis or marketed using techniques once associated with private or limited offerings.

§ 1:2.1 Exempt Offerings

By exempt offerings, we mean offerings of securities that are exempt from, or excluded from (in the case of offshore, or Regulation S, offerings), the registration requirements of section 5 of the Securities Act. The securities sold in these offerings generally are restricted securities. As a result, we also discuss the various safe harbors available for the resale of restricted securities. As discussed above, a private company may rely on exempt offerings to finance its growth. Exempt offerings may be used by both private companies and public reporting issuers for their potential capital raising needs. However, a private company conducting an exempt offering will have different concerns than those facing a reporting issuer that proposes to conduct an exempt or hybrid offering. We discuss both below.

§ 1:2.2 Hybrid Offerings

We also discuss “hybrid offerings.” As a result of changes in market dynamics, and changes in the regulations applicable to securities offerings, there has been a coalescence of offering types. Private or exempt offerings are looking more like “public offerings” in many respects. Public offerings, especially follow-on offerings conducted as shelf takedowns, are being structured to have many of the useful features typically associated with private or more limited offerings.

For example, many more shelf takedowns are being completed in a very compressed time period, with little to no public disclosure of the “launch” of an offering, and are being marketed principally to institutional investors, sometimes on a confidential basis. When we refer to hybrid offerings, we mean securities offerings that have some features or characteristics typically associated with private or exempt offerings, and some features or characteristics typically associated with public offerings. We include private investment in public equity (PIPE) transactions, Rule 144A offerings, certain kinds of shelf take-downs, registered direct offerings, equity lines of credit, and certain continuous offering programs, such as at-the-market offerings and medium-term note and commercial paper programs set up as ongoing private offerings, as “hybrid offerings.”

§ 1:3 Growth of Exempt Offerings and Hybrid Offerings

For reasons that we hope will become clearer once you have read the thirty or so chapters that follow, in recent years, more and more issuers have turned to exempt offerings and hybrid offerings to finance their growth. Most securities that are sold are sold without registration under section 5, so it is important to understand exempt transactions.

We have collected some statistics to illustrate the increased reliance on exempt and hybrid offerings. As we discuss specific offering types in this treatise, we provide more analysis regarding the trends that affect each. There has been substantial growth in the PIPE market in recent years. As noted, the term “PIPE” has come to include a number of different transaction types—all of which involve a private placement of securities by an already public issuer. There are a number of third parties that track activity in the PIPE market; however, each information provider defines the “PIPE universe” somewhat differently. As a result, the information from these different sources may not be directly comparable. For example, PrivateRaise includes registered direct offerings (due to the targeted nature of the marketing process in these offerings) in its PIPE statistics.

For 2002, PrivateRaise reported that there were 978 PIPE transactions completed, raising approximately \$15 billion in offering proceeds. In 2016, there were 1,199 PIPE transactions completed, raising approximately \$52 billion in offering proceeds.³

In February 2012, the SEC’s Division of Risk Strategy and Financial Innovation published a comprehensive study titled “Capital Raising in the U.S.: The Significance of Unregistered Offerings Using

3. Report furnished by PrivateRaise, a service of DealFlow Media.

the Regulation D Exemption,”⁴ which demonstrated conclusively that private offerings have become increasingly important, especially since 2009. The study showed “a substantial shift in capital raised from public to private methods.” For example, the study noted that “there has been a shift from public to private capital raising over the past three years, due to both a decline in public issuances and an increase in private issuances: public issuances fell by 11% from 2009 to 2010 while private issuances increased by 31% over the same period. Given the volatility of the capital markets from 2009 to 2011, it is not surprising that companies chose to rely on private or exempt transactions rather than announced, traditionally marketed underwritten public offerings. In October 2015, the SEC’s Division of Economic Research published an updated study. This study showed that, in 2014, SEC-registered offerings accounted for \$1.35 trillion of new capital compared to \$2.1 trillion reported raised through private offerings.⁵ Also, over time, more companies have chosen to rely on hybrid offerings, such as registered direct offerings or confidentially marketed offerings. We expect that these trends will become even more pronounced in the years to come as the lines between private placements and public offerings become even more blurred by changes arising in the aftermath of the Jumpstart Our Business Startups Act, or “JOBS Act,” passed in 2012.⁶ It is notable that in the years since adoption of the JOBS Act, which was in part intended to facilitate and promote IPOs, more and more companies have chosen to defer their IPOs and rely on private capital. According to an industry report, in 2012, global private companies raised \$40 billion from investors and this amount climbed to \$127 billion in 2016.⁷ In fact, large, late-stage private funding rounds have in certain instances displaced IPOs and, with increasing valuations, have resulted in nearly 200 “unicorns,” or private companies with at least \$1 billion private market valuation.

In order to put all of this in perspective, a bit more background may be helpful. A complete explanation of the securities regulatory framework would require its own separate treatise. Below, we outline the bare essentials.

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4. See SEC, *Capital Raising in the U.S.: The Significance of Unregistered Offerings Using the Regulation D Exemption* (Feb. 2012), www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf.
 5. See S. Baugess, R. Gullapalli & V. Ivanov, Division of Economic Research and Analysis, *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Offerings, 2009–2014* (Oct. 2015), <https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf>.
 6. The Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (Apr. 5, 2012) (the “JOBS Act”).
 7. Data gathered from Venture Pulse Q4 2016, <http://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/01/venture-pulse-Q4-2016-report.pdf>.

§ 1:4 Securities Regulatory Framework—In Brief

A privately held company (or a company that does not have securities that are publicly traded in the United States), whether domestic or foreign, that would like to access the U.S. markets first must determine whether it is willing to subject itself to the ongoing securities reporting and disclosure requirements, as well as the corporate governance requirements, which are part and parcel of registering securities publicly in the United States. An issuer may conduct a public offering in the United States by registering the offering and sale of its securities pursuant to the Securities Act and also by registering its securities for listing or trading on a U.S. securities exchange pursuant to the Securities Exchange Act of 1934, as amended (the “Exchange Act”).⁸ Instead, an issuer may choose to access the U.S. capital markets by offering its securities in an offering exempt from the registration requirements of the Securities Act.

Section 5 of the Securities Act sets forth the registration and prospectus delivery requirements for securities offerings.⁹ In connection with any offer or sale of securities in interstate commerce or through the use of the mails, section 5 requires that a registration statement must be in effect and a prospectus meeting the prospectus requirements of section 10 of the Securities Act must be delivered prior to sale.¹⁰ This means that the Securities Act generally requires registration for any sale of securities, although it also provides exemptions or exclusions from this general registration requirement. A number of exemptions from the section 5 registration requirements are available, based either on the type of security being offered and sold (these are generally set out in section 3 of the Securities Act), or on the type of transaction in which the security is being offered and sold (these are based on the type of transaction in which the securities are offered and sold). Also, the registration requirements are not intended to apply to ordinary trading transactions for securities that are already issued, assuming that these transactions are not engaged in by the securities issuer or its affiliates. Public information regarding the issuer of the securities is already available.

The Securities Act is a disclosure statute. The purpose of the Securities Act is to ensure that an issuer provides investors with all information material to an investment decision about the securities that it is offering. The registration and prospectus delivery requirements of section 5 require filings with the SEC and are intended to

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8. Securities Exchange Act of 1934, 48 Stat. 881 (June 6, 1934), codified at 15 U.S.C. § 78a *et seq.*
 9. 15 U.S.C. § 77e.
 10. 15 U.S.C. § 77e(b).

protect investors by providing them with sufficient information about the issuer and its business and operations, as well as about the offering, so that they may make informed investment decisions. These apply to offerings that are made to the general public (regardless of the sophistication of the offerees). The SEC presumes that distributions not involving public offerings (or widespread distributions) do not involve the same public policy concerns as offerings made to a limited number of offerees that have access to the same kind of information that would be included in a registration statement.¹¹ That information can be conveyed by providing disclosure or by ensuring that the offerees have access to the information. There are a number of regulatory restrictions on communications and information requirements in exempt offerings.¹² However, it is generally the case that an issuer will have greater flexibility in connection with the materials that it produces and furnishes to investors in an exempt offering. Although the antifraud and other liability provisions are applicable to offering materials used in connection with exempt offerings, there are few prescriptive requirements for an issuer preparing an offering memorandum for an exempt offering. The absence of such requirements stands in contrast to the detailed disclosure requirements applicable to a registered securities offering.

§ 1:5 IPO and Exchange Act Registration

In connection with an initial public offering of securities, an issuer must provide extensive information about its business and financial results. The preparation of the principal disclosure document, that is, the registration statement, is a time-consuming and expensive process. We do not discuss the factors to be considered in connection with preparing a registration statement, nor do we discuss the steps required in connection with the preparation of the document.¹³ Once filed with the SEC, the SEC will review the document closely and provide the issuer with detailed comments. The comment process may take as long as sixty to ninety days once a document has been filed with, or submitted to, the SEC. Once all of the comments have been addressed and the SEC Staff is satisfied that the registration statement is properly responsive, the registration statement may be used in connection with the solicitation of offers to purchase the

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11. For a more detailed discussion, see chapter 4, Section 4(a)(1) and Concept of 4(a)(1½).
 12. For a more detailed discussion, see chapter 23, Communications in Connection with Exempt and Hybrid Securities Offerings.
 13. See CHARLES JOHNSON, JR. & JOSEPH McLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS (4th ed. 2006).

issuer's securities. Depending upon the nature of the issuer (whether it is a domestic or foreign private issuer) and the nature of the securities being offered by the issuer, the issuer may use one of various forms of registration statement.

Once an issuer has determined to register its securities under the Securities Act, the issuer usually will also apply to have that class of its securities listed or quoted on a securities exchange, and in connection with doing so will register its securities under the Exchange Act. The Exchange Act requires registration of securities for the benefit of investors that purchase securities in the secondary market. The Exchange Act imposes two separate but related obligations on issuers: (1) registration obligations and (2) reporting obligations. Section 12 of the Exchange Act¹⁴ sets forth the requirements for registration of securities under the Exchange Act and requires that an issuer register a class of its securities with the SEC under two circumstances, pursuant to either section 12(b) or 12(g). Pursuant to section 12(b) of the Exchange Act, an issuer must register a class of its equity or debt securities under the Exchange Act prior to the listing of those securities on a national securities exchange.¹⁵ Section 12(a) prohibits any transaction by any member, broker or dealer in any unregistered security (other than an exempted security) on a national securities exchange.¹⁶ The section 12(b) registration requirement is applicable regardless of whether the securities previously have been registered under the Securities Act. Section 12(g) of the Exchange Act requires registration when the issuer has total assets exceeding \$10 million and a class of equity securities held of record by either 2,000 persons, or 500 persons who are not accredited investors.¹⁷ Section 13(a) of the Exchange Act imposes reporting obligations on an issuer that has registered a class of securities under section 12 of the Exchange Act.¹⁸ Section 15(d) of the Exchange Act requires registration when the issuer has filed a registration statement that has become effective pursuant to the Securities Act.¹⁹ Registration under either section 12(b) or (g) of the Exchange Act or under the Securities

14. 15 U.S.C. § 78l.

15. 15 U.S.C. § 78l(b).

16. 15 U.S.C. § 78l(a).

17. 15 U.S.C. § 781(g). Prior to the JOBS Act, the threshold for all issuers was 500 holders of record. More recently, the Fixing America's Surface Transportation Act, Pub. L. No. 114-126 Stat. 405 (Dec. 4, 2015) (the "FAST Act"), Title LXXXV—Holding Company Registration Threshold Equalization, Section 85001, amended the threshold for savings and loan holding companies, equalizing it with the threshold for banks and bank holding companies.

18. 15 U.S.C. § 78m.

19. 15 U.S.C. § 78o(d).

Act will subject the issuer to the periodic reporting requirements and other requirements under the Exchange Act.

If an issuer becomes subject to the reporting requirements of the Exchange Act, the issuer remains subject to those requirements until, in the case of exchange-listed securities, those securities are delisted, or, in the case of securities listed by reason of the issuer's asset size and number of record holders, the issuer certifies that it meets certain requirements.

Once an issuer becomes a reporting issuer, it must adhere to the disclosure requirements of the Exchange Act relating to annual and periodic filings. A reporting issuer must also meet the requirements of the Securities Act and its regulations in connection with any subsequent public offering conducted by the issuer. Securities Act disclosures that relate to specific offerings are required to be coordinated with those required under the Exchange Act. Given the public availability of information, investors are assumed to have access to disclosures made by reporting issuers—whether that disclosure is contained in filings made pursuant to the Securities Act or the Exchange Act. This is referred to as the “integrated disclosure system.” Regulation S-K provides a single set of instructions to be used by registrants under the Securities Act forms as well as the Exchange Act forms. For U.S. domestic issuers, the required non-financial disclosure items are set forth in Regulation S-K, and the required financial disclosure items are set forth in Regulation S-X. For foreign private issuers, the SEC has provided a separate integrated disclosure system, which provides a number of accommodations for foreign practices and policies.

§ 1:6 Being Public

As noted above, once an issuer conducts an IPO in the United States, or has a class of securities listed or traded on a national securities exchange, the issuer will be generally subject to the ongoing reporting requirements of the Exchange Act.²⁰ Issuers may be subject to reporting obligations pursuant to both section 13 and section 15(d) of the Exchange Act. In addition, a reporting issuer will become subject to many other rules and regulations. We will highlight only some of the most significant.

§ 1:6.1 Proxy Rules

Generally, an issuer (other than a foreign private issuer) that has registered a class of securities under the Exchange Act is subject

20. See *supra* section 1:5.

to the proxy rules and the tender offer rules of section 14 of the Exchange Act.²¹

§ 1:6.2 Reporting for Significant Security Holders

Issuers (other than a foreign private issuer) that have registered a class of securities under the Exchange Act are generally subject to the insider stock trading reports and short-swing profit recovery provisions under section 16 of the Exchange Act.²² Section 16(b) provides that any profit realized by an insider upon a “short-swing transaction” (that is, any purchase and sale, or sale and purchase, of any equity security of the issuer within a period of less than six months) is recoverable by the issuer,²³ while section 16(c) prohibits insiders from engaging in any short sales of the issuer’s equity securities.²⁴ Pursuant to section 13 of the Exchange Act, a security holder that accumulates more than 5% of the equity securities of a reporting issuer must provide notice of the acquisition to the issuer and must file a statement with the SEC on Schedule 13D or 13G disclosing its ownership (direct or indirect) within ten days after the acquisition of such securities.²⁵ Schedule 13G is very similar to Schedule 13D, but requires less information and, in most cases, must only be updated annually. Schedule 13G also can only be used by qualified institutional buyers (QIBs) and passive investors that hold securities due to their normal course of business and not to effect change or influence control of the issuer.²⁶

§ 1:6.3 Sarbanes-Oxley

In 2002, following a series of widely reported corporate scandals involving fraudulent accounting practices and governance abuses, the United States adopted legislation affecting all public companies, the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”).²⁷ Sarbanes-Oxley was a reaction to these abuses, which had eroded investor confidence in corporate boards and in regulatory oversight. Sarbanes-Oxley imposed a broad series of requirements relating to corporate governance, enhanced public disclosure, and the imposition of civil and criminal

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21. 15 U.S.C. § 78n.
 22. 15 U.S.C. § 78p.
 23. 15 U.S.C. § 78p(b).
 24. 15 U.S.C. § 78p(c).
 25. 15 U.S.C. § 78m.
 26. For a more extensive discussion of these requirements, see chapter 33, Change of Control Transactions.
 27. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

penalties for wrongdoing. The rules adopted pursuant to Sarbanes-Oxley amended the Exchange Act, and the rules and regulations promulgated thereunder as well as, to a lesser extent, the Securities Act. Pursuant to Sarbanes-Oxley a new oversight board was created, the Public Company Accounting Oversight Board (PCAOB) that is subject to supervision by the SEC. The PCAOB supervises the registration and regulation of accounting firms that audit public companies.

Sarbanes-Oxley and the rules adopted thereunder:

- Require that CEOs and CFOs certify the accuracy and completeness of their company's periodic reports and impose criminal penalties for false certification;
- Require the establishment and regular evaluation of disclosure controls and procedures, and internal control over financial reporting designed to ensure the accuracy and completeness of the information reported to the SEC and for the preparation of financial statements;
- Require the establishment by all listed companies of an independent audit committee;
- Require the disgorgement of compensation by CEOs and CFOs following an accounting misstatement that results from misconduct;
- Impose limitations on trading by officers and directors during retirement plan blackout periods;
- Prohibit the extension of credit to related parties; and
- Require the SEC to review a registrant's filings once every three years.

Section 301 of Sarbanes-Oxley requires that an issuer's audit committee must be directly responsible for the appointment, compensation, and oversight of the work of the public accounting firm retained by the issuer. Moreover, all of the members of the audit committee must be independent of the issuer. These requirements are distinct from those requirements that may be imposed by the national securities exchange on which the issuer's securities are listed or quoted.

Section 302 of Sarbanes-Oxley requires that the principal executive officer and principal financial officer of an issuer must:

- (1) review the filed financial report;

- (2) based on the officer's knowledge, certify that the filed report does not contain any material misstatement or omission of a material fact;
- (3) based on the officer's knowledge, certify that the included financial information fairly represents the issuer's financial condition and results of operations;
- (4) be responsible for various aspects of the issuer's internal controls; and
- (5) disclose to the issuer's auditors and the auditor committee all design or operation deficiencies of significance and any fraud involving employees with significant roles in the issuer's internal controls.²⁸

Section 404 of Sarbanes-Oxley requires that an issuer discuss its internal controls, (1) stating management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (2) providing an assessment of the effectiveness of the internal financial reporting control structure and procedures.²⁹

Section 906 of Sarbanes-Oxley requires that the principal executive officer and principal financial officer of an issuer provide a written statement certifying that (1) the financial statements fully comply with the requirements of section 13(a) or 15(d) of the Exchange Act, and (2) the information within the filed report fairly presents the issuer's financial conditions and results of operations in all material respects. Issuers may also be subject to criminal penalties under certain circumstances. The purpose of section 906 is to deter potential financial reporting misstatements by imposing potential criminal liabilities on the principal officers of the issuer.

Sarbanes-Oxley also requires that an issuer make additional specific disclosures in its Exchange Act reports. These additional ongoing disclosure requirements are intended to enhance the quality of the information made available to investors. For example, an issuer must specifically disclose all material off-balance sheet arrangements in a separate section of Management's Discussion and Analysis (MD&A).

§ 1:6.4 Investment Company Act

The Investment Company Act of 1940, as amended (the "Investment Company Act"),³⁰ governs the registration and regulation of

28. 15 U.S.C. § 7241.

29. 15 U.S.C. § 7262.

30. Investment Company Act of 1940, Pub. L. No. 768 (Aug. 22, 1940), codified at 15 U.S.C. § 80a-1 through § 80a-64.

investment companies, which may be better known to foreign issuers as collective investment vehicles. Under the U.S. regulatory scheme, every investment company is subject to registration and regulation pursuant to the Investment Company Act, unless it is exempt. An investment company is defined broadly as an entity that holds itself out as being engaged primarily in “investing, reinvesting or trading in securities” and also includes entities engaged in the business of “investing, reinvesting, owning, holding or trading in securities if securities represent 40% or more of the value of its assets.”³¹ As a result, foreign issuers that are banks, insurance companies, or specialized finance companies may find that they inadvertently fall within the definition of an “investment company.” Similarly, operating companies that devote themselves principally to research and development activities, and retain offering proceeds in cash, cash equivalents, or securities should also take care to avoid being classified as “investment companies” within the meaning of the Investment Company Act.

§ 1:6.5 Trust Indenture Act

The Trust Indenture Act of 1939, as amended (the “Trust Indenture Act”)³² supplements the Securities Act in relation to the registration and distribution of debt securities. In connection with a registered distribution of debt securities, an issuer must file a trust indenture that is qualified with the SEC. The indenture (and as a result the debt securities) generally must be governed by a body of U.S. law. A separate corporate trustee that meets the requirements set out in the Trust Indenture Act, which include independence from the issuer, must act pursuant to the trust indenture to represent the interests of the security holders.

§ 1:6.6 Securities Exchange Regulations

Generally, an issuer that chooses to offer its securities in the United States in a public offering registered under the Securities Act will contemporaneously register its securities under the Exchange Act, and have its securities listed or quoted on a securities exchange. In order to have its securities accepted for listing or quotation on a securities exchange, the issuer must meet the eligibility standards of the applicable exchange. In addition to imposing quantitative listing standards that relate to the issuer’s business performance, each securities exchange will also require that a listed company comply with its regulations for listed companies. These regulations relate to corporate governance matters, as well as to regular communications

31. 15 U.S.C. § 80a-3(a)(1).

32. Trust Indenture Act of 1939, Pub. L. No. 76-253, 53 Stat. 1149 (1939), codified at 15 U.S.C. § 77aaa through § 77bbbb.

with security holders and other disclosure requirements. Following the passage of Sarbanes-Oxley, each securities exchange adopted more stringent corporate governance requirements for its listed companies.

§ 1:6.7 State Blue Sky Laws

Each state has laws, referred to as “blue sky” laws, requiring the registration or qualification of securities in connection with offerings in those states. An issuer that conducts a public offering in the United States must comply with blue sky laws, as well as with federal securities laws. The National Securities Markets Improvement Act of 1996 (NSMIA)³³ provides for federal preemption of state laws and regulations requiring state registration of securities or securities offerings that meet certain standards. Generally, under NSMIA, “covered securities” (securities that are listed on the NYSE or Nasdaq) are exempt from state securities registration requirements. Blue sky laws may also be applicable to private placements (offerings exempt from the registration requirements).³⁴

§ 1:6.8 Regulation FD

Regulation FD encourages broad public disclosure by prohibiting the selective disclosure of material, nonpublic information except in certain situations. Selective disclosure occurs when an issuer provides third parties with material information about the issuer that is unknown to the public. Selective disclosure is not problematic in all instances and is often warranted, for example, where an issuer shares nonpublic information with its advisers. However, selective disclosure is problematic when the issuer provides such information to securities market professionals or corporate shareholders who can profit from, or avoid a loss because of, the information. The concerns over selective disclosure are heightened when an issuer is conducting a securities offering. There are numerous SEC rules relating to communications and the disclosure of information that must be considered during the offering process.³⁵

§ 1:6.9 Liability Concerns

An issuer considering whether to register its securities in the United States under the Securities Act or the Exchange Act should

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33. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3415 (Oct. 11, 1996).
 34. For a discussion of the application of blue sky laws, see chapter 2, Private Placements—An Overview.
 35. For a discussion of communication issues, including Regulation FD, see chapter 23, Communications in Connection with Exempt and Hybrid Securities Offerings.

consider carefully the securities liabilities to which the issuer and its directors and officers and other control persons may become subject. Liability may be civil and in certain cases criminal. Moreover, given the highly litigious environment in the United States, an issuer also may wish to consider the possibilities for private rights of action.³⁶

Several provisions under the Securities Act and the Exchange Act prohibit manipulation or fraud in connection with securities transactions. Under the Securities Act, the main antifraud provisions are section 11 and section 12. Section 11 covers misstatements or omissions in registration statements at the time of effectiveness,³⁷ while section 12 imposes liability on any person who offers or sells a security in violation of section 5.³⁸ Under the Exchange Act, the main antifraud provision is section 10(b), which is commonly associated with Rule 10b-5. Section 10(b) prohibits any manipulative or deceptive devices in connection with the purchase or sale of any securities.³⁹ Rule 10b-5 generally prohibits employing any device or scheme to defraud. There are a number of other liability provisions (for example, section 9(e) and section 18).⁴⁰ Note that the liability provisions under the Securities Act and the Exchange Act apply to all issuers, including foreign private issuers.

Under section 11 of the Securities Act, liability may arise from misstatements or omissions in a registration statement at the time it became effective. Any person acquiring a security registered under a registration statement that has been declared effective by the SEC, who did not have knowledge of the misstatement or omission at the time of the acquisition of the security, can sue the following:

1. every person who signed the registration statement, including the issuer,
2. every director of the issuer at the time of the filing of the registration statement, whether or not such director signed the registration statement,
3. experts (for example, accountants, appraisers, attorneys, etc.) who consent to such status, but only with respect to those sections of the registration statement which they have “expertized,” and
4. underwriters.⁴¹

36. For a discussion of liability considerations, see chapter 28, *Liability Considerations*.

37. 15 U.S.C. § 77k.

38. 15 U.S.C. § 77l.

39. 15 U.S.C. § 78j.

40. For a discussion of these other liability provisions, see chapter 28, *Liability Considerations*.

41. 15 U.S.C. § 77k(a).

Plaintiffs may also assert claims against any person who controls any of the foregoing persons, including controlling security holders who are not also officers and directors of the issuer, by or through the ownership of stock or an agency relationship.⁴² The acquisition of the security for purposes of determining liability covers both initial purchases and subsequent open market purchases. Section 12 of the Securities Act imposes liability on any person who offers or sells a security in violation of section 5, or by means of a prospectus or oral communication that includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.⁴³ Liability under section 12 may be for rescission, if the security is still owned by the plaintiff, or for damages, if the security is no longer owned by the plaintiff.

§ 1:7 IPO or No IPO—Considerations

An issuer that chooses to register its securities with the SEC and list its securities on a national securities exchange has always been subject to comprehensive registration requirements. However, as noted above, over time, the ongoing disclosure requirements have become more extensive.⁴⁴ In part, this is due to an increased recognition on the SEC's part that given technological and other communications advances, investors are more likely to rely on an issuer's ongoing public filings. Over time, for example, the SEC has focused on promoting enhanced disclosure by issuers regarding their financial results and business operations through more informative discussions in the MD&A section of disclosure documents. Also, in order to make the registration and disclosure process more efficient and seamless for issuers, the SEC has focused on improving the integrated disclosure system. Finally, in connection with Sarbanes-Oxley, the SEC mandated increased disclosures. With the adoption of Regulation FD, an issuer is required to carefully consider its communications, especially during an offering of securities. An issuer must make almost real-time disclosures.

There are a number of reasons why an issuer may wish to defer an IPO and why issuers appear to be waiting longer to go public in the United States.

42. *Id.*

43. 15 U.S.C. § 77l(a).

44. *See supra* section 1:6.

§ 1:7.1 Larger Companies Make Better Public Companies

There is a view that larger companies, with more visible and predictable earnings trajectories, make better public companies. This may be a backlash to the dot-com boom, during which relatively small, undercapitalized companies were taken public and did not demonstrate strong performance post-IPO. This may be as a result of regulatorily-imposed changes in the research analyst process, which have had the effect of reducing the number of companies that will be covered regularly by the research areas of leading investment banks. Securities exchanges are more actively regulating the activities, including the governance practices of their listed companies. This too may make it more difficult for a smaller public company to remain a listed company.

§ 1:7.2 Compliance Costs

There have been many press reports and many studies that indicate that issuers are waiting longer to go public as a result of the anticipated costs associated with Sarbanes-Oxley compliance, as well as a result of related liability considerations. There are many surveys and published studies regarding compliance costs. A survey conducted by Financial Executives International concluded that small companies anticipated spending approximately \$825,000 to comply with Sarbanes-Oxley initially and that the average cost for all companies is approximately \$4.3 million.⁴⁵ Another study by AMR Research put the compliance costs for U.S. public companies at \$6.1 billion.⁴⁶ Over time, as market participants have become more familiar with the requirements, these costs have declined, but may still remain substantial for a smaller company. Aside from the initial and ongoing Sarbanes-Oxley related compliance costs, many reporting issuers have found that they are required to increase their expenditures for their boards of directors, and particularly for audit committees. The cost of directors and officers (D&O) insurance also has increased and the more expensive D&O

45. Financial Executives International (FEI) conducts annual surveys on Sarbanes-Oxley compliance. *See* Financial Executives International, FEI Special Survey on Sarbanes-Oxley Section 404 Implementation (2005). FEI and others have noted that the costs of compliance have declined over time. In the FEI 7th Sarbanes-Oxley Compliance Survey published in April 2008, FEI noted that total average costs for section 404 compliance had declined. During fiscal 2007, the survey noted that total average cost for section 404 compliance for “accelerated filers” had declined to \$1.7 million.

46. KEVIN REILLY, AMR RESEARCH, AMR RESEARCH ESTIMATES SARBANES-OXLEY SPENDING WILL EXCEED \$6 BILLION IN 2006 (Nov. 29, 2005), www.amrresearch.com/Content/View.asp?pmillid=18972.

insurance comes with many more carve outs. Venture and private equity investors with a significant ownership interest in a portfolio company may not want to incur these costs in order to have a listed security. These investors may also be board members and will not welcome the increased liability associated with being a director of a U.S. reporting issuer. Also, these investors may favor another alternative to obtaining liquidity—for example, a sale transaction. Finally, the restricted securities that these investors hold may be more “liquid” as a result of the emergence of dark pools and private secondary markets, and because of regulatory changes that have minimized the limitations associated with reselling restricted securities.

Although the SEC has made a number of revisions to the Sarbanes-Oxley-related requirements for smaller public companies, many market participants continue to cite compliance costs as a deterrent to going public.

§ 1:7.3 Foreign Issuers May Choose to Avoid U.S. Reporting

These concerns may be accentuated for foreign issuers who generally are unaccustomed to extensive disclosure and corporate governance requirements. Although the SEC has made certain accommodations for foreign private issuers, many foreign issuers nonetheless remain wary. Foreign issuers and domestic companies too look at the highly litigious environment in the United States and the increase in enforcement activities and criminalization of more activities, and become quite skeptical about the benefits of being a U.S. reporting issuer. Foreign issuers may have more alternatives to an IPO in the United States. There are now more foreign markets that present attractive alternatives to the U.S. markets. Various studies note that the domestic markets in both Asia and Europe have become larger and more liquid.⁴⁷ For some time, listing on a U.S. securities exchange (and becoming subject to U.S. reporting standards) validated the foreign issuer’s success and had a certain prestige associated with it. Many foreign issuers that now do this calculus, choose not to become subject to U.S. reporting requirements.

47. See Christopher Woo, *The Effects of the Sarbanes-Oxley Act on Foreign Private Issuers*, Harvard Law School, International Finance Seminar, www.law.harvard.edu/programs/pifs/pdfs/christopher_woo.pdf; Committee on Capital Markets Regulation, *Interim Report* (2006), www.capmktreg.org/research.html; Committee on Capital Markets Regulation, *The Competitive Position of the U.S. Public Equity Market* (2007), www.capmktreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf; Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 735–39.

Some foreign securities exchanges have less onerous initial listing qualification requirements and fewer ongoing regulatory requirements, including fewer corporate governance obligations. Also, foreign issuers may access U.S. markets through exempt offerings. In recent years, private capital has been available to participate in securities offerings by foreign issuers. Moreover, more U.S. investors can readily invest directly in foreign listed securities.

§ 1:7.4 Limited Flexibility

Many executive officers of privately held companies are concerned that going public will limit their flexibility. Executive officers and directors of reporting issuers face tremendous burdens, especially in a post-Sarbanes-Oxley world. More and more, they are required to make very difficult decisions, including decisions regarding financial reporting, accounting estimates, accounting policies, etc., while they are subject to more scrutiny and more risk as a result of their choices. Given the prospect of shareholder litigation and other litigation concerns, their determinations become fraught with risk. This may inhibit their desire to take risk and may lead them to be more conservative than they otherwise would be. A recent survey found that, in fact, the principal reason given by senior managers of privately held companies for remaining private is that they would like to preserve decision-making control.⁴⁸

Similarly, managers at reporting issuers may find that the obligations associated with being a public company inhibit them from making more interesting choices. As noted in the preface, once a company goes public, it must report earnings on a regular basis. Earnings pressure and the need to respond to many constituencies (including research analysts, large institutional holders, aggressive hedge fund holders, etc.) may affect the decision-making processes. With Sarbanes-Oxley also came significant limitations on executive compensation arrangements. All of these considerations may influence the choice to defer an IPO.

§ 1:7.5 The IPO Process Is Expensive

Actually conducting an IPO will be time-consuming and expensive, and discussion of the process is beyond the scope of this treatise. In brief, from start to finish, an IPO may require at least three to six months of management time. An issuer will have to work closely with its counsel to draft a registration statement that meets the specific and

48. See James C. Brau & Stanley E. Fawcett, *Initial Public Offerings: An Analysis of Theory and Practice*, 61 J. FIN. 399 (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=530924.

detailed requirements of the Securities Act. The issuer may be describing its business for the first time. This is always a slow and painful process. The registration statement must include audited financial information. The issuer and its counsel will be required to work with the issuer's independent accountants to produce the required financial information and financial statements. The issuer will engage an investment bank, or more likely, several banks that will act as the underwriters for the transaction. Typically, underwriting fees will range from 6.5% to 8% of the gross proceeds raised in the offering. The issuer will also incur significant out-of-pocket costs (legal fees, accounting fees, registration fees, listing fees, transfer agent fees, printing expenses, travel expenses, etc.). The issuer, the underwriters, and their respective advisers will meet regularly for weeks at a time to craft a disclosure that meets applicable requirements and also satisfies the marketing needs. The underwriters and their counsel will engage in a careful due diligence review.⁴⁹ Key members of management will be focused principally on this process to the exclusion of attending to the company's business. The opportunity cost associated with this is difficult to calculate. Although Title I of the JOBS Act, often called the "IPO on-ramp" provisions, had as its principal objectives providing certain disclosure accommodations for a certain class of company (*i.e.*, an "emerging growth company"), as well as providing for the phase-in of certain corporate governance requirements, these provisions have done little to reduce the actual time and expense associated with undertaking an IPO.

§ 1:7.6 Alternative Financing Options

Companies may defer IPOs simply because there are other available and attractive financing opportunities. As discussed below, there are a number of important exemptions from the section 5 registration requirements.⁵⁰ An issuer could choose to avail itself of one of these exceptions in connection with a private or exempt offering. While there was once uncertainty regarding whether an offering would be deemed a "public offering" (subject to the registration requirements) or a "private offering," there have been many regulatory changes that have provided greater certainty. The SEC has adopted a number of safe harbors that enable an issuer (or a reseller) to offer securities without the fear of violating the registration requirements. In large measure, as a result of these changes, a number of securities offering methodologies involving exempt offerings have developed and become increasingly popular. Many of these offering methodologies have come to

49. For a discussion of this process, see chapter 28, Liability Considerations.
 50. See *infra* section 1:8.

resemble the process used for public distributions of securities. All of this has contributed to removing any stigma that may once have been associated with reliance on exempt offerings. Also, as discussed below, many already reporting issuers, including large public companies, are turning to exempt offerings. This too validates the choice of an exempt offering.⁵¹

§ 1:7.7 *The Growth of Private Equity and Hedge Funds*

Until the recent financial crisis, there were many investors that were eager to invest in good privately held companies. The private equity sector was extremely active. Hedge funds also became important participants in private transactions. In fact, a number of studies have shown that in recent years sophisticated investors have become increasingly more significant owners of public equity securities in the United States.⁵² In the United States, retail investors historically owned the largest percentage of publicly traded equity securities. This is no longer true. Hedge funds invested both in privately held companies that were expected to go public within a short timeframe and made private investments in already public companies, through PIPE transactions. As a result, good privately held companies and, for that matter, good publicly held companies, were able to find investors to participate in exempt offerings. In more recent years, the array of investors interested in participating in later stage private placements, especially by companies in certain industry sectors, has increased. Now, venture capital funds, private equity funds, and hedge funds have been joined by sovereign wealth funds, family offices and mutual funds. The latter had in the past concentrated principally on investing in the securities of public companies, but have turned to later stage private placements to achieve improved investment returns.

§ 1:7.8 *The Increased Value of Restricted Securities*

As noted above, securities that are offered in an exempt offering (whether it is an exempt offering conducted by a private company or an exempt offering conducted by a reporting issuer) are “restricted securities.”⁵³ Investors must be advised that they are purchasing

51. See *infra* section 1:12.

52. See Steven M. Davidoff, *Paradigm Shift: Federal Securities Regulation in the New Millennium*, 2 BROOK. J. CORP. FIN. & COM. L. 339 (2007–2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1080087; Brian G. Cartwright, Gen. Counsel, SEC, Speech at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation (Oct. 24, 2007), www.sec.gov/news/speech/2007/spch102407bgc.htm.

53. See *supra* section 1:1.

securities in an exempt transaction and must be made aware that those securities are subject to restrictions on transferability. In order to resell restricted securities, an investor must resell the securities either pursuant to an effective registration statement or in another exempt transaction. For an already public company, an investor may hold freely tradable securities of that issuer (purchased in the market) and restricted securities of the same issuer. The two will be distinct. As a result of the transfer restrictions, investors that purchase restricted securities have less liquidity. Historically, this has been referred to as the “liquidity discount.”

Traditionally, many private companies have been motivated to go public in order to maximize the value of their securities. As a rule, a share of restricted stock of an issuer is less valuable than a share of the same issuer’s listed stock. In the past, an issuer may have believed that it could obtain a better price for its securities in a public offering than in a private offering. Also, an issuer may have believed that having public equity was important for purposes of having a form of “currency.” An issuer that sought to establish stock-based compensation plans for its employees may have wanted to provide securities that were free of transfer restrictions. An issuer that contemplated completing an acquisition may have wanted to use its stock as consideration for some or all of the acquisition.

§ 1:7.9 *Alternative Liquidity Events and the Availability of Hedging Transactions*

Private equity and venture investors may have seen a public offering as a way to cash out. A private equity or venture investor may choose another liquidity event, or may choose to hold its securities and monetize its investment through a derivative, given that there are many more investors that are willing to purchase restricted securities, organized venues through which transactions in restricted securities may be effected, fewer limitations associated with reselling restricted securities, on balance, and many more available derivatives trading strategies.⁵⁴

§ 1:8 *Exempt Offering Alternatives*

The most common exemptions from registration relied upon by issuers seeking to raise capital and by holders of restricted securities to resell their securities are discussed below.

54. For a discussion of these issues, see chapter 32, Investment Representations/Hedging.

§ 1:8.1 Section 4(a)(2) and Regulation D

Section 4(a)(2) of the Securities Act (previously section 4(2)) provides that the section 5 registration requirements do not apply to “transactions by an issuer not involving any public offering.”⁵⁵ Although section 4(a)(2) provides a statutory private placement exemption, the statute itself is of little help in determining whether any particular offering meets its requirements. Instead, issuers, underwriters, and their respective counsel must rely on judicial and administrative interpretations. The only U.S. Supreme Court interpretation of section 4(a)(2) is *SEC v. Ralston Purina Co.*⁵⁶ In determining whether an offering was private, the Court set forth a two-part test requiring that (1) the issuer prove that no offeree needs the protection afforded by registration (that is, the investors are sophisticated), and (2) each offeree has access to the kind of information that would be provided in a registration statement. This test, referred to as the “Ralston test,” focuses on the offerees, rather than on the investors, as does Regulation D. The person claiming the exemption must establish that the exemption is available for the particular transaction. Furthermore, since the definition of “offeree” potentially is broad, an issuer may be required to view every person with whom contact regarding the offering is made as an offeree. Following this decision, there continued to be a fair amount of confusion and ambiguity concerning the factors that were relevant in determining whether an offering would be exempt from registration in reliance on section 4(a)(2).

In 1982, the SEC promulgated Regulation D, which provides issuers with a safe harbor from the Securities Act registration requirements. Regulation D is intended to provide issuers with greater certainty than reliance on interpretations of the section 4(a)(2) exemption. However, Regulation D is nonexclusive, which means an issuer that fails to satisfy the objective criteria of Regulation D generally may still rely on section 4(a)(2). Regulation D is available only to issuers, and applies only to a particular transaction. Therefore, resales of securities must be registered or made pursuant to another exemption. Most private offerings by issuers are conducted in reliance on section 4(a)(2)/Regulation D.

§ 1:8.2 Rule 144A

In 1990, the SEC adopted Rule 144A under the Securities Act. Rule 144A provides investors with a methodology for reselling certain securities without registration. Rule 144A is a limited exemption or safe harbor from the section 5 registration requirements, one which

55. 15 U.S.C. § 77d(2).

56. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

permits persons other than the issuer to resell, in a transaction not involving a public offering, restricted securities acquired from the issuer. A Rule 144A offering consists of two parts: (1) the section 4(a)(2) private placement to the initial purchasers, typically investment banks, and (2) the resale of such securities by the initial purchasers to institutional investors.

Rule 144A requires that: (1) the restricted security be sold to persons (without limitation as to number) the seller reasonably believes to be QIBs; (2) the securities were not, when issued, of the same class as securities listed on a national securities exchange or quoted on an automated interdealer quotation system; (3) the investor is aware that the seller is relying on Rule 144A for its resale; and (4) the issuer either is a reporting company under the Exchange Act or makes available certain information to holders. Sales to QIBs made in reliance upon Rule 144A are not distributions, and the seller in a 144A sale is not considered an “underwriter.” Many foreign issuers that would like to access the U.S. institutional investor community as part of their capital raising efforts, choose to conduct their securities offerings as 144A offerings. Rule 144A is only available for securities offerings of eligible securities (securities of a different class than the issuer’s equity securities, which are listed or quoted on a securities exchange).⁵⁷

Securities acquired pursuant to a section 4(a)(2) offering or a Regulation D offering may be immediately resold under Rule 144A. The intent to resell under Rule 144A is not inconsistent with section 4(a)(2) or Regulation D. As a result, a Rule 144A offering is usually structured so that the issuer first sells the newly issued restricted securities to an “initial purchaser,” typically a broker-dealer, in a private placement exempt from registration under section 4(a)(2) or Regulation D. Rule 144A then permits the broker-dealer to immediately reoffer and resell the restricted securities to QIBs, regardless of when the securities were issued or the broker-dealer seller’s investment intent when it purchased the securities. This ability to immediately resell securities in reliance on Rule 144A has enabled broker-dealers to structure offerings that more closely resemble traditional firm commitment public offerings.

§ 1:8.3 Regulation S

Section 5 of the Securities Act prohibits any person from using interstate commerce in connection with the offer or sale of a security unless a registration statement is in effect with respect to such

57. For a more detailed discussion, see chapter 7, Rule 144A.

security.⁵⁸ Theoretically, interstate commerce may include trade or commerce in securities between the United States and a foreign country, that is, that securities transactions with only tenuous links to the United States could be subject to section 5 registration requirements. However, the SEC views section 5 as a protection for U.S. investors and, prior to the adoption of Regulation S, stated in releases that securities offered or sold outside the United States would not be subject to these registration requirements if precautions were taken to ensure that the securities came to rest abroad. Because interpretations of these SEC releases were unclear, the SEC adopted Regulation S in June 1988.

Regulation S clarifies the SEC's position that securities offered and sold outside of the United States need not be registered with the SEC and specifies two safe harbors—an issuer safe harbor (Rule 903) and a resale safe harbor (Rule 904)—that provide that offers and sales made in compliance with certain requirements are deemed to have occurred outside the United States and are, therefore, excluded from the application of section 5. There are two general conditions for the issuer and resale safe harbors: (1) any offer, sale, or resale must be made in an offshore transaction (as defined in Regulation S); and (2) no directed selling efforts (as defined in Regulation S), may be made in the United States in connection with an offer, sale, or resale under the safe harbors.

Resales by (1) any persons other than the issuer, a distributor or their respective affiliates, and (2) any officer or director of the issuer or a distributor, who is an affiliate of the issuer or distributor solely by virtue of holding such position, are deemed to have occurred outside the United States if the two general conditions, plus any applicable additional resale requirements, are met. The resale safe harbor is available for all securities, whether or not acquired in an offshore transaction. For example, securities originally sold under a private placement exemption may be resold outside the United States under Rule 904 without affecting the validity of the original transaction.

§ 1:8.4 Combined Rule 144A/Regulation S Offerings

Rule 144A offerings are often structured as global offerings, with a side-by-side offering targeted at foreign holders in reliance on Regulation S. Doing so permits an issuer to broaden its potential pool of investors. The issuer may sell to an initial purchaser outside the United States in reliance on Regulation S, even though the initial purchaser contemplates immediate resales to QIBs in the United States. A Rule 144A

58. 15 U.S.C. § 77e.

offering may also be combined with a simultaneous offering to accredited investors, typically limited to institutional accredited investors under the so-called section 4(a)(1½) exemption. Again, doing so would permit an issuer to broaden its potential pool of investors.

§ 1:8.5 Rule 144

Securities that have been sold in a private placement in reliance on section 4(a)(2) and/or Regulation D and securities eligible for resale pursuant to Rule 144A are “restricted securities.” Similarly, securities that were sold outside of the United States in compliance with Regulation S also are “restricted securities.” Restricted securities must be sold either pursuant to a registration statement or pursuant to another available exemption. Generally, section 4(a)(1) exempts from registration “transactions by any person other than an issuer, underwriter, or dealer.”⁵⁹ This exemption alone should make it possible for most investors to resell their restricted securities without registration. However, section 2(a)(11) of the Securities Act defines an “underwriter” as any person who has purchased securities from the issuer with a view to, or who offers or sells, for an issuer in connection with, the distribution of any security.⁶⁰ For these purposes, an “issuer” includes a “control person” or “affiliate.”

Persons who have purchased securities in a private placement directly from an issuer or directly from an affiliate, and who wish to resell the securities, may be deemed to have purchased securities with a view to a distribution and, as a result, may be considered “underwriters.” Because a control person is deemed to be an “issuer,” an investor who is an affiliate of the issuer has a similar problem with respect to both restricted and nonrestricted securities.

If an investor is deemed to be an underwriter, certain liability provisions of the Securities Act may become applicable, as described below. As a result, and as noted above, a holder of restricted securities will have limited liquidity. A security holder that has restricted securities may choose to hold its restricted securities until these securities can be freely resold, or the security holder may choose to resell the restricted securities pursuant to Rule 144, which permits limited resales over a defined period of time, or the selling security holder may demand (at the outset of the transaction with the issuer) that the issuer provide a registration statement covering the resale of the restricted securities by the security holder from time to time. Of course, if the issuer has chosen to conduct a private placement precisely to avoid the registration of its securities in the United States,

59. 15 U.S.C. § 77d(1).

60. 15 U.S.C. § 77b(a)(11).

it will not be in a position to grant investors registration rights. In this case, the selling security holders will be left to rely on Rule 144. Rule 144 provides some relief to investors from being deemed “underwriters,” especially for affiliates.

Rule 144 has been called the “dribble-out rule” since it permits investors (often affiliates) to sell limited quantities of securities acquired in private transactions over a protracted period of time. More precisely, Rule 144 provides a safe harbor for investors selling restricted securities without registration. Rule 144 also applies to sales of securities by affiliates of the issuer regardless of whether such securities were acquired in a public offering. If an investor and a broker make a sale in compliance with the conditions set forth in Rule 144, they will be deemed to be neither “underwriters” nor engaged in a “distribution” and may sell the securities without registration.

The SEC adopted amendments to Rule 144 in December 2007 that, among other things, shortened the holding period for public securities, reduced the sales limitations for non-affiliates, eliminated manner of sale restrictions for debt securities, and simplified and reduced the Form 144 filing requirements. The 2007 amendments reduced the minimum holding period for restricted securities issued by reporting companies from one year to six months and from two years to one year for non-reporting companies.⁶¹ These revisions to Rule 144 have, in effect, facilitated the resale of Rule 144A securities and may over time contribute to reducing the “liquidity discount” demanded by investors.

§ 1:9 Restricted Securities and the Illiquidity Discount

Certificates evidencing restricted securities contain a restrictive legend that prohibits transfer except pursuant to an effective registration statement or pursuant to an exemption from registration. In order to remove the legend, an investor must certify to the issuer’s transfer agent that it has complied with the prospectus delivery requirements (the broker involved in the trade may ultimately be responsible for delivering the prospectus). Alternatively, the investor may provide the issuer with evidence that the transfer complies with an exemption from registration. These obligations subject the investor to risk—the risk that the transfer agent will not timely process its transfer request or, in the case of convertible securities, in delays in the receipt of underlying common stock. The prompt delivery of unlegended shares is important because investors may have entered into an agreement to sell or deliver the shares, or may need to pledge unlegended shares as

61. Revisions to Rules 144 and 145, Securities Act Release No. 8869 (Dec. 6, 2007), www.sec.gov/rules/final/2007/33-8869.pdf.

collateral. With respect to a convertible security, the investors rarely will convert the derivative security until they are ready to sell the underlying common stock. In fact, in many cases, the investor will enter a sell order for the underlying common stock at the same time that it converts the derivative security. As a result, many transactions are now structured with penalty provisions to protect the investors from these delays.

An investor in a private offering is subject to additional risks associated with holding or transferring restricted stock. If the issuer fails to qualify for an exemption from registration, immediate investors in a private placement that do not purchase securities with the requisite investment intent and that resell their securities may be deemed “statutory underwriters” with section 12 liability and may be unable to rely on the section 4(a)(1) resale exemption. To prevent such a determination, issuers include restrictive legends on the securities, place a stop transfer on them with the transfer agent and require the investors make representations as to their investment intent.

In addition, restricted securities are priced at a discount to the then-current market price of the issuer’s common stock. This discount, known as a “liquidity discount,” is intended to compensate investors for the lack of liquidity in the securities. Liquidity discounts generally range from 25.8% to 45% of prevailing market prices⁶² and vary based on a number of factors, most importantly the perception that investors may not be able to resell their securities either pursuant to a resale registration statement or otherwise. The greater this perceived risk, the greater the liquidity discount that investors will demand. As noted above, the shortened Rule 144 holding period will reduce the liquidity discount.

Over time, a number of securities offering methodologies have developed that are intended to enhance the “liquidity” of restricted securities sold in exempt offerings. By structuring a financing transaction (that begins as a private placement or exempt offering) that allows for the immediate resale of the restricted securities that were sold to investors, the overall transaction becomes much more like a public deal.

PIPE transactions were created in response to the regulatory change that made it possible for holders of restricted securities to reoffer these restricted securities publicly under an abbreviated shelf registration statement. A PIPE transaction broadly refers to any private placement

62. See William P. Dukes, *Business Valuation Basic for Attorneys*, J. BUS. VALUATION & ECON. LOSS ANALYSIS, Jan. 2006, at 16 tbl. 1, www.bepress.com/cgi/viewcontent.cgi?article=1008&context=jbvela (providing a summary table of eleven restricted stock studies).

of equity or equity-linked securities of an already public company. This definition encompasses many different types of financings, including everything from a venture-style private placement for an already public company, to a change of control transaction, to a private placement of highly structured securities. A traditional PIPE transaction is a private placement of either newly-issued shares of common stock or shares of common stock held by selling stockholders (or a combination of these) principally to “accredited investors” at a fixed price. The closing of a PIPE transaction may be conditioned upon the preparedness of the SEC to declare effective a resale registration statement relating to the securities. Alternatively, the PIPE transaction may fund and close, and in connection therewith the issuer will covenant to register the resale of the purchased shares within a specified period of time following the closing (referred to as trailing resale registration rights). Investors in a traditional PIPE transaction will have a resale registration statement available promptly after closing. This means that the investors will incur limited liquidity risk and will demand a smaller liquidity discount. For the issuer, the transaction expenses associated with a traditional PIPE transaction are usually lower than the expenses associated with other financings. A traditional PIPE transaction generally can be executed in a more efficient and timely manner than an underwritten public offering.

This is just one example of a private/public hybrid transaction that offers already public issuers greater flexibility.

§ 1:10 Private Placement Reform

The continuing evolution of the securities laws and regulations has also contributed to the increase in exempt transactions by public companies. The shortening of the Rule 144 holding period has made exempt transactions more attractive to various categories of buy-and-hold investors. The adoption of Regulation S has provided much-needed clarity concerning the availability of the extra-territorial exclusion from U.S. securities laws for unregistered offerings that are executed abroad. Most recently, the JOBS Act has resulted in modernizing the regulatory framework for certain Rule 506 offerings and has brought about a couple of new exempt offering alternatives, such as an exemption for limited public offerings and an exemption for crowdfunded offerings. There are still certain areas of uncertainty or ambiguity in relation to exempt offerings. These include the following:

- The meaning of “general solicitation” (especially in the Internet age);
- The meaning of an “offer”;
- The integration of various exempt offerings; and

- Issues that arise in connection with private and public offerings conducted in close proximity to one another.

The passage of the JOBS Act has contributed to ambiguity in relation to exempt offerings. However, on the whole, SEC guidance and rule making has provided greater certainty for issuers that rely on exempt offerings, as well as for resellers of restricted securities.

§ 1:11 Shelf Registration and Improvements to Capital Formation

The SEC has made numerous changes to the registered offering process over the years. In doing so, the SEC has sought to balance investor protection needs with the continuing need to improve the capital formation process. The SEC's reforms reflect fundamental changes in the markets. The capital markets have become increasingly competitive and more internationalized. The pace of financial innovation has quickened. As discussed above,⁶³ issuers have access to many more different types of investors in many more markets. Issuers also have many more capital-raising options. In order to meet their business needs, issuers need to preserve maximum flexibility in terms of choosing among financing options. Finally, cutting down on time to market is essential.

Historically, the public offering process, even for a reporting issuer, was time-consuming. An issuer prepared a registration statement, filed it with the SEC, waited between four to six weeks for initial SEC comments, prepared and filed one or more pre-effective amendments to the registration statement in order to respond to SEC comments, sought and obtained SEC effectiveness of the registration statement, offered its securities to the public through underwriters, priced the offering, entered into an underwriting agreement, and, hopefully, closed the transaction three days after pricing. Somewhere during this period, the underwriter(s) would introduce the issuer's senior management to investors through a series of road show presentations. This entire process, from start to finish, could take just under three months.

Market participants observed that for established issuers, this process was outmoded, slow and inflexible. Most of all, there was a consensus that the public offering process failed to respond to the needs and requirements of a rapidly changing market. The SEC responded in 1982 by creating shelf registration, citing the needs of issuers and the financial markets for flexibility and speed. Shelf

63. See *supra* section 1:8.

registration is a process or methodology that enables issuers to register the public sale or distribution of securities in advance of considering one or more specific transactions. The operative effect of this process is to enable issuers to be ready to complete a public offering should a compelling financing need or opportunity arise. It is aptly named insofar as one can imagine an issuer taking securities down off of a shelf (that is, the registration statement) and offering them to purchasers. An issuer may file a shelf registration statement for primary offerings of its securities in which the issuer receives the proceeds of sale, or it may file a secondary or “resale” shelf registration statement in which the securities to be sold have already been issued to the security holders and the proceeds of any sales of such securities will go directly to the security holders. There are few limits on the types of securities that may be sold pursuant to a shelf registration statement.⁶⁴

For those who have become involved in the securities industry since 1982, it may be difficult to imagine what the public offering process might be like if shelf registrations were unavailable. Since the early 1980s, the SEC has undertaken a number of steps to facilitate capital formation. The SEC has, among other changes, created and modified the integrated disclosure system, instituted and expanded the continuous and delayed offerings processes, permitted the electronic submission of most SEC filings, and generally endeavored to accommodate the needs of both large and small issuers. In 2005, the SEC again revolutionized the regulation of securities offerings and offering-related communications with Securities Offering Reform. The reforms resulted in the following:

- Introduction of a new category of issuers, called well known seasoned issuers (WKSI), which benefit greatly from the new rules, most notably by being permitted to communicate freely (without gun-jumping concerns) and to file automatically effective shelf registration statements;
- Creation of a new communications framework and expanded offering-related communication safe harbors;
- Redefinition of “written communications” as all communications other than oral communications for Securities Act purposes;
- Adoption of an “access equals delivery” concept for prospectus delivery requirements; and

64. For a discussion of the shelf registration process, see chapter 10, Shelf Registration Statements.

- Adoption of a “time of sale” concept for purposes of determining liability under sections 12(a)(2) and 17(a)(2) of the Securities Act.

Securities Offering Reform eliminated unnecessary and outdated offering restrictions. The changes better enable issuers to integrate their Securities Act and Exchange Act disclosures, thus streamlining the offering process and shortening the time required for an issuer’s securities to reach the market.⁶⁵

A shelf registration statement is a convenience for issuers, selling security holders, and investment bankers. Shelf registration statements permit an issuer to issue and sell securities without significant delay in order to take advantage of market opportunities. This is especially true for WKSI, who may file shelf registration statements that are automatically effective upon filing with SEC. A WKSI may “time” the market and issue securities at the most auspicious time. An issuer may structure a shelf takedown in a number of different formats. Of course, an issuer can structure a shelf takedown as a traditional fully marketed firm commitment offering. An issuer may also choose a number of alternative approaches. A larger issuer may instead conduct an offering on a firm commitment basis with limited pre-marketing. This is often referred to as a blast marketed offering or, depending on how compressed the timetable, as an overnighter. An issuer may bid out an offering and structure a takedown as a bought deal in which the underwriter agrees to purchase the issuer’s securities and takes the resale risk. An offering may also be conducted on an agency or best efforts basis through a placement agent. A registered direct offering is a best efforts offering in which the placement agent limits its marketing efforts principally to institutional investors. An issuer may also use a shelf registration statement for continuous offerings of its debt securities (or of more structured securities). The range of offering methodologies is broad and depends largely only on the ability of financial intermediaries (and their advisers) to innovate.

The availability of shelf registration statements also has contributed to blurring many of the lines between private placements and traditional underwritten public offerings. As discussed above, the principal benefits associated with a private placement are speed and efficiency. An issuer that needs capital can undertake a private placement quickly without subjecting itself to the possibility of SEC review. Also, the issuer retains much of the control over the timing of the offering. For an issuer that can use a shelf registration statement, and that has a shelf registration statement that is ready for use, the timing

65. For a discussion of Securities Offering Reform, see chapter 11, Securities Offering Reform.

differences between undertaking a private placement and a registered shelf takedown are no longer very significant.

§ 1:12 Reporting Issuers Turning to Exempt Offerings and Hybrid Offerings

There is another important respect in which the lines have been blurred. For existing U.S. public companies, at those times when the public market window is either closed or only slightly open, exempt transactions and hybrid offerings become the transactions of choice.

An intriguing aspect of the increased popularity of exempt transactions is that the process for executing exempt transactions and the process for executing registered public offerings have coalesced. Approaches to capital raising necessarily adapt to changing conditions and preferences in the marketplace. When we look at the changes in exempt transactions over the last ten years, we see an unmistakable progression toward providing investors with enhanced liquidity in the near term. When we look at registered offerings over this same period of time, we see much greater emphasis on “targeted” marketing or identifying large institutional investors prior to or immediately upon launching a public transaction. This is not surprising when you consider the market dynamics.

Regulation FD has left issuers very concerned that required public disclosure of the possibility that they may launch a public offering functionally locks them into proceeding with a financing. Public announcement of a potential financing typically exerts downward pressure on an issuer’s stock price just as the marketing phase of the public offering process is getting underway. In short, an increasing number of public companies have determined that market dynamics have shifted in ways that make public offerings less certain and more risky than exempt transactions. Day traders, momentum buyers, formula traders, the availability of equity derivatives, and the increase in stock borrow/stock loan activity have all contributed to this significant change.

Frequently, once an issuer and underwriter publicly announce or launch a registered follow-on offering, market participants, including potential investors, will attempt to short the issuer’s stock. A follow-on offering will be priced at a discount to the market price of the issuer’s common stock on the trade or pricing date. In the interim period, between launch and pricing, the market price of the issuer’s stock generally will have declined. Investors that expect to be allocated stock in the offering will have “locked in” a return through their hedging transactions. By contrast, a private placement or a Rule 144A offering is not publicly announced until definitive agreements are executed. At that point, there is no particular incentive for market

participants to short the issuer's stock. Furthermore, there is no overallotment option (or green shoe) in a private placement or a Rule 144A offering—market participants again will be less inclined to engage in hedging transactions in the issuer's stock because there will be less assurance of being allocated shares in the offering.

Studies of the effects of an offering announcement by a seasoned issuer in the U.S. have demonstrated that, in general, these announcements result in a decline in the market price of the issuer's securities.⁶⁶ These studies have suggested a number of different theories for the price drop, including inelastic demand for the securities resulting in a drop in the equilibrium market price. These studies have also examined variables that influence this negative price effect, including deal structure, marketing strategy, underwriter compensation, pricing convention and selection of listing exchange. Interestingly, this negative effect on price associated with public announcement of an equity offering by a seasoned issuer appears to be a U.S.-focused phenomenon. These studies suggest that, when considering a public offering, an issuer should factor in as a cost the likely impact of the offering announcement (if the offering is pre-announced or marketed) on the value of the issuer's outstanding securities and the cost to the issuer's existing security holders in terms of market capitalization, valuation, and dilution. This data, combined with empirical evidence that demonstrates a pattern of underpricing of equity issuances by seasoned issuers, suggests that follow-on public offerings may not represent the most efficient method of raising capital when measured in terms of pricing, execution efficiency, and cost. This may explain the results of yet a different study. Economists reviewed over 13,000 issuances of securities by already public companies, including offerings of six different types of securities, and concluded that the market for private offerings by already public issuers is large. In fact, as noted earlier, in recent years, more money has been raised in exempt offerings by already public issuers than in registered offerings. Given that markets change quickly, it is not clear whether this trend will continue. We do expect that, given market volatility, public issuers that choose to conduct registered offerings will continue to structure their offerings to target institutional investors or at least to secure indications of interest for a sizeable percentage of the anticipated offering before publicly announcing the shelf takedown.

66. For a more detailed discussion of these studies, see chapter 31, Application of Regulation M to Exempt and Hybrid Offerings.

