Federal Securities Law

Exempted Transactions

Alternatives to Accessing the U.S. Public Markets

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Overview

There are many benefits for foreign companies to being a public company in the United States – increased visibility and prestige; an ability to more readily access U.S. capital markets, still the largest and most liquid in the world; an enhanced ability to attract and retain key employees by allowing them to share in the company's growth and success through equity-based compensation structures; and the sending of credible signals to the market that the company will protect minority shareholder interests and will not extract private benefits of control. However, becoming and remaining a U.S. public company is an expensive, time-consuming project that can require foreign companies to reorganize their operations and corporate governance in ways that such companies would not choose absent U.S. requirements.

There are a number of alternative ways to access the pools of capital available in the United States without subjecting a foreign company to registration with, and oversight by, the U.S. Securities and Exchange Commission (SEC).[1] This article will highlight the most common:

- Private Placements,
- Rule 144A offerings, and
- Furnishing information under Rule 12g3-2(b) under the Securities Exchange Act of 1934, as amended (Exchange Act).

The general private placement exemption is available for any foreign issuer seeking U.S. investors, including foreign start-up companies. Private placements pursuant to Section 4(2) of the Securities Act of 1933, as amended (Securities Act), do not limit by statute the nature or number of potential investors (although there are customary practices). On the other hand, in Regulation D private placements of any significant size, there is generally a requirement that investors be "accredited investors" (as defined). More established companies usually undertake Rule 144A offerings. Although an issuer can use a Rule 144A offering as a kind of private "IPO," Rule 144A offerings may be made only to qualified institutional buyers (QIBS). As discussed below, in connection with Rule 144A offerings, the disclosure typically approximates the kind of disclosure that would be made in a public offering without the registration and ongoing compliance obligations. The Rule 12g3-2(b) exemption is available only to a foreign issuer that is already listed on a foreign exchange.

This article will also briefly discuss the antifraud provisions of the U.S. federal securities laws that may be applicable to the transactions described in this article.

Private Placements

The broad statement is that all purchases and sales of securities are subject to the U.S. federal securities laws unless there is an available exemption from some or all of the provisions of such laws. Section 4(2) of the Securities Act is the general exemption for issuer offerings from the operation of the registration and prospectus delivery requirements of the Securities Act.

Section 4(2) of the Securities Act provides that the Section 5 registration and related prospectus delivery requirements do not apply to "transactions by an issuer not involving any public offering." The rationale for the private placement exemption is that the extensive regulation applicable to public offerings is not required for offerings made to a limited number of offerees capable of protecting themselves. Although Section 4(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. Over the years, case law has provided significant guidance on best practices for conducting a private placement. In addition, in 1982, the SEC promulgated Regulation D, which provides issuers with a safe harbor from the Securities Act registration requirements. By providing greater certainty regarding which transactions are exempt from registration, Regulation D gives issuers additional flexibility in structuring private offerings. Regulation D is also nonexclusive, which means an issuer that fails to satisfy the objective criteria of Regulation D still may seek to rely on Section 4(2). Regulation D is available only to issuers, and applies only to a particular transaction. Therefore, resales of securities sold in a Regulation D offering must be registered or made pursuant to another exemption.

Neither Section 4(2) nor Regulation D exempts the issuer from, among other things, the antifraud provisions of the Securities Act, the ongoing registration requirements of the Exchange Act,[2] the broker-dealer registration requirements of the Exchange Act, the Investment Company Act of 1940, as amended (Investment Company Act), the Investment Advisers Act of 1940, as amended (Investment Advisers Act), or any applicable state laws relating to the offer and sale of securities.[3]

Why should an issuer comply with Section 4(2) and Regulation D? If the private placement exemption is not available, among other consequences, the SEC could bring civil charges against the issuer for conducting an unregistered public offering or require the issuer to offer rescission of the purchase to the purchasers and assess penalties, the purchasers could sue for damages and, if the circumstances are sufficiently egregious, the issuer could be subject to criminal charges. Even if the issuer were to prevail in any proceeding, it would be expensive and time-consuming.

Section 4(2)

Generally, a statutory private placement involves an offering with some or all of the following elements:

- A limited number of
- Financially sophisticated offerees,
- Given access to information relevant to their potential investment,
- That have some relationship to each other and to the issuer, and
- That are offered securities in a manner not involving any general advertising or general solicitation.

The SEC and the federal courts have focused on, and provided further interpretation of, these elements. They have identified the following factors in determining whether the Section 4(2) exemption is available, each of which is flexible and highly fact-dependant and none of which alone is determinative:

- *The number of offerees and their relationship to each other and to the issuer*. This factor is significant. There is no "magic" number of offerees. An offering to a limited number of offerees (e.g., fewer than 25 offerees) should not, in the absence of considering the other factors enumerated below, be assumed to be a "private placement." Similarly, there is no maximum permitted number of offerees; however, an offering to a large and diverse group with no preexisting relationship to the issuer suggests a public offering. Note that an offering to offerees that have a relationship to the issuer is less likely to be considered a public offering than an offering to the same number of offerees who have no relationship to the issuer. This factor also relates to the nature and kind of information made available to offerees or to which the offerees have ready access. It is presumed that offerees having a special relationship to the issuer (*e.g.*, employees) will have greater access to information about the issuer.
- *The* number *of securities offered/the size of the offering*. The smaller the number of securities offered or the size of the offering, the less likely the offer will be deemed a public offering, although this is not necessarily a determinative factor.
- *The manner of the offering*. There are two general conditions: (1) the offering should be made through direct communication with eligible offerees by either the issuer or the issuer's agent; and (2) the offering cannot include any general advertising or general solicitation. In part, determining whether a communication "offers" securities depends upon whether the communication conditions the market for the securities. This can be a difficult analysis; however, as a general guideline, the issuer and its advisers should consider the content of the communication, the intended audience, and the proximity of the announcement to the commencement of the securities offering. There is significant SEC interpretative guidance on general advertising or general solicitation, and avoiding general solicitation is critical to a determination that there is no public offering.
- *The sophistication and experience of the offerees*. General business knowledge and experience usually are sufficient. Important factors to consider are education, occupation, business and investment experience, and net worth. An investor having a sophisticated representative probably satisfies this test. Alternatives to sophistication are the financial ability to bear risks (*i.e.*, the investor' wealth) and the existence of a special relationship to the issuer (*i.e.*, "insider" or "privileged" status, or personal relationship).
- *The nature and kind of information provided to the offerees or to which the offerees have ready access*. The disclosure need not be as extensive as that in a registered offering, but must be factually equivalent. Disclosing basic information regarding the issuer's financial condition, business, results of operations, and management is usually satisfactory. All information must be made available to the offerees prior to the sale.
- *Actions taken by the issuer to prevent the resale of securities*. Securities must come to rest in the hands of immediate investors. Investors in a private placement must not purchase the securities "with a view to a distribution." The Securities Act defines an "underwriter" as a "person who has purchased . . . with a view to, or sells for an issuer in connection with, the distribution of any security." As a result, premature resales of securities may be deemed a distribution and considered part of the original offering. Immediate investors in a private placement

who do not purchase securities with the requisite investment intent and who resell the securities may be deemed statutory underwriters and may be unable to rely on available resale exemptions. As a result, issuers generally will take precautions to prevent the resale of their securities.

Regulation D

Regulation D is comprised of eight rules that provide three safe harbors from registration under two statutory provisions. Rule 501 sets forth definitions for terms used throughout Regulation D. Rule 502 sets forth the general conditions relating to integration,[4] information requirements, limitations on the manner of offering, and limitations on resale. Rule 503 requires notices for sales. Rules 504 and 505 are promulgated under Section 3(b) of the Securities Act, which provides an exemption for small offerings. Rule 504 provides an exemption pursuant to Section 3(b) for offerings up to $1 million by non-reporting issuers. Rule 505 provides an exemption pursuant to Section 3(b) for offerings up to $5 million.

Rule 506, which is promulgated under Section 4(2) and is the rule most often relied upon for Regulation D private placements, provides an exemption for limited offerings and sales without regard to the dollar amount. Although the number of "purchasers" (as defined in Rule 501) under Rule 506 is limited to 35, issuers may sell securities under Rule 506 to an unlimited number of "accredited investors."[5]

Rule 507 disqualifies an issuer from relying on Regulation D in certain situations. Rule 508, the "substantial compliance rule," provides that an insignificant failure to comply (when considered in connection with the offering as a whole) with the terms or conditions of Rules 504, 505 or 506 will not disqualify the offering from the exemption.

One of the most critical concepts in private placements generally and Regulation D in particular is that of "accredited investor," which provides a regulatory description of certain sophisticated or experienced investors. Rule 501 defines an "accredited investor" as any person who comes within any of the following categories, or whom the issuer reasonably believes comes within any of the following categories, at the time of the sale:

- Any bank (as defined) or any savings and loan association or other institution (as defined), whether such bank, savings and loan association, or other institution is acting in its individual or fiduciary capacity;
- Any broker or dealer registered under the Exchange Act and purchasing for its own account;
- Any insurance company (as defined);
- Any registered investment company or business development company;
- Any licensed small business investment company;
- Any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5 million;
- Any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA) if (1) the investment decision is made by a plan fiduciary, which is either a bank, savings and loan association, insurance company, or registered investment adviser; (2) the employee benefit plan has total assets in excess of $5 million; or (3) if a self-directed plan, with investment decisions made solely by persons who are accredited investors;
- Any private business development company (as defined);
- Any organization, corporation, limited liability company, Massachusetts or similar business trust, or partnership exempt under Section 501(c)(3) of the Internal Revenue Code of 1986 (Internal Revenue Code), with total assets in excess of $5 million and not formed for the specific purpose of acquiring the securities offered;
- Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
- Any natural person whose (1) individual net worth, or joint net worth with that person's spouse, at the time of the purchase exceeds $1 million, or (2) income or joint income with that person's spouse exceeds $200,000 or $300,000, respectively, in each of the two most recent years, and who has a reasonable expectation of reaching that same income level in the current year;
- Any trust with total assets exceeding $5 million not formed for the specific purpose of acquiring the securities offered, and whose purchases are directed by a sophisticated person; and
- Any entity in which all equity owners are accredited investors.

The SEC has also provided interpretive guidance regarding the types of investors that qualify as accredited investors.

As noted above, the disclosure provided in a private placement does not have to be as extensive as that in an SEC-registered offering but must be factually equivalent. If the foreign private issuer already provides a lot of disclosure – in

English – on its website and there are a very limited number of accredited investors, the disclosure document might be quite short and simple. For other foreign private issuers and for a variety of reasons, the private placement memorandum could be quite extensive. The issuer and its advisers can spend a significant amount of time preparing the private placement memorandum. However, under Rules 505 and 506, if the purchasers are not accredited investors, the issuer is required to provide specified information, depending on whether the issuer is subject to U.S. reporting requirements.

An issuer relying on Regulation D must file a notice on Form D with the SEC no later than 15 days after the first sale of the securities.[6]

Rule 144A Offerings

General

Rule 144A provides a non-exclusive safe harbor from the registration and prospectus delivery requirements of Section 5 of the Securities Act for certain offers and sales of qualifying securities by certain persons other than the issuer of the securities. The safe harbor is based on two Section 5 exemptions from registration, Section 4(1) and Section 4(3). In summary, Rule 144A provides that:

- for sales made under Rule 144A by a reseller, other than the issuer, an underwriter, or a broker-dealer, the reseller is deemed not to be engaged in a "distribution" of those securities and, therefore, not to be an "underwriter" of those securities within the meaning of Section 2(a)(11) and Section 4(1); and
- for sales made under Rule 144A by a reseller that is a dealer, the dealer is deemed not to be a participant in a "distribution" of those securities within the meaning of Section 4(3)(C) and not to be an "underwriter" of those securities within the meaning of Section 2(a)(11), and, therefore, those securities are deemed not to have been "offered to the public" within the meaning of Section 4(3)(A).

A Rule 144A offering usually is 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(2) or Regulation D. Rule 144A then permits the broker-dealer to immediately reoffer and resell the restricted securities to a category of the largest and most sophisticated investors known as QIBs or to persons and entities that the issuer reasonably believes are QIBs.[7] Unlike in a typical private placement, the intention to resell the securities immediately does not affect the issuer's ability to rely on exemptions under Section 4(2) or Regulation D for the initial sale of the securities to the initial purchaser. This ability to resell securities immediately in reliance on Rule 144A has enabled broker-dealers to structure exempt offerings that more closely resemble traditional firm commitment underwritten public offerings. Although Rule 144A does not include specific "general solicitation" prohibitions, market practice is to offer securities in accordance with Regulation D limitations.

Rule 144A offerings often are structured as global offerings, with a side-by-side offering targeted at foreign holders in reliance on Regulation S.[8] 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 offering also may be combined with a simultaneous offering to accredited investors, typically limited to institutional accredited investors (as defined in Rule 501 of Regulation D) under the so-called Section 4(1½) exemption.

Most Rule 144A offerings by foreign private issuers that are not otherwise U.S. reporting companies are of debt offerings, in large measure because the issuer wants to avoid having more than 300 holders of its equity securities, which could trigger the obligation to become a U.S. reporting company.[9]

QIBs

Rule 144A(a)(1)(i) defines a QIB as any of the following entities, acting for its own account or for the accounts of other QIBs, that in the aggregate owns and invests on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the entity:

- Any insurance company as defined in Section 2(a)(13) of the Securities Act;
- Any investment company registered under the Investment Company Act, or any business development company as defined in Section 2(a)(48) of the Investment Company Act;
- Any Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958;
- Any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees;
- Any employee benefit plan within the meaning of Title I of ERISA;
- Any trust fund whose trustee is a bank or trust company and whose participants are exclusively plans of the types identified in the two preceding bullet points, except trust funds that include as participants individual retirement accounts or H.R. 10 plans;

- Any business development company as defined in Section 202(a)(22) of the Investment Advisers Act;

- Any organization described in Section 501(c)(3) of the Internal Revenue Code, corporation (other than a bank as defined in Section 3(a)(2) of the Securities Act or a savings and loan association or other institution referenced in Section 3(a)(5)(A) of the Securities Act or a foreign bank or savings and loan association or equivalent institution), partnership, or Massachusetts or similar business trust; or

- Any investment adviser registered under the Investment Advisers Act.

Note that a QIB, acting for its own account or the accounts of other QIBs, may be formed for the sole purpose of acquiring restricted securities in a Rule 144A transaction. QIBs also may be domestic or foreign entities. Although most of the entities listed above must satisfy the $100 million ownership test, certain entities that may qualify as QIBs, including registered investment companies, banks and savings and loan associations, and broker-dealers, are subject to different requirements.

Disclosure

Unlike documents used in connection with a simple private placement, most Rule 144A offering memoranda approach in content and style a prospectus for a registered offering under the Securities Act. The benefits of this more inclusive offering document are that it may be used by the initial purchasers as a marketing document for the ultimate investors and serve as a defense against potential liabilities of the issuer and the initial purchasers for violations of the antifraud provisions of the U.S. securities laws.[10] Practitioners take the position that the disclosure requirements for a registered public offering are a good guide to the scope of disclosure to be included in the offering memorandum. Indeed, since most U.S. QIBs and institutional accredited investors are familiar with the traditional format of a prospectus, an offering memorandum may look nearly identical to a prospectus. The common practice is to have an offering memorandum that contains all the information the issuer and the initial purchasers deem necessary in order for investors to make an investment decision. For an issuer that is not public in any jurisdiction, drafting a Rule 144A offering memorandum can be a difficult, expensive and time-consuming process.

Restricted Securities; Resales by Investors

The securities issued in Section 4(2), Regulation D or Rule 144A offerings are "restricted" securities. Securities acquired directly from an issuer (whether or not the issuer is already subject to the reporting obligations of the U.S. federal securities laws) are considered restricted and may only be sold pursuant to a registration statement or an available exemption.

The most commonly available exemption, particularly for U.S. investors, is Rule 144 of the Securities Act, which offers a safe harbor for sales of any shares purchased in a private placement from a company six months following their purchase, provided that the issuer has been public for at least 90 days and is current in its filing obligations; provided that sales during a three-month period by any affiliate of the issuer, whether or not the affiliate's shares were purchased in a private placement, will be limited to the greater of one percent of the issuer's outstanding shares or a number of shares equal to an average week's trading volume. If the issuer is not a U.S. reporting company, the holding period prior to any sale under Rule 144 is one year; however, affiliates of the issuer will be subject to additional conditions to selling such securities, including the public availability of specified information about such issuer.

Although Rule 144A itself includes no such requirement, limitations generally are placed on the ability of the purchasers from the initial purchasers to resell securities acquired in the Rule 144A transaction. The issuer, on the advice of the initial purchasers, may place several forms of restrictions upon the securities; however, with some variation, the practice has generally been to allow resales back to the issuer or pursuant to (1) Rule 144A itself, (2) Rule 144 and (3) Rule 903 or 904 of Regulations S. Some issuers also permit resales pursuant to any other exemption from registration.

As noted in the previous paragraph, another available exclusion from registration is a sale pursuant to Regulation S under the Securities Act, which may be more meaningful for non-U.S. investors. Rule 904 of Regulation S provides a safe harbor for resales of all securities (whether or not originally acquired in an offshore transaction) by persons other than the issuer, a distributor or their respective affiliates, and any officer or director of the issuer or a distributor who is an affiliate solely by virtue of holding that position. Resales by these persons are deemed to occur outside the United States in compliance with Regulation S, provided that two general conditions are met: there are no "directed selling efforts" in the United States and the offer or sale must be part of an "offshore transaction."[11] Regulation S has additional restrictions on resales depending on whether the proposed reseller is an affiliate of the issuer, or a dealer or other person receiving selling concessions from the issuer and whether the sale occurs within certain time periods following the original issuance of the securities.

If an exemption is not available for resale of securities by investors or the issuer desires to avoid disruption of the market for its securities because the investors may sell a large number or significant percentage of the issuer's securities, the issuer can agree to register the investors' securities for resale, including as part of its initial public offering.[12] Issuers who do not want to become subject to the U.S. federal securities laws should be careful in agreeing to any registration rights.

Rule 12g3-2(b) Exemption

Rule 12g3-2(b) may be an attractive alternative for foreign private issuers that wish to accommodate a limited number of U.S. investors without triggering ongoing U.S. federal registration and disclosure obligations. Securities of any foreign private issuer shall be exempt from registration under Section 12(g) of the Exchange Act, if the foreign private issuer meets the requirements of Rule 12g3-2 under the Exchange Act. The SEC substantially amended Rule 12g3-2, effective in October 2008. Under Rule 12g3-2, as amended, a foreign private issuer will be able to claim the exemption as long as the issuer:

- is not required to file or furnish reports under applicable SEC requirements;
- currently maintains a listing of the subject class of securities on one or more exchanges in a foreign jurisdiction that, either singly or together with the trading of that class in another foreign jurisdiction, constitutes the primary trading market[13] for those securities; and
- has published specified non-U.S. disclosure documents in English on its website or through an electronic information delivery system generally available to the public in its primary trading market.

This exemption is immediately available without having to submit an application to the SEC. In order to maintain the Rule 12g3-2(b) exemption, the issuer is required to publish, on an ongoing basis and for each subsequent fiscal year, in English, on its website or such electronic information delivery system, the information specified for its last fiscal year.

The information required to be furnished is information:

- made public or that has been required to be made public pursuant to the laws of its country of incorporation, organization or domicile;
- filed or required to have been filed with the principal stock exchange in the issuer's primary trading market on which its securities are traded and which has been made public by that exchange; and
- that the issuer has distributed or been required to distribute to its security holders.

The types of information required to be published electronically under this exemption is information material to an investment decision, such as:

- results of operations or financial condition;
- changes in business;
- acquisitions or dispositions of assets;
- issuance, redemption or acquisitions of securities;
- changes in management or control;
- granting of options or the payment of other compensation to directors or officers; and
- transactions with directors, officers or principal security holders.

At a minimum, Rule 12g3-2(b) requires that the foreign private issuer electronically publish English translations of the following documents if originally in a foreign language:

- the annual report, including or accompanied by annual financial statements;
- interim reports that include financial statements;
- press releases; and
- all other communications and documents distributed directly to security holders of each class of securities to which the exemption relates.

The Rule 12g3-2(b) exemption is *not* available if the foreign private issuer:

- has or has had during the prior 18 months any securities registered under Section 12 of the Exchange Act or a reporting obligation (suspended or active) under Section 15(d) of the Exchange Act (with certain exceptions);
- issued securities in a transaction to acquire by merger, consolidation, exchange of securities or acquisition of assets, another issuer that had securities registered under Section 12 of the Exchange Act or a reporting obligation (suspended or active) under Section 15(d) of the Exchange Act (with certain exceptions); or
- has securities quoted in an "automated inter-dealer quotation system" or securities represented by American Depositary Receipts (with certain exceptions).

Rule 12g3-2(b) and Unsponsored ADRs

As noted above, the recent amendments to Rule 12g3-2(b) eliminated the requirement that the issuer apply for the exemption; it is now self-actuating. At the same time, the SEC amended Form F-6, the form that issuers of American Depositary Receipts (ADRs)[14] file to register the ADRs (not the underlying securities), to provide that in the case of an unsponsored[15] ADR facility, the bank depositary may base its representation about the availability of information in accordance with Rule 12g3-2(b) upon its "reasonable, good faith belief after exercising reasonable diligence."[16] Thus, any depositary bank, upon its own review of an issuer's website, can establish an unsponsored ADR facility, and the ADRs can begin to trade in the over-the-counter market, establishing a trading market in the United States for the issuer's securities. In fact, following the effectiveness of the amendments to Rule 12g3-2(b) in October 2008, the number of unsponsored ADR facilities exploded. In the last three months of 2008 alone, depositary banks established nearly 700 new unsponsored ADR facilities,[17] at a time when, in contrast, there were virtually no public securities offerings in the United States.

An unsponsored ADR facility can be useful to an issuer as a way for the U.S. markets to become familiar with the issuer. However, unsponsored ADR facilities can have potentially adverse consequences, including:

- the issuer has no control over the timing or the nature of the trading of its securities in the United States;
- the issuer could at some point not of its choosing be required to register under the Exchange Act if its securities are held by 300 or more U.S. residents and there is no other available exemption from U.S. reporting requirements;
- the depository bank has no obligation to forward any shareholder materials to the ADR holders and communications between the issuer and its (indirect) shareholders could be adversely affected;
- the issuer has no involvement in the mechanics of the ADR program, including its fees and charges and any securities lending arrangements; and
- ADR investors may not be aware that the issuer has no involvement in the ADR facility and can attribute problems with the facility to the issuer.

Assuming the issuer wants to have more control over its communications with its securities holders and its securities trading, the issuer can establish a sponsored ADR facility. A Level I sponsored ADR facility continues to rely on the Rule 12g3-2(b) exemption, but the agreement between the issuer and the depositary bank will, among other matters, cover fees (including fees paid by investors), communications with investors and monitoring the U.S. trading activity to provide early warning of the possibility of U.S. registration.

When the sponsored ADR facility is established, the unsponsored ADR facility must be taken down, and the issuer must arrange for the depositary bank for the unsponsored facility to transfer the deposited securities and the related ADR holders to the sponsored facility and terminate the unsponsored facility.[18] If the depositary bank is not the same for both facilities, the issuer will likely be required to pay the unsponsored facility's bank to effect the transfer.

Rule 12g3-2(b) and Sponsored ADRs

As noted above, a sponsored Level I ADR program offers foreign private issuers access to U.S. investors without triggering U.S. federal securities reporting obligations. A Level I sponsored ADR program:

- does not require any filing with the SEC other than the Form F-6 by the depositary bank;
- can rely on the Rule 12g3-2(b) exemption;
- permits trading of the ADRs on the OTC Bulletin Board[19] or the "Pink Sheets;"[20]
- allows the issuer to establish regular communication with the ADR holders;
- is governed by a deposit agreement between the foreign private issuer and the depositary bank that covers, among other matters, fees payable by the issuer and the ADR holders and the depositary bank's obligation to forward shareholder materials to ADR holders and to monitor trading in the ADRs.

A foreign private issuer with a Level I ADR program, whether sponsored or not, can still access the private placement and Rule 144A markets. If the issuer subsequently determines to list its securities on a national securities exchange (including Nasdaq) or to conduct a public offering of its ADRs, it would change its ADR facility to Level II or Level III, which would require the issuer to register with the SEC, either under the Exchange Act alone (Level II) or under both the Exchange Act and the Securities Act (Level III).

Antifraud Protections

The exemptions for private placements, Rule 144A offerings and Rule 12g3-2(b) are all exemptions from the registration and prospectus delivery requirements of the Securities Act. The antifraud provisions of the securities laws still apply to these transactions.

In general, purchasers of an issuer's securities in a registered offering[21] have private rights of action against various participants in the offering for materially deficient disclosure in registration statements under Section 11 of the Securities Act and in prospectuses and oral communications under Section 12(a)(2) of the Securities Act. Under Section 11, liability exists for untrue statements of material facts or omissions of material facts required to be included in a registration statement or necessary to make the statements in the registration statement not misleading at the time the registration statement became effective. Under Section 12(a)(2), sellers have liability to purchasers for offers or sales by means of a prospectus or oral communication that includes an untrue statement of material fact or omits to state a material fact that makes the statements made, based on the circumstances under which they were made, not misleading. In addition, Section 17(a) of the Securities Act is a general antifraud provision that provides, among other things, that it will be unlawful for any person in the offer and sale of securities to obtain money or property by means of any untrue statement of a material fact or any omission 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.

Purchasers also may have private rights of action under Section 10(b) and Rule 10b-5 under the Exchange Act. Section 10(b) and Rule 10b-5 are implied causes of action covering all transactions in securities, including private placements, and all persons who use any manipulative or deceptive devices in connection with the purchase or sale of any securities. Courts have held that claims brought under Section 10(b) and Rule 10b-5 require proof that the defendant acted with scienter (meaning intent or knowledge of the violation), which is not a requirement for actions brought under Section 11 or Section 12.

Each of these statutes and rules has many decades of judicial interpretations explicating their elements and defenses. While the antifraud protections often frighten foreign private issuers from accessing the U.S. capital markets and litigation can always be brought, experienced counsel can be very helpful in guiding issuers and investment banks through the process in order to minimize the possibility of such litigation.

Conclusion

Foreign companies wishing to access the deep capital pools within the United States should be aware that the public markets are not the only choice. Foreign companies can choose a simple private placement or other combinations of public and private offerings in order to raise capital and attract investors.

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[1] Foreign private issuers that are already U.S. reporting companies may also effect private placements and Rule 144A offerings, but this article is directed to non-reporting companies.

[2] The Securities Act governs public offerings of securities. The Exchange Act, among other things, requires registration by a foreign private issuer when, among other factors, it has total assets exceeding $10 million; and it has a class of equity securities held of record by 500 or more persons worldwide, of whom 300 or more holders are resident in the United States. *See* Section 12(g) of the Exchange Act and the rules thereunder.

[3] While many of the indicated statutes will not be relevant, for foreign issuers, one confusing issue may be that each state in the United States has the authority to regulate sales of securities within its borders, colloquially known as "blue sky" laws. The U.S. federal securities laws generally preempt the operation of state laws for registered securities transactions, transactions with securities listed on the major exchanges and securities exempt from registration under a federal securities law exemption, including pursuant to rules promulgated under Section 4(2). However, certain private placements of securities may be subject to one or more states' blue sky laws. Experienced securities law counsel will provide necessary compliance advice.

[4] Integration generally means the aggregation of two or more ostensibly independent offerings in order to determine whether the private placement exemption is available. For example, several private placements offered within a short period of time (less than six months), each relying on separate offering exemptions, may be integrated, and when taken together, may constitute a single plan of financing for which the private placement exemption is not available.

[5] In August 2007, the SEC proposed changes to Regulation D, including the creation of a new exemption under Regulation D for offers and sales of securities to a new category of investors called "large accredited investors." This new exemption would be contained in a new Rule 507 (existing Rule 507 would be replaced with new Rule 502(e)). As proposed, the new rule would permit certain limited advertising for exempt offerings in which each purchaser qualifies as a "large accredited investor." The SEC included this proposed new exemption in order to facilitate capital formation. *See* SEC Release Nos. 33-8828, IC-27922 (Aug. 3, 2007); File No. S7-18-07.

[6] The "first sale" is not necessarily the closing date. It is when an investor is irrevocably contractually committed to invest. Counsel often advises an early filing of Form D to avoid this problem.

[7] *See* Rule 144A(a) for a definition of QIB and related terms.

[8] Regulation S provides an exclusion from the Section 5 registration requirements for offerings made outside the United States by both U.S. and foreign issuers. A securities offering, whether private or public, made by an issuer outside of the United States in reliance on Regulation S need not be registered under the Securities Act. Regulation S is available only for "offers and sales of securities outside the United States" made in good faith and not as a means of circumventing the registration provisions of the Securities Act. The availability of the issuer and resale safe harbors of Regulation S is contingent on two general conditions: (1) the offer or sale must be made in an offshore transaction; and (2) no "directed selling efforts" may be made by the issuer, a distributor, any of their respective affiliates, or any person acting on their behalf. There are also specific additional conditions that are based on the nature of the security offered and whether the issuer already has securities that are publicly registered in the United States.

[9] *See* note 3 *supra*.

[10] Rule 144A is an exemption from registration under Section 5 of the Securities Act. As stated in Preliminary Note 1 to Rule 144A, it does *not* relate to the antifraud or other provisions of the federal securities laws.

[11] "Directed selling efforts" is defined in Rule 902(c) and "offshore transaction" is defined in Rule 902(h). However, these concepts can be quite complicated, and counsel should be consulted if an issuer or an investor intends to take advantage of the Regulation S exclusion.

[12] Investors do not have the right to register the securities without the involvement of the issuer. All registration statements must be filed by the issuer even if only investors are selling securities under the registration statement.

[13] As defined in Exchange Act Rule 12g3-2(b)(1)(ii), "primary trading market" means (i) at least 55 percent of the trading of the subject class of securities on a worldwide basis took place in, on or through the facilities of a securities market or markets in a single foreign jurisdiction or in no more than two foreign jurisdictions during the issuer's most recently completed fiscal year, and (ii) if a foreign private issuer aggregates the trading of its subject class of securities in two foreign jurisdictions, the trading for the issuer's securities in at least one of the two foreign jurisdictions is greater than the trading in the United States for the same class of the issuer's securities.

[14] An ADR is a negotiable instrument issued by a U.S. bank that represents an ownership interest in a specified number of securities that have been deposited with a custodian typically in the issuer's country of origin. The filing of Securities Act Form F-6 is required in order to establish an ADR facility. The eligibility criteria for the use of Form F-6 include the requirement that the issuer of the deposited securities have a reporting obligation under Exchange Act Section 13(a) or have established the exemption under Rule 12g3-2(b). While required to be registered on Form F-6 under the Securities Act, ADRs are exempt from registration under Exchange Act Section 12(g) pursuant to Exchange Act Rule 12g3-2(c).

[15] An "unsponsored" ADR facility is one in which the issuer of the underlying security is not involved.

[16] *See* Note to Part I, Item 2 of Form F-6.

[17] *See* The Bank of New York Mellon, The Year in Review - 2008 (Depositary Receipts).

[18] *See* Question 105.04, SEC Staff Interpretation, Division of Corporation Finance, Securities Act Forms, (Feb. 27, 2009).

[19] *See* http://www.otcbb.com/.

[20] *See* http://www.pinksheets.com/pink/index.jsp. Pink OTC Markets Inc. is an electronic over-the counter market; "pink sheets" refers to the color of the paper used for the original paper-based system.

[21] The term "registered offerings" includes those private offerings that, as determined in hindsight, should have been registered under Section 5 of the Securities Act. This would, for example, include an offering that was intended to comply with Section 4(2) or Regulation D or Rule 144A but was determined not to satisfy the applicable requirements for an exemption from registration.