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Securities Offerings 2017:

A Public Offering: How It Is Done

Chair

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The Statutory Arrangement for Public and Private Securities Offerings Under the Securities Act of 1933 (December 1, 2015)

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Introductory Note: The material discussed in this outline is for training and illustrative purposes only and does not purport to reflect appropriate or inappropriate disclosure or procedures that should be followed or inquiries that should be made, if any, in any particular situation.

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**PUBLIC AND PRIVATE SECURITIES OFFERINGS
UNDER THE SECURITIES ACT OF 1933**

The Securities Act of 1933 (as amended, the "1933 Act")[1] which became law on May 27, 1933, establishes the principal legal framework for the offer and sale of securities in the U.S. It is fundamentally premised on disclosure, rather than "qualitative" evaluations of different securities. The preamble of the 1933 Act sets forth that its purpose is to ensure "full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails."

The 1933 Act relies on a combination of regulatory oversight and private litigation to ensure compliance with its requirements. Regulatory oversight is carried out by the Securities and Exchange Commission (the "SEC") which, among other things, administers the "registration process". Absent an exemption, § 5 of the 1933 Act prohibits offers and sales of securities unless the registration process is utilized. It is worth underscoring that it is the offer or sale (that is, the transaction) that needs either an exemption or registration in every case.[2]

The "civil liability" provisions of the 1933 Act impose strict liability on issuers, underwriters, directors, certain named officers and experts for material misstatements and omissions in connection with the offer and sale of securities, subject only to limited defenses, including a "due diligence" defense (for persons other than the issuer).

I. Key Definitions under the 1933 Act.

Pursuant to Section 5 of the 1933 Act, a person must either have an exemption available or use the registration process with regard to any offer or sale of securities. The 1933 Act defines several key categories of persons who might be involved in offers or sales of a security (although the general principle just noted applies to anyone). In particular, "issuer" and "underwriter" are defined in § 2 of the 1933 Act and can have significantly broader meanings than what may apply to them in lay person English. So who or what is an "issuer" and an "underwriter" for securities law purposes?

A. Issuer: § 2(a)(4) defines an issuer as every person who issues or proposes to issue a security. Note that issuers must potentially register all sales, even small sales and even resales of previously publicly traded securities—e.g., an issuer cannot purchase 100 shares of its own stock on a stock exchange and later resell those shares without registration or reliance on an available exemption.

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[1] Unless otherwise noted, all section references in this outline are to the 1933 Act.

[2] In contrast, many non-U.S. jurisdictions rely on "company" registration.

B. Underwriter: § 2(a)(11) defines an underwriter as any person (note then that this term is not limited to investment banks or others who expressly call themselves underwriters) who has purchased a security either

> from an issuer (or any person who offers or sells a security for an issuer) or
>
> from "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer" (a "controlling person")

in either case with a view to distribution of the security.

The definition of "underwriter" in § 2 also includes any person (i) who "offers or sells for an issuer in connection with the distribution of any security," or (ii) who "directly or indirectly participates in any such undertaking or the underwriting of such an undertaking".

1. This definition clearly includes a managing underwriter and other members of an underwriting syndicate.

2. Excluded are dealers who are so-called "selling group" members-- § 2(a)(11) and related Rule 141 provide that, if a person's interest in the sale of a security is limited to a commission from an underwriter (but not from the issuer) which is not in excess of a usual and customary seller's commission, such person is not an underwriter.

3. If an investment bank (that is, a "dealer") purchases securities for resale from a "controlling" person, the investment bank is an "underwriter" and the registration process must be used. It is not relevant how the controlling person acquired the securities--open market purchase, directly from the issuer or in a registered public offering--registration is required on resale, unless an exemption is available.

4. Non-controlling persons (which the vast majority of people are with regard to the vast majority of issuers) may sell unrestricted securities through a dealer without registration, since the dealer is not deemed to be an underwriter and is exempt in its capacity as a "dealer" pursuant to § 4(a)(3).

II. **<u>Need to Register: § 5</u>**

A. Section 5 is the heart of the Act and provides in its most simple terms that securities cannot be sold or delivered, absent an exemption, unless an effective registration statement is in place. This section also prohibits offers with regard to securities unless a registration statement is on file, and establishes the general rule that § 10 governs prospectuses and their content.

III. **<u>Exemptions from Registration: §§ 3 and 4 and Related Rules.</u>**

A. <u>Exempted Securities.</u>

Section 3(a) exempts all transactions in certain securities from registration:

1. § 3(a)(2) exempts, among others, securities issued or guaranteed by:

   a. the U.S. Government and its agencies;

   b. state and local governments; and

   c. banks (but not bank holding companies); this includes a letter of credit issued by a bank that is guaranteeing a non-exempt security.

2. § 3(a)(3) exempts commercial paper arising out of current transactions (or the proceeds of which have been or will be used for current transactions) with a maturity not exceeding 9 months. Note that the § 3(a)(3) exemption is irrelevant to a commercial paper program that avails itself of the exemption under § 4(a)(2).

3. § 3(a)(6) exempts certain railroad equipment trust certificates.

4. § 3(a)(9) exempts any security of an issuer exchanged with its own existing security holders exclusively where no commission is paid for soliciting the exchange. For example, this exemption covers issuance of common stock upon conversion of outstanding convertible debt (assuming no fee is paid to solicit the exchange), but does not cover issuance of common stock upon exercise of a warrant by payment of a cash exercise price. There are extensive "no action" letters under § 3(a)(9). "Restricted securities," described below, retain their character as "restricted securities" following a § 3(a)(9) exchange.

5. § 3(a)(10) exempts any security issued in exchange (except in a Chapter 11 bankruptcy proceeding) for one or more outstanding securities, claims

or property interests (and partly for cash), where the exchange terms have been approved (after a fairness hearing) by a court (U.S. or foreign) or state or federal agency expressly authorized by law to grant the approval. The exchanged securities are not considered "restricted securities" for purposes of Rule 144 and are freely tradeable so long as the seller is not an affiliate of the issuer and has not been an affiliate in the 90 days before the § 3(a)(10) transaction.

6. § 3(a)(11) exempts any security that is part of an issue offered and sold only to persons in the state where the issuer is resident, does its business and, in the case of a corporation, is incorporated. Rule 147 outlines requirements that, if met, satisfy the § 3(a)(11) exemption.

Pursuant to Section 3(b), as modified by the Jumpstart Our Business Startups Act (the "JOBS Act"), the SEC has modified the Regulation A exception (as modified, informally referred to as "Regulation A+") to create two tiers of exempt public offerings.[3]

<table>
<tr><th></th><th>Tier 1</th><th>Tier 2</th></tr>
<tr><td>Annual Offering Limit</td><td>$20 million in offering and 12 month prior period</td><td>$50 million in offering and 12 month prior period</td></tr>
<tr><td rowspan="2">Selling Shareholder Participation</td><td>$6 million by affiliates</td><td>$15 million by affiliates</td></tr>
<tr><td colspan="2">Affiliate and non-affiliate selling shareholders limited to 30% of aggregate offering price in (i) initial Regulation A offering or (ii) any follow-on Regulation offerings within one year.</td></tr>
<tr><td>Issuer Eligibility</td><td colspan="2">U.S. and Canadian issuers; not a 1934 Act reporting company; and not otherwise a "bad actor"</td></tr>
<tr><td>Investment Limit</td><td>None</td><td>For non-accredited investors of unlisted securities: Up to the greater of 10% of investor's annual income or net worth or annual revenue or net assets</td></tr>
<tr><td>Eligible Securities</td><td colspan="2">Equity securities, debt securities and debt securities convertible or exchangeable into equity, including any guarantees of these types of securities</td></tr>
</table>

[3] See SEC Release 33-9741 (March 25, 2015)

<table>
<tr><th></th><th>Tier 1</th><th>Tier 2</th></tr>
<tr><td>1933 Act Status</td><td colspan="2">Public offering exempt from registration. Not integrated with prior or subsequent offers or sales of securities (subject to limited exceptions)</td></tr>
<tr><td>1934 Act Status</td><td colspan="2">Securities issued in a Tier 2 offering will not count toward the registration thresholds of section 12(g) of the 1934 Act so long as the issuer is current in its reporting requirements, has a transfer agent and had either (i) a public float of less than $75 million as of its most recent semiannual period or (ii) if it had no public float, annual revenues of less than $50 million as of its most recently completed fiscal year.</td></tr>
<tr><td>Offering Statement Filing and Qualification</td><td colspan="2">No offers before Form 1-A is filed with SEC.
“Testing the waters” solicitation materials permitted to be used before and after Form 1-A is filed, subject to legend and filing requirements.
Oral and regulated written offers permitted after filing and before qualification.
No sales before Form 1-A is “qualified”.
Non-public review process is available for first-time issuers.
FINRA filing and review required if a FINRA member firm participates in the offering.</td></tr>
<tr><td>Offering Statement Contents</td><td>Unaudited balance sheets, income statements, cash flows and stockholders’ equity for two most recent years; business and other information analogous to Form S-1</td><td>AUDITED balance sheets, income statements, cash flows and stockholders’ equity for two most recent years; business and other information analogous to Form S-1</td></tr>
<tr><td>Ongoing Reporting</td><td>Very limited disclosure obligations after qualifying an offering</td><td>Similar to public company reporting (annual reports, semiannual reports, current event updates)</td></tr>
</table>

	Tier 1	Tier 2
Potential Liability	Section 12(a)(2), NOT section 11	
State Law Pre-emption	No pre-emption	All persons to whom offers or sales are made in a Tier 2 offering; states may require notice filings, consents to service of process and filing fees

B. <u>Exempt Transactions.</u>

Section 4 exempts specific transactions from registration:

1. § 4(a)(1) exempts all transactions by any person other than an "issuer" (§ 2(a)(4)), an "underwriter" (§ 2(a)(11)) or a "dealer" (§ 2(a)(12)).

2. § 4(a)(2) exempts transactions by an issuer not involving any public offering:

    a. These are so-called "private placements" of securities by the issuer to a limited number of qualified purchasers who agree to resale restrictions. There can be no "general solicitation" in connection with a transaction that relies on the statutory exemption, but an issuer that is a public company can make a public announcement under Rule 135(c).

    b. Regulation D (described below) establishes a safe harbor under Section 4(a)(2) for certain eligible private placements. Certain transactions under that safe harbor can involve a "general solicitation".

3. "§4(1)(½) Exemption" (now §4(a)(1)(½)). This exemption has not been written into law but instead relies on a combination of §4(a)(1) and §4(a)(2). It allows parties that have acquired restricted securities in a §4(a)(2) private placement to resell these securities in a further private placement by following procedures necessary under §4(a)(2). However, because §4(a)(2) applies only to issuers, the actual exemption for this kind of transaction is §4(a)(1) because the third party avoids being deemed either an underwriter or a dealer. Note that these securities retain their "restricted" status.

4. § 4(a)(3) (and related Rule 174) exempts dealer transactions from § 5 so long as the transaction does not: (i) involve unsold allotments (i.e., the securities which are still in the hands of an underwriter but not sold as part of the initial distribution and are being held for distribution rather than investment) OR (ii) occur during the applicable 25 or 90 day period following an initial public offering. A "dealer" generally includes any person who acts as an agent, broker or principal in the business of dealing or trading in securities issued by another person (§ 2(a)(12)).

5. § 4(a)(5) exempts private placements to "accredited investors" of less than $5 million.

6. Section 4(a)(6), which was added by the JOBS Act, creates a "crowdfunding" exemption from registration, whereby small aggregate amounts of securities of an issuer can be sold through brokers or "funding portals" to investors in small individual amounts. On October 30, 2015, the SEC adopted rules to implement the crowdfunding exemption.[4] Securities issued under the crowdfunding exemption will be subject to the following:

   - Transfer of securities issued in crowdfunding transactions will be restricted for one year, with limited exceptions.
   - Securities issued in a crowdfunding transaction are "covered securities" under the Securities Act (i.e., exempt from state Blue Sky laws with respect to the issuance of the securities).
   - Securities issued in crowdfunding transactions will not count toward the registration thresholds of section 12(g) of the 1934 Act, so long as the issuer is current in its reporting, has a transfer agent and has no more than $25 million in assets.
   - Securities issued in crowdfunding transactions will not be integrated with other exempt offerings by the issuer, to the extent that each offering complies with the requirements of the applicable exemption being relied upon.
   - An issuer is required to prepare and file a Form C before the commencement of the offering and is subject to certain ongoing reporting requirements.

[4] See SEC Release 33-9974 (October 30, 2015)

    - Under Section 4A(c), the issuer may be held liable for written or oral material misstatements or omissions in accordance with Sections 12(b) and 13, as if the liability were created under Section 12(a)(2).

Restrictions on crowdfunding transactions include:

- An issuer cannot raise more than $1 million through crowdfunding offerings in any 12-month period.

- An investor may not invest more than the following in crowdfunding offerings in any 12-month period

    - the greater of (i) $2,000 or (ii) 5 percent of the lesser of annual income or net worth of such investor, if either the annual income or the net worth of the investor is less than $100,000; and

    - 10 percent of the lesser of annual income or net worth of such investor (not to exceed an amount sold of $100,000), if both the annual income and net worth of the investor are equal to or more than $100,000.

- Crowdfunding transactions must be conducted through a broker or funding portal (a specially created intermediary for crowdfunding transactions).

Crowdfunding is not available for: (i) foreign issuers; (ii) issuers that are required to file reports pursuant to section 13 or 15(d) of the 1934 Act; (iii) investment companies as defined in section 3 of the Investment Company Act, or that are excluded from the definition of investment company by section 3(b) or 3(c) of that Act; and (iv) other categories of issuers designated by the SEC as prohibited.

Issuers and intermediaries must fulfill a number of other requirements, including several related to disclosure and investor education.

Regulation D.

Regulation D, which implements several of the exemptions under §§ 3 and 4, provides both (i) exemptions for certain limited offerings by issuers of securities not exceeding $1 million and $5 million and (ii) a non-exclusive safe harbor for issuer private placements under § 4(a)(2) (Rule 506). The safe harbor in Rule 506 has no limit on the dollar amount of the offering, the number of offerees, or the number of "accredited investor" purchasers (non-accredited investor purchasers are limited to a total of 35).

Prior to the JOBS Act, Regulation D prohibited all forms of general solicitation and general advertising, although a Rule 135(c) announcement by a 1934 Act reporting company was permitted. Issuers may continue to rely on these provisions.

As a result of a rule change mandated by the JOBS Act, the SEC amended Regulation D to allow issuers to choose to engage in general solicitation and general advertising, *provided* that (i) all purchasers of the securities are accredited investors and (ii) the issuer takes reasonable steps to verify that such purchasers are accredited investors. Amended Rule 506 contains a non-exclusive list of methods that issuers may use to satisfy the verification requirement.[5] These include obtaining tax returns, bank statements or brokerage statements, together with written representations or third party confirmations from a broker dealer, accountant, investment advisor or attorney. Practice is still developing around what steps constitute legally sufficient reasonable verification.

A second JOBS Act required amendment to Regulation D disqualified certain "bad actors" from relying on Regulation D. Bad actors include issuers where the issuer, and any predecessor or affiliate or 20% owner (i) has been convicted within the past 10 years of a felony or misdemeanor in connection with the sale of securities, or of making a false filing with the SEC, (ii) is subject to any order, judgment or decree entered within the past five years enjoining the person from engaging in the activities noted above, (iii) is the subject of an order of the SEC or banking regulator suspending the person's ability to engage in such businesses or (iv) has been the subject within 5 years of an order to cease and desist from any disclosure violation under the securities laws.[6]

As outlined below, securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer are one category of "restricted securities".[7] The transferability of these securities is limited because any holder runs the risk of being deemed an underwriter in that transfer.

<u>Regulation S.</u>

The SEC has also recognized a non-statutory "exemption" for securities offered and sold outside the United States under Regulation S (adopted in SEC Release

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[5] See SEC Release No. 33-9415 (July 10, 2013)

[6] See SEC Release No. 33-9414 (July 10, 2013)

[7] See the SEC investor publication, "Rule 144: Selling Restricted and Control Securities," available at http://www.sec.gov/investor/pubs/rule144.htm.

No. 33-6863 (April 23, 1990)). Rule 901 sets out the "general statement" that Section 5 of the Securities Act applies to offers and sales that occur within the U.S. and does not apply to offers and sales that occur outside the U.S.

Resolution S also provides safe harbors for

a. offers and sales by issuers, distributors and their affiliates (Rule 903), and

b. resales by others (Rules 904 and 905).

Rule 903 sets out three safe harbors

"Category 1" includes offers and sales of

(i) securities of foreign private issuers for which there is no substantial U.S. market interest in the class offered (in the case of an offering of equity securities) or in its debt securities generally (in the case of an offering of debt securities) or in the underlying securities (in the case of an offering of warrants or convertible securities); (ii) an overseas directed offering (i.e., directed to a single country) of any security of a foreign private issuer or non-convertible debt securities or preferred stock of a U.S. issuer; (iii) foreign government securities; and (iv) certain employee benefit plan offerings of any issuer.

For purposes of Regulation S, "substantial U.S. market interest" ("SUSMI") means, with respect to the most recent fiscal year (or if less period since incorporation),

a. in the case of equity securities, either (A) the U.S. exchanges represent the largest single market or (B) 20% or more of the worldwide trading took place on U.S. exchanges and less than 55% of the trading took place on the exchanges in any single non-U.S. country; and

b. in the case of non-convertible debt and preferred stock and asset-backed securities (collectively defined as "debt securities" in Rule 902(a)), (A) there are more than 300 U.S. "holders of record" of all of such securities (exclusive of Section 3(a)(2) commercial paper), (B) more than $1 billion in principal or liquidation amount of such securities are held of record by U.S. persons AND (C) more than 20% in principal or liquidation amount of such securities are held of record by U.S. persons. Note that because this prong of the SUSMI definition requires all three tests to be "flunked", it is extremely unlikely for a foreign issuer's non-convertible debt, preferred stock and asset backed securities to have SUSMI.[8]

"Category 2" includes offers and sales of securities that

a. do not qualify for Category 1; and

b. are any of the following

(i) equity securities of a foreign private issuer that is an Exchange Act reporting company that has filed all reports required for at least 12 months (or, if less, as long as has been a reporting company); or

(ii) debt securities of any Exchange Act reporting issuer that has made its required filings as specified in (i) above; or

(iii) debt securities of any foreign private issuer that is <u>not</u> an Exchange Act reporting company.

"Category 3" includes all securities that

a. Do not qualify for Category 1 or 2.

b. Examples

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[8] While it may seem illogical to require an issuer to flunk all three tests, the adopting release makes it reasonably clear that this result was intended. See note 92, 46 SEC Docket 52-2, Release No. 33-6863 (April 24, 1990); *See also* Reproposing Release at 6, 43 SEC Docket 2008-557, SEC Release No. 33-6838 (July 11, 1989). The effect of clauses (B) and (C) of this definition is that an issuer must have at least $1.0 billion of debt, preferred stock and asset backed securities held by U.S. persons, which in turn represents at least 20% of the total amount outstanding (so, for example, SUSMI would not exist where (i) the issuer has less than $1.0 billion of such securities held by U.S. persons <u>OR</u> (ii) less than 20% of the total outstanding amount of such securities is held by U.S. persons).

Clause (A) additionally requires that these securities must be held "of record" by 300 or more U.S. Persons under Rule 12g5-1. The Staff interpretations under that rule make clear that for securities held through the DTC, the number of holders of record is the number of DTC participants that hold the security, not the number of beneficial owners that hold through one or more DTC participants. Given that most debt is held through the DTC or another clearing system, even companies with multi-billions of debt and preferred stock outstanding are unlikely to have 300 U.S. holders. See SEC Compliance and Disclosure Interpretation 152.01 (September 30, 2008)

(i) Equity securities, including convertible securities, of U.S. domestic companies, whether or not they are reporting companies

(ii) Debt of non-reporting U.S. domestic companies

The theory is that the "natural home" for these securities is the U.S. market so that most stringent procedures should apply to them.

Note also that debt and equity securities of a non-reporting foreign private issuer are likely to be eligible for Category 1 because of lack of SUSMI.

Restrictions under Regulation S

In order to qualify for any Regulation S safe harbor, there must be an "offshore transaction" (i.e., an offer cannot be made to a person in the United States and the buyer must be outside the United States or the seller must reasonably believe the buyer is outside the United States). Furthermore, neither the issuer nor any distributor (or any affiliate of either) may engage in any "directed selling efforts" (i.e., activities that may condition the United States market for the securities).

For Category 1 offerings there are no other conditions imposed on the transaction. (See Rule 903 of Regulation S.)

For Category 2 offerings:

a. "offering restrictions" must be implemented, which means that (x) each underwriter, dealer or other distributor must agree (i) to abide by the "distribution compliance period" restrictions set out below and, in the case of equity securities of U.S. domestic issuers" (ii) to hedge only in compliance with the Securities Act and (y) all offering materials must include specific legends and other information on the inside cover, in the underwriting section and in any advertising;

b. a "distribution compliance period" must be observed, which means in the case of Category 2 that

(i) offers and sales of allotments of the securities may not be made to U.S. persons (other than a distributor), except for sales pursuant to registration or another exemption (e.g., Rule 144A); and

(ii) during a 40-day "distribution compliance" period beginning when the securities are first offered to third parties, no offer or sale of the securities, including those acquired in the trading market, can be made to U. S. persons (other than a distributor), except pursuant to registration or another exemption; and

c. During the distribution compliance period, each distributor selling securities to another distributor or a dealer or anyone receiving a selling concession must include a notice in the confirmation stating that the purchaser is subject to the same restrictions as the distributor.

For Category 3 offerings:

a. "offering restrictions" are implemented;

b. a "distribution compliance period" must be observed, which

   (i) in the case of debt securities is 40 days; and

   (ii) in the case of equity securities is either (i) six months (in the case of reporting issuers) or (ii) one year (in the case of non-reporting issuers); and

c. during the distribution compliance period, each distributor selling securities to another distributor or a dealer or anyone receiving a selling concession must include a notice in the confirmation stating that the purchaser is subject to the same restrictions as the distributor.

d. The following additional procedures apply:

   (i) in the case of non-convertible debt or preferred stock, the securities are represented by a temporary global note during the 40 day distribution compliance period and are not exchangeable for permanent securities unless the holder certifies as to its non-U.S. status; and

   (ii) in the case of equity securities, including convertible securities, during the six month or one year distribution compliance period:

      (1) the purchaser (other than a distributor) certifies either (A) that it is not a U.S. person or (B) that is a U.S. Person that purchased in a transaction that did not require registration under the Securities Act;

      (2) the purchaser agrees to resell the securities only in accordance with the provisions of Regulation S, a registration statement or another exemption and agrees that

any hedging transactions will be in compliance with the Securities Act;

(3) in the case of securities of a domestic U.S. issuer, the certificates bear a required legend; and

(4) the issuer is required by contract or a provision in its bylaws or other charter document to refuse to register any transfer of securities not made in compliance with Regulation S, a registration statement or another exemption; provided that in the case of bearer securities and where foreign law prevents the foregoing, other reasonable procedures are implemented.

Guaranteed Securities. In the case of non-convertible debt and preferred stock, that is fully and unconditionally guaranteed by a parent company, the offering only needs to comply with the rules applicable to the parent company guarantor. In the case of subsidiary guarantors, the interpretive guidance is less clear but many practitioners advise that the transaction should follow the rules applicable to the "primary credit" in the transaction, and rely on Rule 901.

Special rules apply for offerings of warrants (Rule 903(b)(5)) and for resales by affiliates and dealers (Rule 904(b)). Also Rule 905 states that equity securities of U.S. domestic issuers sold under Regulation S will be "restricted securities" for purposes of Rule 144. Also, there is special interpretive guidance relating to convertible securities.[9]

C. Resale of Restricted Securities and Sales of Securities by Control Persons.

1. An owner of "restricted securities" (e.g. securities acquired in a private placement) or a control person owning any securities of the issuer, (however they were acquired (often called "affiliate securities" or "control securities") can dispose of such securities in five ways:

a. in a registered offering;

[9] See Cravath, Swaine & Moore, SEC No-Action Letter (August 26, 1998) relating to the issuance by U.S. reporting companies of convertible securities held in global form. Also see SEC Interpretive Release No. 33-7516 (March 26, 1998) which contains guidance on when the posting of offering materials on an Internet site by a foreign issuer would not be considered to be an offering "in the United States".

b. in a further private placement (the so-called "§ 4(1)(½) exemption" (now §4(a)(1)(½)))--note that the § 4(a)(2) private placement exemption is by its terms available only to an issuer and not in connection with a resale;

c. to the public in a transaction not involving a "distribution", as defined by Rule 144;

d. in the case of certain securities that are not publicly traded, to "qualified institutional buyers" ("QIBs"), who purchase for their own account (or that of another QIB) pursuant to Rule 144A; or

e. in an offshore transaction under the resale provisions of Regulation S.

2. <u>Restricted Securities.</u>

The term "restricted securities" is defined in Rule 144(a)(3) to mean:

a. Securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering under section 4(a)(2);

b. Securities acquired from the issuer that are subject to the resale limitations of Rule 502(d) under Regulation D or Rule 701(c) (which relates to certain unregistered employee benefit plans);

c. Securities acquired in a transaction or chain of transactions meeting the requirements of Rule 144A;

d. Securities acquired from the issuer in a transaction subject to the conditions of Rule 1001 under Regulation CE, which relates to certain California state law exemptions;

e. Equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of Rule 901 or 903 under Regulation S;

f. Securities acquired in a transaction made under Rule 801 (which exempts certain rights offerings of foreign private issuers to the same extent and proportion that the securities held by the security holder of the class with respect to which the rights offering was made were, as of the record date for the rights offering, "restricted securities" within the meaning of Rule 144(a)(3);

g. Securities acquired in a transaction made under Rule 802 (which exempts certain exchange offers and business combinations of foreign private issuers) to the same extent and proportion that the securities that were tendered or exchanged in the exchange offer or business combination were "restricted securities" within the meaning of Rule 144(a)(3); and

h. Securities acquired from the issuer in a transaction subject to an exemption under section 4(a)(5) of the Securities Act.

Note that securities issued in a Section 3(a)(9) exchange retain the character (restricted or unrestricted) of the securities surrendered.

3. Rule 144. Rule 144 defines those circumstances under which an owner of restricted securities, or a person selling restricted or other securities for a control person, may offer and sell such securities to the public and avoid being deemed to be engaged in a "distribution" of such securities. Therefore that selling person will not be deemed to be an "underwriter".

Restricted securities that are sold into the public markets in reliance on Rule 144 are no longer restricted once held by a purchaser in the public market (assuming that person is not an affiliate).

The following chart outlines the applicable holding periods and resale restrictions:

	Affiliate or Person Selling on Behalf of an Affiliate	**Non-Affiliate (and Has Not Been an Affiliate During the Prior Three Months)**
Restricted Securities of Reporting Issuers and Affiliate or Control Securities	During six-month holding period - no resales of restricted securities under Rule 144 permitted. After six-month holding period (for restricted securities) and at any time (for affiliate or control securities) - may resell in accordance with all Rule 144 requirements including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144	During six-month holding period - no resales under Rule 144 permitted. After six-month holding period but before one year – unlimited public resales under Rule 144 except that the current public information requirement still applies. After one-year holding period - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.
Restricted Securities of Non-Reporting Issuers	• During one-year holding period - no resales under Rule 144 permitted. • After one-year holding period - may resell in accordance with all Rule 144 requirements, including: • Current public information, • Volume limitations, • Manner of sale requirements for equity securities, and • Filing of Form 144.	During one-year holding period - no resales under Rule 144 permitted. After one-year holding period - unlimited public resales under Rule 144; need not comply with any other Rule 144 requirements.

Current Public Information means:

a. for a reporting issuer (1) it has been subject to reporting under Exchange Act Section 13(a) or 15(d) for at least 90 days and (2) it has filed all annual and quarterly reports required during the prior 12 months (or as long as public, if less than 12 months); or

b. for a non-reporting issuer, certain specified information is publicly available.

Volume Limitations means:

a. for equity or debt securities, within any three month period, the affiliate (subject to aggregation rules) can sell the higher of (1) 1% of the shares or units outstanding and (2) the average weekly trading volume during the four preceding weeks;

a. for debt securities, the rules provide an alternative test allowing for resales of up to 10% of a tranche of debt securities in any three-month period.

Manner of Sale Requirements means:

a. equity securities must be sold in a brokers' transaction, a transaction directly with a market maker, or a riskless principal transaction as defined in the rule (and the person selling the securities shall not solicit orders or make any payments in connection with the sale other than to the broker executing the order).

4. Rule 144A. Rule 144A provides a safe harbor for resales of privately placed securities and other unregistered securities (e.g., debt and foreign equity) to "qualified institutional buyers" ("QIBs") so long as the conditions discussed below are met. Rule 144A provides a tremendously important (and common) mechanism under the 1933 Act by which high-yield bonds are placed with institutional investors.

a. Sold only to QIBs—the securities are sold to a QIB (or a person reasonably believed to be a QIB) who purchases for its own account (or the account of another QIB). The following qualify as QIBs:

(1) any corporation, partnership or other entity (but not an individual) that owns and invests on a consolidated basis

$100 million in the aggregate in securities of non-affiliates (other than (x) bank deposits and loan participations, (y) repurchase agreements and securities subject thereto and (z) currency, interest rate and commodity swaps);

(2) registered dealers that own or invest $10 million of such non-affiliate securities or are engaged in "riskless principal transactions" on behalf of QIBs;

(3) any investment company that is part of a "family" that has the same investment adviser and together own $100 million of such non-affiliate securities; and

(4) any U.S. or foreign bank or savings and loan that owns and invests on a consolidated basis $100 million in such non-affiliate securities and has a net worth of at least $25 million.

In determining the status of a purchaser, a seller can rely on (x) published financial statements or (y) a certificate of an executive officer.

Note that as a result of a JOBS Act mandated rule change, Rule 144A securities may be offered to non-QIBs, so long as the actual purchasers meet the above requirements[10]

b. <u>"Non-fungible securities"</u>—debt or equity securities that, when issued, were not of the same class as securities listed on a national securities exchange or quoted through an automated interdealer quotation system ("Fungible Securities"). For this purpose securities that are immediately convertible into Fungible Securities at a conversion premium of less that 10% are also Fungible Securities. Securities of open-end investment companies, unit investment trusts and face-amount certificate companies registered under the 1940 Act are excluded.

c. <u>Disclosure documents</u>—if the issuer is not either (x) a reporting issuer under the Securities Exchange Act of 1934 (the "1934 Act") or (y) a foreign issuer exempt from reporting under Rule 12g3-2(b), the seller and the prospective purchaser must have the right to obtain from the issuer (and if requested, the

[10] See SEC Release No. 33-9415 (July 10, 2013)

purchaser must have actually obtained) a brief description of the issuer and the issuer's financial statements for the most recent period and the two preceding fiscal years.

d. Notice from seller—the seller in the Rule 144A transaction must notify each purchaser that Rule 144A reliance may be claimed.

e. Timing of sale—the resale under Rule 144A may occur at any time, e.g., immediately.

f. Other restrictions on purchaser—None. Rule 144A does not itself require resale restrictions, though a sale pursuant to Rule 144A does not "cleanse" a security of "restricted" status.

Note that a Rule 144A offering must always be preceded by a "good" private placement under §4(a)(2), which is how the seller (typically an investment bank) acquires the securities from the issuer before placing them with one or more institutional investors.

Rule 144A offerings are often followed by SEC-registered exchange offers (referred to as "AB exchange offers" or "Exxon Capital exchange offers") where the issuer (usually pursuant to a contractual commitment outlined in the Rule 144A offering documents) offers to holders of the Rule 144A securities to exchange the privately placed Rule 144A securities for similar securities that have been registered and, therefore, are freely resalable. This procedure is only available for non-convertible debt securities, certain non-convertible preferred stock and initial public offerings of common stock by foreign issuers. Participants in the exchange offer receive freely resalable securities only if they are not affiliated with the issuer, acquired the original securities in the ordinary course of business and do not have an arrangement with the issuer for the distribution of the exchange securities. See Exxon Capital Holding Corp., SEC No-Action Letter (May 13, 1988), Morgan Stanley & Co. Incorporated, SEC No-Action Letter (June 5, 1991), and their many progeny.

Note that many offerings under Rule 144A are for convertible debt. Here, the issuer often agrees to file a so-called resale shelf-registration statement in order to provide investors with freely tradable securities. This procedure is not as desirable as a registered exchange offer. Unlike an AB exchange offer, under a resale registration statement, the investors are selling shareholders and must assume liability as such. The investors may also be subject to blackout periods and as a result may not be able to sell at the times they desire. And, issuers are required to keep an effective registration statement in place until the securities are freely tradable. Alternatively, in many convertible debt offerings, rather than filing a shelf registration statement, the issuer is obligated to pay penalty interest if unaffiliated holders are not eligible to resell the debt or underlying equity securities following the applicable holding period.

D. Public Announcements of Unregistered Offerings.

1. Rule 135c provides that a public announcement of a private placement or other unregistered offering (including a Rule 144A offering or Regulation S offering) will not in turn itself be deemed a prohibited "offer" under § 5 provided that the announcement is not for the purpose of conditioning the market in the United States for any of the securities offered and meets other conditions (including content limitations) stipulated by the rule. The Rule 135c safe harbor is available to issuers who are 1934 Act reporting companies and to foreign issuers exempt from 1934 Act reporting pursuant to Rule 12g3-2(b).

   Pursuant to a JOBS Act requirement, the SEC amended Rule 144A to permit a seller to "offer" securities to a non-qualified institutional buyer, including by means of general solicitation or general advertising. However, "sales" under Rule 144A still will be restricted to persons reasonably believed to be qualified institutional buyers.

   Notably, the JOBS Act did not require the SEC to extend this relief to "directed selling efforts" in the United States in connection with Regulation S transactions occurring offshore. As a result, in a "pure" Regulation S transaction or a transaction that has both a Rule 144A component and a Regulation S component, parties will need to consider whether their communications plan will satisfy the stricter limitations on communications in the United States contained in Regulation S.

   In addition, consideration has to be given to state securities registration laws if Federal preemption is not available under NSMIA. NSMIA provides that the offer and sale of "covered securities" are exempt from state registration requirements. Covered securities include, among other things, listed securities and securities of the same issuer if the unlisted securities are equal in rank or senior to the issued securities.

IV. **Private Placements Turned Into Public Offerings and Public Offerings Turned Into Private Placements.**

1. Overview

As many issuers seek rapid access to global public and private capital markets on the most favorable terms and on a near continuous basis, the traditional learning on separation of public and private offerings of securities--including that reflected in the "integration" and "general solicitation" doctrines--has become more difficult to apply. Two areas of concern are as follows:

a. How and when can securities that are initially being privately placed (in a transaction that may or may not have been consummated) be passed through the registration process so that such securities can be freely tradable in the future?

b. Once a registration statement for a public offering of securities is on file with the SEC, how and when can the same or similar securities be sold in private placements?

2. Development of Integration Doctrine

Integration Doctrine. Since adoption of the 1933 Act, an issue with respect to various exemptions thereunder--in particular, § 4(a)(2)--has been whether a private offering of securities should be viewed as part of (i.e., "integrated with") another past, present or future offering of securities by the same issuer, with the result that such private offering would be deemed to be part of a public offering.

Several safe harbors have developed:

a. Five Factors. In 1962, the SEC stated that, in determining whether to integrate apparently separate offerings, the following five factors are relevant to the question of integration:

"whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, and (5) the offerings are made for the same general purpose".

SEC Release No. 33-4522 (November 6, 1962).

In 1982, in a note to § 502 of Regulation D, the SEC reiterated that the determination as to whether separate sales of securities are an "integrated" part of the same offering depends on the particular facts and circumstances, and the five factors were repeated in full.

Application of the five factors, which are largely subjective in nature, has provided little certainty. Not only do the factors overlap (e.g., what is the difference between two offerings being "part of a single plan of financing" and being "made for the same general purpose"?), but the SEC has provided little guidance as to how the individual factors are to be weighed and, indeed, it has stated that "any of the . . . factors can be determinative". SEC Release No. 33-4552 (November 6, 1962).

b. Six Months Rule. In order to provide some certainty, in 1982 the SEC provided Rule 502(a) of Regulation D which excludes from integration offerings more than six months before or after a Regulation D offering so long as there are not offers or sales of the same or similar type of security as that offered or sold in the Regulation D offering during the six month periods before and after the Regulation D offering.

c. Safe Harbor for Offshore Offerings. In the Regulation S adopting release (SEC Release 33-6863 (April 23, 1990)) and Preliminary Note 7 to Regulation D, the SEC adopted the position that offshore sales under Regulation S generally would not be integrated with offerings in the United States.

d. Rule 152. Rule 152, which has remained essentially unchanged since its adoption in 1935, provides as follows:

> "The phrase 'transactions by an issuer not involving any public offering' in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement."

SEC Release No. 33-305 (March 2, 1935).

The adopting release for Rule 152 stated that the "rule allows those who have contemplated or begun to undertake a private offering to register the securities without incurring any risk of liability as a consequence of having first contemplated or begun to undertake a private offering." The apparent purpose of the rule was a limited one--to enable a failed private offering to be salvaged by a registered offering of the unsold securities. See L. Johnson and S. Patterson, "The Reincarnation of Rule 152; False Hope on the Integration Front", 46 Wash. & Lee L. Rev. 539 (1989).

Prior to a 1986 no-action letter, Rule 152 had not been applied to any specific situation by the SEC. In Verticom, Inc., SEC No-Action Letter (February 12, 1986), however, relying entirely on Rule 152, the SEC Staff concluded that, notwithstanding the issuer's contemplation, at the time of a previously completed private placement of convertible debt, of a registered public offering of common stock within three or four months, the private placement would not be integrated with the subsequent registered offering. The Staff specifically stated that it was not applying the five factor integration test.

Shortly thereafter this interpretation of Rule 152 was confirmed, when another issuer was advised (before either offering had taken place) that a proposed sale of common stock pursuant to Rule 506 of Regulation D would not be integrated with a planned subsequent registration of common stock which would not fit within Regulation D's six-month safe harbor. Vulture Petroleum Corporation, SEC No-Action Letter (February 2, 1987). Again, the five-factor integration test was not considered applicable. Numerous subsequent no-action letters have reached a similar result. See Quad City Holdings, Inc., SEC No-Action Letter (April 8, 1993).

Accordingly, it appears that Rule 152 stands as an exception to the integration doctrine (the Aircraft Carrier Release calls Rule 152 a "safe harbor"): if a good private placement is either completed (or abandoned), that transaction will not be integrated with a later public offering of additional securities (or with the abandoned offering). As a result of Rule 152 the two offerings will not be integrated and the five-factor integration test need not be applied.

e. Black Box and Squadron, Ellenoff No Action Letters. In Black Box Incorporated, SEC No-Action Letter (June 26, 1990) (collectively, with the Squadron, Ellenoff SEC No Action Letter (February 28, 1992) described below, *Black Box"* or the "*Black Box* letters"), the SEC Staff addressed both integration issues and

Rule 152. The *Black Box* letters involved a restructuring where the following transactions were to occur contemporaneously: (i) existing security holders were to receive new securities in a private placement in exchange for existing securities, (ii) new capital was to be raised in a private placement of convertible debentures and (iii) new capital was to be raised in an initial public offering of common stock. The following conclusions were reached by the SEC Staff:

(1) The private placement with existing securityholders need not be integrated with the later public offering of common stock. This conclusion relied on Rule 152 and the facts that (i) the existing securityholders would have entered into the recapitalization agreement prior to the filing of the registration statement for the public offering, and (ii) the private placement, although not consummated, would be "complete" prior to filing of the registration statement because the obligations of the existing securityholders to acquire the privately placed securities would be subject only to conditions that were not within their control.

(2) The private placement of the convertible debentures need not be integrated with the later public offering of common stock. This conclusion relied on Rule 152 and the fact that (i) the investors would have negotiated and executed definitive securities purchase agreements prior to filing of the registration statement for the public offering, and (ii) the private placement, although not consummated, would be "complete" prior to filing of the registration statement because the obligations of the investors to purchase the debentures would be subject only to satisfaction of specified conditions which would not be within the control of the investors.

(3) Alternatively, if the private placement of the convertible debentures was made only to QIBs and three or four accredited investors, for policy reasons, the private placement need not be integrated with the public offering of the common stock even if it would not be "completed" at the time the registration statement was filed. The SEC Staff explained that this exception was made for policy reasons, primarily in consideration of the nature and number of purchasers, and, accordingly, it is to be narrowly

construed. The position is described as a formal articulation of the previously informal position of the Staff that a simultaneous registered offering and an unregistered offering to a limited number of first-tier institutional investors in connection with a structured financing should not be integrated. This is often referred to as the "concurrent" or "parallel" offering branch of *Black Box*--i.e., both a public and a private offering (to appropriately limited investors) can be conducted at the same time, in parallel. The *Black Box* letters assume that the private offering is a "valid" private placement, "if viewed separately". Thus, the marketing efforts must be conducted so that there is no "general solicitation" with respect to the private offering.

(4) Alternatively, if the private placement of the debentures was terminated prior to completion and later there is a registered offering of the debentures based on Rule 152, the abandoned private placement would not be integrated with such public offering.

(5) The filing of a registration statement is deemed to be the commencement of the public offering.

Squadron, Ellenoff, Pleasant and Lehrer, SEC No-Action Letter (February 28, 1992), clarified the initial *Black Box* letter as follows:

(6) the initial *Black Box* letter's conclusions with respect to a simultaneous registered offering of common stock and an unregistered offering of convertible debentures were a policy position taken primarily in consideration of the nature and number of offerees, and not based on the financial condition of the issuer;

(7) the number of offerees and purchasers is a factor in evaluating the applicability of this policy position, and the policy position is limited to situations involving QIBs and "no more than two or three large institutional accredited investors" (reduced from "three or four" as stated in Black Box); and

(8) the conclusions in the *Black Box* letter would have been the same even if the offerings had both involved common stock.

3. In SEC Release 33-8828 (August 3, 2007), the Commission considered how a private placement can comply with the requirements of Section 4(a)(2) when it occurs during the pendency of a public offering. It provided the following guidance relating to Rule 152 and the Black Box letters.

The filing of a registration statement generally constitutes a general solicitation; however, it does not necessarily preclude an issuer from concluding a Section 4(a)(2) private placement. Instead the following factors must be considered:

a. Whether the investors in the private placement were solicited by the registration statement or though some other means; for example,

(1) Was there a substantive pre-existing relationship between the company and the investor (good);

(2) Was the investor solicited by the company or an agent through direct contact outside the registered offering process (good);

(3) Did the investor appear as a result of a reverse inquiry based on its review of the registration statement (bad), or where the source of its interest is unclear (probably bad);

b. While the nature and number of investors may be relevant, they need not be QIBs or accredited investors.

In addition, under Rule 506(c) (added September 23, 2013) issuers may engage in general solicitation and general advertising provided that the accredited investor status of all purchasers is verified generally with third-party sources or official documents.

4. Rule 155.

Rule 155 (SEC Release No. 33-7943 (January 26, 2001)) addresses two common integration problems.

(1) An issuer begins a private offering and (usually due to a high level of interest in the issuer's securities) abandons it without selling any securities and begins a registered public offering. In this situation, the issuer faces the integration problem that marketing activity in the private placement constitutes pre-filing offers, or "gun jumping", in violation of Section 5(c). Rule 155(b) allows the issuer to commence a public offering 30 days after abandoning the private offering, subject to certain conditions.

(2) An issuer is unable to complete a public offering and, prior to selling any securities, wishes to withdraw the registration statement and begin a private offering. In this situation the issuer faces the integration problem that the filing of the registration statement constitutes a general solicitation, in violation of the Section 4(a)(2), Section 4(a)(5) and Regulation D private placement exemptions (other than permitted general solicitation of accredited investors). Rule 155(c) allows the issuer to commence the private offering 30 days after withdrawing the registration statement, subject to certain conditions.

The Rule 155 safe harbor applies only to private placements pursuant to Section 4(a)(2), Section 4(a)(5) and Rule 506 of Regulation D. Rule 155 is only a safe harbor for integration. Issuers must still meet the conditions for a private placement exemption under Section 4(a)(2), Section 4(a)(5) or Rule 506 of Regulation D. Also, literal compliance with Rule 155 will not afford the issuer a safe harbor if it is part of a "plan or scheme" to evade registration.

a. Safe harbor for changing a private offering into a registered offering - Rule 155(b)

Rule 155(b) enables an issuer to abandon a private offering and commence a public offering under the following conditions:

(1) no securities are sold in the private offering;

(2) all offering activity is terminated prior to filing the registration statement;

(3) the prospectus for the public offering discloses certain information about the private offering including:

- the size and nature of the private offering,
- the date on which the issuer terminated all offering activity in the private offering,
- that all offers to buy or indications of interest were rejected by the issuer, and
- that the prospectus delivered in the registered offering supersedes any selling material used in the private offering; and

(4) the registration statement is not filed until at least 30 days after the termination of all offering activity, <u>unless</u> the private offering was made only to accredited or sophisticated investors, in which case the issuer may file immediately after terminating the private offering.

The Rule 155(b) safe harbor does not specify what steps are necessary to terminate offering activity. Clearly, the issuer must cease actively soliciting investors. In order to establish compliance, offerors probably should notify private offerees that the offer has been terminated and, possibly, ask for return of the private placement memo.

b. Safe harbor for abandoning a registered offering and conducting a private offering - Rule 155(c).

Rule 155(c) enables an issuer to abandon a registered offering and commence a private offering under the following conditions:

(1) no securities are sold in the registered offering;

(2) the issuer withdraws the registration statement;

(3) the private offering does not commence until 30 days after withdrawal of the registration statement;

(4) the issuer notifies the private offerees that:

- the offering is not registered under the Securities Act,

- the securities will be "restricted securities" as defined in Rule 144 and cannot be resold without registration unless an exemption is available,
- purchasers do not have the protection of Section 11 of the Securities Act, and
- a registration statement for the abandoned offering was filed and withdrawn, specifying the effective date of the withdrawal; and

(5) any private offering materials must disclose any material changes to the issuer's affairs since the filing of the registration statement that are "material to the investment decision in the private offering".

c. Rule 477.

Under Rule 477:

(1) a registration statement that has become effective may only be withdrawn if the Commission finds it to be consistent with the public interest and protection of investors.

(2) if a registration statement is not yet effective, its withdrawal is automatic upon request, unless the SEC objects within 15 calendar days. If applicable, the withdrawal application should state that the issuer may commence a private placement pursuant to the Rule 155(c) safe harbor. If the SEC does not object, the 30 day waiting period is measured from the date the request for withdrawal was filed. If the SEC does object, the 30 day waiting period is measured from the date the SEC finally approves the withdrawal under the standard noted above.

d. Note that Rule 155 did not repeal or supersede Rule 152 or the Black Box line of no-action letters. See SEC Release No. 33-7943 (January 26, 2001), nn. 11, 22.

5. Private Placements Turned Into Public Offerings

There has been pressure to combine the convenience and speed of the private placement process to institutional purchasers with the desire of such institutional purchasers to hold securities that have been registered under the 1933 Act and thus can be freely resold. A number of approaches emerged for which the legal principles are well established:

a. provide registration rights to the private purchasers which are available either on demand or are "piggy-backed" on a future registration statement by the issuer;

b. at an appropriate interval after the closing of the private placement, provide a shelf registration for the secondary resale of the securities from time-to-time by the private purchasers (not optimal because holders will have selling shareholder liability and may be subject to blackout periods);

c. add a penalty to alternative (b) above by providing that the interest or dividend rate on the privately-placed securities will be increased if a shelf registration statement for the secondary resale of the securities is not effective by a certain future date (or, alternatively, start with a higher rate which steps down upon effectiveness);

d. if eligible, follow the AB (or Exxon Capital) exchange offer procedure and exchange the privately placed securities for identical registered securities in a registered exchange offer; or

e. follow Rule 144A resale procedures (although this approach provides substantial liquidity, it still restricts sales to QIBs and does not result in securities that can be freely resold to the public).

Since Rule 155 provides a safe harbor but does not replace any of the prior integration interpretations, the alternatives of the integration interpretations remain available. Going beyond these well-established approaches, consider the following questions (the answers are for illustrative purposes only--all the facts and circumstances need to be evaluated in any particular situation):

<u>Question 1</u>: First scenario. Assume a private placement of common stock is "completed" and is then followed by a public offering of common stock. Two separate offerings of different shares of common stock. Is this okay?

<u>Answer</u>: This scenario should be okay, assuming that the private placement was "completed" before the registration statement was filed.

This is classic Rule 152. In fact, as interpreted in the Verticom and subsequent no-action letters, even if both transactions were planned in advance, this is okay.

Question 2: Second scenario. Again, start with a "completed" private placement of the securities. Now, if this is followed by the registration of the resale of those same securities by the original buyers, that is clearly okay. However, what if the initial closing of the private placement is conditioned on the effectiveness of a registration statement for the resale of the privately-placed securities?

Answer: The Staff has said okay, if binding purchase commitments have been obtained from the private purchasers (subject only to conditions beyond their control) prior to filing of the registration statement. Since obtaining an effective resale registration statement is considered a condition beyond the control of the private purchasers, the private placement is "completed" prior to filing the registration statement. This is a so-called PIPE or "private investment, public equity" transaction. Other conditions considered to be beyond the control of the private purchasers might be regulatory approvals or a material adverse change (but not a due diligence out).

Note that the only transaction which can be registered in this scenario is the resale of the securities by the private purchasers. The Staff does not permit the registration of the initial sale to the private purchasers so that they can hold "registered" (rather than "restricted") securities. See Current Issues and Rulemaking Projects Quarterly Update, Division of Corporation Finance, SEC (March 31, 2001), topic VIII, Equity Line Financings.

Question 3: What if a private sale of common stock is never consummated, and a public sale of those same shares follows? The question is: can a proposed private sale somehow fail or be abandoned and then be followed by a direct primary, public sale of those same shares under a registration statement?

Answer: Regardless of whether the private placement is abandoned because it failed or because it resulted in great demand and there is a desire to do a public offering, the Rule 155(b) safe harbor is available. If the issuer has conducted a road show for the private placement that reached more than just accredited or sophisticated investors, then under Rule 155(b) the issuer must wait 30 days before filing the registration statement.

If the issuer does not want to comply with the 30-day or other requirements of Rule 155(b), it could attempt to use Rule 152 which should, in theory, cover this situation. There is likely to be reluctance, however, to operate outside Rule 155(b)'s safe harbor, unless other factors are present such as a different security being offered or some time having intervened.

Question 4: Assume the private placement phase consists of investment bankers talking to a few private buyers with the intention of "testing the waters" for a possible public offering? Is this gun jumping?

Answer: This is a difficult question. Rule 155 does not directly address the "testing the waters" issue, but the safe harbor requires that the issuer undertake a bona fide private offering. If the *only* purpose was to "test the waters" for a public offering, one could argue the private placement was not bona fide. Alternatively, presumably a conversation with a few institutions could be carefully scripted so that it did not constitute an offer.

Question 5: What if the private placement is marketed very broadly with a road show, an offering circular that looks like a prospectus, etc. and is then abandoned? Can you follow with a public offering in which the private offerees are the principal purchasers?

Answer: Yes. Under the Rule 155(b) safe harbor, the fact that the original private offerees are the principal investors in the registered offering is not relevant. If the issuer has conducted a road show for the private placement that reached more that just accredited or sophisticated investors, the issuer must wait 30 days before filing the registration statement. After this delay and with required prospectus disclosures, however, there is nothing to prevent the issuer from commencing a public offering in which the private offerees are purchasers.

Alternatively, under the integration interpretations, the manner of offering the private offering--as long as it does not violate the requirements for a private placement--should not affect the result. Thus, again, if the private placement truly failed, it should qualify under Rule 152; otherwise, there is a problem. If it qualifies under Rule 152, the public offering should be able to include sales to private offerees.

6. Public Offerings Turned Into Private Placements

Once a registration statement has been filed with the SEC, under what circumstances can the issuer engage in a private placement of the same or similar securities? The first issue is whether the mere filing of a registration statement (without distribution of the prospectus, issuance of a press release or other marketing efforts) constitutes a general solicitation with respect to the securities to be privately placed? The Staff has expressed the view that the filing of a registration statement "is deemed to be the commencement of the public offering" and to constitute a general solicitation for purposes of Regulation D (and § 4(a)(2)). This is the so-called presumptive public offering doctrine (i.e., the filing of a non-shelf registration statement is deemed to commence the public offering). It is not clear, however, that the mere public availability of a registration statement (absent any distribution of the prospectus, issuance of a press release or other marketing or solicitation efforts) should be considered to constitute a general solicitation (and, if it does, presumably the securities deemed to be offered publicly should be narrowly construed both for purposes of applying the integration doctrine and in determining whether there has been a general solicitation).

Question 6: If the issuer has an effective shelf registration statement, is the issuer precluded from relying upon the Rule 155(c) safe harbor?

Answer: The SEC does not regard a generic shelf registration statement as constituting a general solicitation. See Current Issues and Rulemaking Projects, Division of Corporate Finance, SEC (November 14, 2000), topic VIII(A)(9). Thus, an issuer with a shelf in place should not have an integration problem. However, if the issuer has begun marketing a take-down by distributing a preliminary prospectus supplement, it has made a general solicitation. If the issuer pulls the offering and wishes to do a private offering, the Staff has advised that the Rule 155 safe harbor is not available unless the shelf registration statement is withdrawn. It is unclear whether the issuer would be required to withdraw the shelf registration statement if no prospectus supplement had been filed and only oral offers were made. Of course, under appropriate circumstances, the concurrent offering branch of *Black Box* and the five-factor test may be available.

Question 7: Does it make any difference under Rule 155(c) if the issuer has conducted a road show prior to withdrawing the registration statement?

Answer: This raises the question whether there has been a general solicitation. The Rule 155 adopting release provides that:

"At the time the private offering is made, in order to establish the availability of a private offering exemption, the issuer or any person acting on its behalf must be able to demonstrate that the private offering does not involve a general solicitation or advertising."

Clearly, the "presumptive" general solicitation arising from filing the registration statement, which has been of concern in the past, will not disqualify use of the exemption. As a general matter, the various marketing activities, including road show meetings, in connection with the public offering should not disqualify use of the exemption. The 30 day waiting period under Rule 155(c) should address general solicitation concerns. Thus, in the normal circumstances where the private offering is made to investors previously known to the underwriter or the issuer (or to well-known institutional investors and strategic investors), and these same investors were actively marketed to in the public offering, general solicitation concerns should not arise. Presumably there are some circumstances, however, that could give rise to a problem; for example if private offers were made to retail investors with which neither the underwriter nor the issuer had a relationship prior to finding them in the public offering process, that would raise general solicitation concerns.

<u>Question 8</u>: If the issuer does not want to withdraw the registration statement or wants to commence the private placement immediately, can the issuer rely on the Rule 155(c) safe harbor?

<u>Answer</u>: No, in both cases. Rule 155(c) requires withdrawal of the registration statement even if it is only a silent filing. Rule 155(c) does not permit commencement of the private placement for 30 days, even to QIBs.

Issuers may be reluctant to withdraw the registration statement because they want to retain the ability to resume the public offering quickly should market conditions improve. Or, an issuer may need to commence the private placement sooner than 30 days because it needs the funds. While the Rule 155(c) safe harbor would be unavailable in these cases, an issuer could conduct a private placement under the concurrent offering branch of *Black Box* to QIBs and no more than two or three large institutional accredited investors immediately and without withdrawing the registration statement. The issuer must conclude that no general solicitation has occurred in connection with the private placement. Alternatively, an issuer could attempt a private placement meeting the five factor test.

<u>Question 9</u>: What if the issuer begins a private offering under the concurrent offering branch of *Black Box*, but later decides that it would like to expand the private offering to more than just QIBs and two or three

large institutional accredited investors. Is the Rule 155(c) safe harbor still available?

Answer: If the issuer withdraws the registration statement, but makes offers to QIBs and two or three large institutional accredited investors within 30 days under the concurrent offering branch of *Black Box* and later expands the offering, then reliance on the Rule 155(c) safe harbor is precluded. But, depending on the facts and circumstances, the issuer may be able to expand the offering and not face integration under the five-factor test. If the issuer does not withdraw the registration statement prior to commencing the concurrent *Black Box* offering, it should still be able to withdraw the registration statement at a later date and wait the requisite 30 days (without making offers to anyone during that period) and then avail itself of the Rule 155(c) safe harbor.

Question 10: Do the Rule 155 safe harbors apply to switches to or from offerings pursuant to Regulation S or Rule 144A?

Answer: Rule 155 does not specifically mention Rule 144A or Regulation S offerings. The Regulation S exemption does not require an integration analysis. Thus, issuers do not need the Rule 155 safe harbor for a Regulation S offering as long as there has been no directed selling efforts as defined in Regulation S in the U.S.

The Rule 144A exemption for resales of securities privately placed under Section 4(a)(2) should logically be covered by Rule 155. An issuer who wants to switch from a Rule 144A offering to a public offering, should be able to do so immediately, since the Rule 144A offering would have only been to QIBs. Likewise, an issuer who wants to switch from a public offering to a Rule 144A offering should be able to do so 30 days after withdrawing the registration statement. In either case, issuers should be able to go to the same investors after changing the form of their offering without being found to have engaged in a general solicitation.

Question 11: So, in review, what are an issuer's options if it must abandon a public offering, after a registration statement is filed, and proceed with a private placement?

Answer: There are six alternatives available:

1. Use Rule 155 if willing to withdraw the registration statement and wait 30 days.

2. Conduct the private offering in a manner so you can conclude that it should not be integrated with the abandoned public offering applying the five-factor integration test. This is a facts and circumstances analysis looking at, among other matters, the time that has elapsed since abandoning the public offering, whether the registration statement has been withdrawn, the nature of the security sold, the nature of the marketing effort for the public offering, and the status of the investors (are they QIB's or accredited investors, did they have a pre-existing relationship with the issuer, were they marketed to in the public offering?).

3. Limit the private placement to QIB's and "no more than two or three large institutional accredited investors" under the parallel or concurrent offering branch of the *Black Box* Letters. It must be concluded, under the facts and circumstances, that there has been no "general solicitation" with respect to the private offering.

4. Delay the private offering and rely on Regulation D's six-month safe harbor.

5. Continue with the registered offering, but amend the registration statement to reflect that the offering is being directed to a limited number of investors. Presumably this works as a practical matter only for issuers that are already 1934 Act reporting companies.

6. Proceed with an offering solely to foreign investors under Regulation S.

V. Registered Offerings.

A. U.S. Securities and Exchange Commission.

The Securities and Exchange Commission, or the SEC, was created by Section 4 of the 1934 Act as an independent agency of the federal government and is charged with enforcing and implementing the federal securities laws (including those that apply to securities offerings), promoting the stability, competitiveness, efficiency and fairness of the U.S. securities markets, and protecting the interests of investors. See the memo "An Introduction to the U.S. Securities and Exchange Commission" for a fuller (albeit still brief) description and discussion of the SEC.

B. Categories of Issuers.

Pursuant to rule, the SEC has divided all issuers into four categories for purposes of public securities offerings. The four categories of issuers are:

1. "Non-reporting issuers." Issuers that are not required to file reports pursuant to Section 13 or 15(d) of the 1934 Act, e.g., IPO issuers. Section 13 and 15(d) of the 1934 Act require companies with outstanding public securities to, among other things, provide regular periodic reports (annual reports on Form 10-K and quarterly reports on Form 10-Q for U.S. issuers and annual reports on Form 20-F for foreign private issuers) and current reports (Form 8-K).

2. "Unseasoned issuers." Issuers that are required to file reports pursuant to Section 13 or 15(d) of the 1934 Act, but do not satisfy the requirements of the SEC's Form S-3 or Form F-3 for primary offerings of securities pursuant to the 1933 Act.

3. "Seasoned issuers." Issuers that are eligible to use Form S-3 or Form F-3 to register primary offerings of securities.

4. "Well-known seasoned issuers," or WKSI's. Seasoned issuers that also either (i) have outstanding voting and non-voting common equity held by non-affiliates with a worldwide market value of $700 million or more, or (ii) have issued in the last three years at least $1 billion aggregate primary amount of non-convertible securities (whether or not investment grade), other than common equity, in primary offerings for cash, not exchange, registered under the 1933 Act. A company cannot be a WKSI if it is an "ineligible issuer" (as defined in Rule 405 under the 1933 Act) at the relevant determination date.

Unseasoned issuers, seasoned issuers, and WKSIs are all collectively known as "reporting issuers."

The Act creates a new category of issuers, called "emerging growth companies", or EGCs, which are companies that had total annual gross revenues of less than $1 billion during the most recently completed fiscal year (indexed for inflation every five years) that complete their first registered sale of common equity securities after December 8, 2011. An emerging growth company will retain this status until the earliest of (1) the last day of the fiscal year during which the company had total annual gross revenues of $1 billion or more (adjusted for inflation as mentioned above), (2) the last day of the fiscal year following the fifth anniversary of the company's first registered sale of common equity, (3) the date on which the company has, during the prior three-year period, issued more than $1 billion of non-convertible debt and (4) the date on which the company is deemed to be a large accelerated filer under the Exchange Act (generally a reporting issuer for 12 months that has filed at least one annual report, with at least $700 million of common equity held by non-affiliates as of the last business day of the issuer's most recent second fiscal quarter).

According to guidance from the Division, a successor entity will not qualify as an emerging growth company if its predecessor had its first registered sale of common equity on or before December 8, 2011. Furthermore, neither asset backed securities issuers subject to the requirements of Regulation AB nor investment companies registered under the Investment Company Act of 1940 may qualify as emerging growth companies. However, business development companies may qualify.[11]

Foreign Issuers.

Note that U.S. and non-U.S. companies alike may be either reporting or non-reporting issuers. (Foreign governments are all non-reporting issuers regardless of how many times they have offered securities in the U.S. markets.) The SEC has further delineated the different types of foreign issuers. By rule, the SEC recognizes two special sub-categories of foreign issuers: foreign governments and foreign private issuers. Special rules and registration regimes apply to those issuers. Foreign issuers that do not qualify for either of those sub-categories must comply in full with the offering and registration rules applicable to U.S. issuers. Pursuant to Rule 405 under the 1933 Act and Rule 3b-4 under the 1934 Act, the relevant terms are defined as follows:

(1) The term foreign issuer means any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country.

(2) The term foreign government means the government of any foreign country or of any political subdivision of a foreign country.

(3) The term foreign private issuer means any foreign issuer other than a foreign government except an issuer meeting the following conditions:

- More than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; AND

- Any of the following:

[11] See "Jumpstart Our Business Startups Act: Frequently Asked Questions," available at http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

a) The majority of the executive officers or directors are United States citizens or residents;

b) More than 50 percent of the assets of the issuer are located in the United States; or

c) The business of the issuer is administered principally in the United States.

A company needs to confirm its status as a foreign private issuer only once per year, as of the last business day of its second fiscal quarter.

C. Registration Mechanics.

Registration of public securities offerings is done on "forms" prescribed by rule and filed with the SEC. Although a number of specialized forms are available, Forms S-1 and S-3, for U.S. issuers, and F-1 and F-3, for foreign private issuers, are the key forms for registered offerings.

1. Forms S-1 and F-1.

Forms S-1 and F-1 are so-called "long form" registrations statements pursuant to which companies must include essentially all of the business and financial information required under the SEC's integrated disclosure system for public companies' annual reports.

a. Non-reporting issuers must use these forms for their initial public offerings (whether equity or debt). Issuers then become obligated to file regular, ongoing reports with the SEC under Section 13 or 15(d) of the 1934 Act once they have publicly registered securities.

b. Unseasoned issuers (those issuers that do not meet the requirements to use Forms S-3 or F-3) must use Form S-1 or F-1 to register their offerings.

- once an issuer has filed at least one annual report on Form 10-K or 20-F, it may "incorporate by reference" the information in its previously filed 1934 Act reports into its registration statement on the S-1 or F-1.

In light of the requirements for use of Forms S-3 and F-3 (discussed below), unseasoned issuers will most commonly be:

- all companies during the 12 months following their initial public offerings

- public companies that have registered only debt securities and therefore cannot meet the public float requirement, including when they make their "initial public offerings" of equity securities

- small public companies that, while having publicly registered equity, do not meet the $75 million test for Forms S-3 and F-3 (see below)

- any reporting company that has been late in a filing obligation under the 1934 Act (subject to the exceptions noted) during the past 12 months or has committed one of the noted dividend or debt defaults and has thus lost its eligibility to use Form S-3 or F-3 until those tests are met again.

2. Forms S-3 and F-3.

Issuers using forms S-3 and F-3 may incorporate by reference to their 1934 Act reports in order to provide large portions of the information required in their registration statements.

In order to qualify to use Form S-3 or F-3 for a primary equity offering, an issuer must be either a "seasoned issuer" or must meet certain other conditions. A seasoned issuer is one that:

a. has a public float of at least $75 million

b. has been subject to the reporting requirements under Section 13 or 15(d) of the 1934 Act for at least 12 months and has filed all required reports in a timely fashion during the past 12 months except for certain reports on Form 8-K

c. has paid all dividend or sinking fund installments on preferred stock and has not defaulted on any material installment on indebtedness or rental on one or more long-term leases, in each case since the end of its last fiscal year for which audited financial statements have been filed in a 1934 Act report.

An issuer that does not meet the $75 million public float test may still use Form S-3 or F-3 to register securities provided that

a. the registrant meets the other eligibility tests for use of the Form,

b. the registrant is not a shell company and has not been for at least 12 calendar months prior to filing the registration statement

c. the registrant has a class of common equity securities listed and registered on a national securities exchange, and

d. the registrant does not sell more then the equivalent of one-third of its public float in primary offerings pursuant to the new rules in any period of 12 calendar months.

Special EGC Procedures.

Prior to the date of the first sale of its common equity securities under an effective registration statement, an EGC may confidentially submit a draft registration statement to the SEC, provided that the initial confidential submission and all amendments thereto are publicly filed at least 21 days before the commencement of a road show related to the offering under the registration statement. Unlike the confidential submission procedures that were in place for all foreign private issuers prior to December 8, 2011 (and remain in place in a more limited set of circumstances), the JOBS Act requires "the initial confidential submission and all amendments" to be publicly filed. The Division of Corporation Finance has confirmed that, consistent with current practice, SEC staff comment letters and the issuer's responses will not be made public by the SEC until at least 20 business days after the effective date of the registration statement. When an issuer is required to file the confidential submissions, such submissions must be filed as exhibits to the first registration statement filed on EDGAR.

Confidential review is not available for Exchange Act-only registration statements, e.g., Form 10 and Form 20-F. Furthermore, submission of a draft registration statement for confidential review does not constitute a "filing" of a registration statement, and therefore no filing fee is due at the time of submission.

According to guidance issued by the Division, a foreign private issuer that qualifies as an emerging growth company may generally elect to use either the confidential submission process available to foreign private issuers prior to the enactment of the JOBS Act or the confidential review procedures available to EGCs under the JOBS Act. However, if such a company chooses to take advantage of any benefit available to emerging growth companies, the foreign private issuer may only use the confidential submission procedure prescribed for EGCs.

Shelf Registration.

Rule 415 permits issuers to register securities that will be offered and sold on a "continuous or delayed basis in the future." Offerings under this rule are commonly called "shelf offerings" because the securities are registered (and the registration statement is declared effective by the SEC staff) at one point in time and then only subsequently "taken down" when actual sales are made. "Universal shelves" allow seasoned issuers to register different types of securities—debt and equity—on a single registration statement.

Under Rule 415(a)(5) most shelf registration statements expire three years after their effective date. Rule 415(a)(6) permits any unsold securities and any filing fees paid in connection with such securities to be carried forward to a new registration statement filed prior to the expiration of the three-year period. Alternatively, under Rule 457(p) the fee associated with any unsold securities under the expiring registration statement may be offset against a filing fee due for a new registration statement filed within five years.

Most shelf registrations utilize Form S-3 or F-3. These forms are ideally suited to this because an issuer may take advantage of "forward incorporation by reference," by which its registration statement incorporates 1934 Act reports that are filed after the registration statement is declared effective. Standard Forms S-3 and F-3 are subject to review, and must be declared effective, by the staff of the SEC.

Shelf registration statements are also used for medium-term note programs by some corporate issuers.

Automatic Shelf Registration.

Automatic shelf registration ("ASR") is available only to WKSI's and is a subset of Forms S-3 and F-3. Most significantly for a discussion of the registration process, an ASR goes effectively automatically and immediately, without any review or required action by the SEC staff.

ASR also offers numerous other mechanical and procedural advantages over "regular" S-3 or F-3 registration.[12]

VI. **Communications During the Registration Process.**

A. Summary.

Section 5 divides the registration process into three periods:

1. The Pre-filing Period.

   a. The period between the time there is an agreement or understanding to issue and sell securities and the filing of the registration statement.

   b. § 5(c)—cannot offer to sell or offer to buy, by means of a prospectus or otherwise, any security until a registration statement has been filed. Rule 163 exempts offers by WKSI's during the prefiling period from the prohibition of § 5(c), subject to compliance with the rule's conditions. This exemption applies only to the issuer, not to the underwriters in a WKSI offering.

2. The Waiting Period.

   a. The period between the filing of the registration statement and its being declared effective. WKSI's who are utilizing automatic shelf registration have no "waiting period".

   b. § 5(a)(1)—unless a registration statement is in effect as to a security, it is unlawful to "sell such security" by "any prospectus or otherwise"—but "offers" are not prohibited.

   c. § 5(b)(1)—during the waiting period, the prospectus that is used must meet the requirements of § 10—but is not required to satisfy § 10(a). A "free writing prospectus", as defined in Rule 405, meets the requirements of § 10—and therefore its use is

[12] Other benefits of the ASR include the ability to register an indeterminate amount of securities, the ability to pay filing fees as securities are sold (the so-called "pay as you go" mechanism), the ability to add securities and registrants (such as subsidiary guarantors) at any time by an automatically effective post-effective amendment, and the ability to provide the names and other information about any selling security holders by prospectus supplement rather than in the initial registration statement.

permissible during the waiting period—provided it is used in compliance with certain rules of the SEC (discussed below).

3. The Post-effective Period.

a. § 5(a)—after the registration statement is "in effect", securities may be sold.

b. § 5(b)(2)—provides that a security cannot be delivered unless accompanied or preceded by a prospectus that meets the requirements of § 10(a) (i.e., a final prospectus). (Free writing prospectuses do not meet the requirements of § 10(a), nor do base prospectuses in an effective shelf registration statement.)

Pursuant to Rule 172 under the 1933 Act, written confirmations of sale and notices of allocation, as well as sold securities themselves, may, however, be delivered to purchasers without being preceded or accompanied by a final prospectus so long as the final prospectus has been filed with the SEC (or will be so filed within the time period required by Rule 424), no stop orders have been issued and no proceedings or investigations are pending under § 8. This model is known as "access equals delivery" and applies only in the narrow circumstances described by Rule 172.

c. § 2(a)(10) provides that written communications other than the prospectus in the registration statement (the "statutory prospectus") may be used provided they are preceded or accompanied by the final statutory prospectus meeting the requirements of § 10(a). This allows confirms and notices of allocations to be sent to purchasers in the offering in that manner. Per Rule 405, other written offers will not be free writing prospectuses if accompanied or preceded by the final prospectus. The access equals delivery model in Rule 172 expressly applies to confirms and notices of allocation (so that the final prospectus does not need to be sent with those documents). It does not apply to any other written communications, which would therefore continue to be free writing prospectuses and subject to those rules unless preceded or accompanied by the final statutory prospectus.

B. <u>Types of Communications: Graphic communications and electronic media.</u>

1. Those interpreting the securities laws have struggled over the years with how to treat electronic media and how to fit them within the 1933 Act's

paradigm of "oral" versus "written" communications. The SEC has provided a clear answer to this dilemma through its definitions in Rule 405 of "written communications" and "graphic communications."

2. Written communication is defined per the rule as "any communication that is written, printed, a radio or television broadcast, or a graphic communication." Note that pursuant to § 2(a)(9) "the term "write" or "written" shall include printed, lithographed, or any means of graphic communication." The 1933 Act's definition of prospectus also includes the idea of a communication carried by television or radio broadcast.

3. Graphic communication includes "all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD ROM, electronic mail, Internet Web sites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks and other forms of computer data compilation."

   a. Importantly: "Graphic communication shall not include a communication that, at the time of the communication, originates live, in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means." Keep in mind for road shows.

4. Issuer websites. Information posted on an issuer's website may be either an offer (and thus a free writing prospectus as discussed in more detail below) or historical information that is not an offer.

   a. facts and circumstances analysis

   b. SEC has also provided an express safe harbor in Rule 433(e) by which historical information on an issuer's website will not be deemed an offer as long as it is (i) separately identified as historical information, and (ii) located in a separate section of the issuer's website containing historical information only.

C. The Pre-Filing Period.

Under § 5(c), it is unlawful "to offer to sell or offer to buy . . . any security, unless a registration statement has been filed as to such security . . .". What is an offer to sell? See generally, SEC Release Nos. 33-3844 (October 8, 1957), 33-4697 (May 28, 1964), 33-5009 (October 7, 1969) and 33-5180 (August 16, 1971). Generally the SEC has clarified that an "offer" for purposes of § 5(c) encompasses a broad array of activities that would not fit within the definition of "offer" at common law. Specifically, during the prefiling period, a security cannot be offered (except by a WKSI) or sold, prospective purchasers cannot be contacted, a prospectus cannot be used (except by a WKSI), and prospective underwriters cannot be publicly identified. These prohibited activities are commonly referred to as "gun jumping."

Because WKSI's are allowed to make pre-filing offers and communications, they do not face the same risks of "gun jumping" as other issuers. Rule 163, which allows WKSIs to make pre-filing offers, contains several conditions with which WKSI's must comply in order to enjoy the rule's protections, however. If those conditions are not met, a WKSI would be subject to the same consequences for gun jumping as any other issuer.

1. <u>Preliminary negotiations.</u>

   Section 2(a)(3) provides that the terms "offer to sell" and similar terms and "offer to buy" do "not include preliminary negotiations or agreements between an issuer [or controlling person] . . . and any underwriter or among underwriters who are or are to be in privity of contract with an issuer [or controlling person] . . .".

   a. Letter of intent (allowed under § 2(a)(3))

      (1) identifies conditions that underwriters expect, <u>e.g.</u>, earnings;

      (2) establishes who pays what; and

      (3) is not binding, except for any reimbursements if the underwriting is not effected.

   b. In practice, in most underwritings (other than initial public offerings), there are no letters of intent or preliminary negotiations or agreements among underwriters before filing, except understandings among managers.

   c. Negotiations and agreements between the issuer and/or underwriters and the selling group are prohibited. The "offer to buy" prohibition in § 5(c) was intended to apply to dealers.

   d. Negotiations with non-affiliate selling stockholders are not explicitly exempt.

(1) Selling stockholders who are not control persons cannot make a decision to sell without seeing the preliminary prospectus.

(2) Practical considerations frequently require mailing of notice of the offering to noncontrol person selling stockholders prior to filing.

2. <u>Prefiling public announcement of an offering (Rule 135).</u>

a. Rule 135 provides that a notice of a proposed offering (<u>e.g.</u>, in the form of a press release or a written communication directed toward security holders or employees) is not deemed an "offer" if it states that the offering will be made only by prospectus and the notice contains no more than the following:

(1) Name of issuer.

(2) Title, amount and basic terms of the securities.

(3) Amount to be offered by any selling security holders.

(4) Anticipated timing of the offering.

(5) Brief statement of the manner and purpose of the offering <u>without naming the underwriters</u>. Naming the underwriters (at least in theory) would tell prospective purchasers whom to approach to purchase the security.

(6) In case of a rights offering or other special offerings, certain information to alert security holders.

b. Purpose for making a prefiling announcement under Rule 135.

(1) In the case of an offering where the issuer already has equity securities currently traded, the existence of the proposed offering will often be material information.

(2) In the case of an initial public offering, there is no legal need, but an announcement may end inquiries and conjecture and may facilitate internal communications and lining up selling stockholders.

(3) In the case of an offering of debt securities:

- sometimes existence of the offering is material information; and
- sometimes there is a desire to "notify" the marketplace in order to get "in line" on the debt offering "calendar".

(4) Underwriters generally prefer that announcements under Rule 135 not be made as they cannot be identified (or begin marketing efforts) and the announcement alerts their competitors to the deal being planned.

c. As a best practice, the Rule 135 announcement should be a stand-alone communication and should not be accompanied by an earnings or new product press release or any other announcement.

3. Communications more than 30-days before registration statement is filed (Rule 163A).

Rule 163A provides that communications (including those made through the media) that are made by an issuer (but not any other offering participant, such as an underwriter) more than 30 days before the filing of a registration statement will not be "offers" for purposes of § 5(c), subject to certain conditions. In order to rely on this safe harbor:

- communications cannot reference a securities offering that will be the subject of a registration statement (the rule contains no other content restrictions)
- the issuer must take reasonable steps within its control to prevent further distribution or publication of such communication during the 30 days immediately preceding the date of filing the registration statement

The preliminary note to Rule 163A observes that the rule is a non-exclusive safe harbor and issuers may claim the availability of any other applicable exemption or exclusion.

4. Regular releases of factual business information (Rules 168 and 169).

If an issuer has previously released or disseminated factual business information in the ordinary course of its business, then SEC rules provide that it may continue to do so at all points during an offering (including during the pre-filing period) and those communications will not be considered "offers" for purposes of § 5(c). In order to rely on the safe harbors provided by Rule 168 (for reporting issuers) and Rule 169 (for non-reporting issuers), the timing, manner, and form in which the information is released or disseminated must be consistent in material respects with the issuer's similar past releases of information. The key distinction between Rules 168 and 169 (aside from the categories of issuers to which they apply) is that Rule 168 permits reporting issuers to continue to release forward-looking information subject to the same general guidelines.

Rules 168 and 169 are not available for releases containing information about the offering or "disseminated as part of the offering activities".

5. "Testing the Waters" by EGCs.

Under section 5(d) of the Securities Act, which was added by the JOBS Act, EGCs and their representatives may engage in oral and written communications with potential investors that are qualified institutional buyers (as defined in Rule 144A under the Securities Act) or institutions that are accredited investors (as defined in Regulation D under the Securities Act) to determine whether those investors "might have an interest in a contemplated securities offering". These communications can occur prior to or following the filing of any registration statement. Market Practice under the "Testing the Waters" rules is evolving. To date they have been utilized on a limited basis, although the practice may expand.

While these activities are permitted at any time before and during the registration process, currently these activities generally occur after an IPO registration statement has been confidentially submitted to, and commented upon by, the SEC staff. The draft registration statement and limited supplemental materials derived therefrom are likely to be the only written materials typically used for purposes of "testing the waters". Financial projections and other financial information not included in the registration statement typically will not be provided to investors in connection with "testing the waters" activities. Generally, any materials shown to potential investors are collected at the end of each meeting. Still the SEC will, as a matter of routine, ask to see any Testing the Waters materials as part of the comment process.

Underwriters will likely wish to conduct due diligence on, and receive representations and warranties from issuers with respect to and an indemnity from issuers on, the contents of such materials.

6. Other publicity.

Other publicity matters, including free writing prospectuses, are discussed below. See generally, In the Matter of Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843 (1959) (where the SEC held in a pre-Rule 135 case "that publicity, prior to the filing of a registration statement by means of public media of communication, with respect to an issuer or its securities, emanating from broker-dealer firms who as underwriters or prospective underwriters have negotiated or are negotiating for a public offering of the securities of such issuer . . . involve[s] an offer to sell or a solicitation of an offer to buy such securities prohibited by Section 5(c)").

7. Short sales to be covered by securities acquired from underwriters or dealers from the offering are illegal during the pre-filing period.[13]

D. The Waiting Period.

Under § 5(c) offers to sell are permitted during the waiting period, but § 5(b)(1) prohibits transmitting any prospectus relating to a security with respect to which a registration statement has been filed unless the prospectus meets the requirements of § 10. As discussed in more depth below, free writing prospectuses meet the requirements of § 10 provided the SEC's conditions for their use are followed. Section 5(a) makes it unlawful to sell any security by a prospectus or to carry a security in interstate commerce for sale, unless a registration statement is in effect with respect to such security.

In other words, during the waiting period offers are permitted (orally or using a statutory or free writing prospectus), but sales are prohibited. Normally during this period so called "indications of interest" or nonbinding "circles" are obtained by the underwriters from prospective purchasers and this information with respect to possible purchasers is used in "pricing" the issue with the issuer.

1. What is a "prospectus"?

Section 2(a)(10) provides that "the term 'prospectus' means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security except . . .". (emphasis added)

a. "Free Writing Material". Section 2(a)(10) excepts the following from the definition of "prospectus":

[13] *See* Rule 105 under Regulation M.

> "a communication sent or given *after* the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10) shall not be deemed a prospectus if *it is proved that* prior to or at the same time which such communication a written prospectus meeting the requirements of subsection (a) of section 10 at the time of such communication was sent or given to the person to whom the communication was made"

This statutory exception for so-called "free writing material" pre-dates and is entirely distinct from a "free writing prospectus" discussed below. It covers, for example, a cover letter or other selling material that may accompany a final prospectus. Note that there is no requirement to file "free writing material".

b. Rule 134 provides that a "prospectus" does not include a notice that contains only items of information permitted by the Rule and contains the legends required by the rule. Types of allowable information include:

   (1) Factual identifying information about the issuer and a brief description of its business (generally this should <u>not</u> include a link or reference to the issuer's website);

   (2) Information about the security, other than price;

   (3) Brief description of the intended use of proceeds (provided that has been included in the filed registration statement);

   (4) Identities of participating underwriters, including their roles within the underwriting syndicate, and descriptions of the procedures they will use for the offering (including account-opening instructions);

   (5) Information about any directed share programs;

   (6) The anticipated schedule of the offering.

   In addition, the following information can be included if a price range is included in the registration statement where required by the relevant form or rule (<u>i.e.</u>, an IPO)

   (1) the price of the security or estimate as to price range

(2) the final maturity and interest rate of a fixed income security

(3) the yield or probable yield range

Note that pursuant to a 2011 amendment, disclosure of ratings is no longer permitted.

A Rule 134 press release must include (i) a legend and (ii) the identity of a person from whom a prospectus can be obtained unless either (x) the release does no more than identify where a prospectus may be obtained (including a web address), the price of the security (where permitted) and the identity of the persons who can execute trades or (y) the release is accompanied or preceded by a §10 prospectus (including a price range where required).

"Tombstone" advertisements during the waiting period and the post effective period may be published pursuant to Rule 134. Tombstone advertisements over the radio or television which comply with the provisions of Rule 134 are permissible. See Merchants National Corp., SEC No-Action Letter (January 12, 1976).

Like Rule 135, as a best practice, an announcement under Rule 134 should be a stand-alone communication and should not be accompanied by an earnings or new product press release or any other announcement.

c. What does "offers any security for sale" mean?
Consider the learning from Diskin v. Lomasney & Co., 452 F.2d 871 (2d Cir. 1971). Lomasney was both (x) underwriting on a best efforts basis shares of Ski Park City West, S. I. covered by an effective registration statement and (y) proposing to underwrite shares of Continental Travel Ltd. as to which a registration statement had been filed but was not yet effective. Lomasney wrote to Diskin on September 17, 1968:

> am enclosing herewith, a copy of the Prospectus on SKI PARK CITY WEST. This letter will also assure you that if you take 1,000 shares of SKI PARK CITY WEST at the issue price, we will commit to you the sale at the public offering price when, as and if issued, 5,000 shares of CONTINENTAL TRAVEL, LTD."

When Continental's registration statement became effective on February 12, 1969, Lomasney sent a confirmation to Diskin. Lomasney sent a final prospectus to Diskin prior to February 28, 1969, when Diskin paid for the securities and received delivery.

Held: The letter was an illegal offer to sell because it did not meet the requirements of § 10 and rescission was permitted under what is now § 12(a)(1) even though Diskin received a final prospectus before payment.

> "The result here reached may appear to be harsh, since Diskin had an opportunity to read the final prospectus before he paid for the shares. But the 1954 Congress quite obviously meant to allow rescission or damages in the case of illegal offers as well as of illegal sales."

(4) Was the letter really an "offer"?

(5) Should Diskin have been entitled to rescind?

(6) Once an unlawful offer is made, when (if ever) and how can a lawful offer be made?

(7) Today, Lomasney's letter would be a free writing prospectus and it could meet the requirements of § 10 (and thus its use would not be a violation of § 5 and would not trigger rescission rights) if the conditions for use of a free writing prospectus were followed.

2. Oral communications.

Oral communications are permitted because they do not fall within the definition of a "prospectus" in § 2(a)(10)—e.g., a sales pitch by a securities salesperson, a live road show presentation (see below) or a presentation for securities analysts. When oral communications are reduced to writing, however, they can become a free writing prospectus. This can present a problem, for example, when a transcript of a presentation to securities analysts or other oral presentation is posted on an issuer's or underwriter's home page. The requirements for use of a free writing prospectus (see below) must be kept in mind as neglecting them will result in a § 5 violation.

3. Free writing prospectuses.

One of the most dramatic components of reforms adopted by the SEC in the summer of 2005 was the creation of a new concept of permissible "free writing prospectuses" which allows issuers and underwriters to make written offers, and otherwise communicate in writing about an offering with potential investors, outside of the statutory prospectus. Written materials used in "testing the waters" communications are not considered to be free writing prospectuses and do not need to be filed with the SEC. Although free writing prospectuses, and the corresponding expansion of how written communications may be used during the waiting period, may considerably reduce incidents of liability under § 12(a)(1) for a violation of § 5, it should be kept in mind that these communications are subject to liability under § 12(a)(2) which applies to material misstatements or omissions in prospectuses (or oral offering communications).

a. A <u>free writing prospectus</u> is defined in Rule 405 as any written communication used in the offer or sale of securities covered by a registration statement that constitutes an "offer" and is made by means other than a statutory prospectus. It may be in a traditional paper format or a graphic form (emails, Internet postings, blast voicemails, etc.).

b. New Rule 164 provides that a free writing prospectus that meets the conditions of Rule 433 will qualify as a § 10(b) prospectus and thus that its use after the filing of a registration statement will not violate § 5(b).

c. Except for a WKSI, the issuer must have a registration statement on file in order to use free writing prospectuses. See Rule 163 for pre-filing offers by WKSIs.

- <u>In the case of an IPO, the registration statement must include a price range before free writing prospectuses can be used.</u> This requirement severely reduces the amount of time in which free writing prospectuses are an available option for IPOs (generally, last two to three weeks before pricing—compared to the six weeks or longer portion of the IPO waiting period in which the registration statement did not contain a price range).

d. There are no content restrictions for free-writing prospectuses other than a required legend. Information in a free writing prospectus may go beyond—but may not "conflict with"—the information in the prospectus that is part of the registration statement.

e. As a general rule, an issuer is required to "file" with the SEC any free writing prospectus that it has itself (as opposed to any other offering participant) prepared or used. Any issuer information in an underwriter free writing prospectuses must also be filed (but underwriters and other offering participants aside from the issuer generally do not have to file their free writing prospectuses unless they are distributing them broadly).

- When free writing prospectuses are required to be filed with the SEC, that filing must, as a general matter, occur by the date of their first use.

- Certain free writing prospectuses do not have to be filed, including most electronic road shows (see below) and preliminary terms sheets.

- Final terms sheets do not have to be filed until 2 days after all terms are finalized.

- If a WKSI uses a free writing prospectus prior to filing a registration statement, then that free writing prospectus must be filed at the time the registration statement is filed.

As explained in Rule 433(d)(1), the word "filed" as it applies to free writing prospectuses does not mean that the free writing prospectus will be part of the registration statement or otherwise subject to liability under § 11. It also does not mean that the free writing prospectus has been filed for purposes of Item 10(e) (non-GAAP financial information). Also per SEC rule, where information in a free writing prospectus has not been included in the registration statement, that omission will not, in and of itself, constitute a material omission for § 11 purposes.

f. A free writing prospectus must include a generic legend indicating that it relates to a registered offering and specifying where the related registration statement and statutory prospectus may be obtained.

- For seasoned issuers and WKSIs, the legend must include the URL (or a hyperlink) where the statutory prospectus may be found on the SEC's website (unless the free writing prospectus is accompanied or preceded by a copy of the statutory prospectus).

- Unseasoned and non-reporting issuers (IPO's) must deliver a statutory prospectus to an investor (or provide an active hyperlink) prior to or with the first free writing prospectus which that investor receives.

- If a WKSI uses a free writing prospectus prior to filing the related registration statement, it must include a different legend (separately specified by the SEC in Rule 163).

g. Issuers and underwriters must retain any free writing prospectuses that were not filed with the SEC for three years from the initial bona fide offering of the securities to which the free writing prospectus pertains.

h. Rule 164 provides cure provisions for "immaterial or unintentional" failures to meet the requirements relating to filing, legending and retaining free writing prospectuses. These cure provisions all require that a "good faith and reasonable effort was made to comply" with the applicable requirement.

(1) In the case of a failure to comply with the filing requirement, Rule 164(b) also requires that the FWP in fact be filed "as soon as practicable" after the failure to file has been discovered.

(2) In the case of a failure to comply with the legending requirement, Rule 164(c) also requires that the FWP be amended "as soon as practicable" after the error is discovered, and that the amended FWP with the legend be retransmitted to anyone who received it without the legend.

"As soon as practicable" has not been further defined by the SEC or otherwise.

There is no corresponding cure provision for a good faith failure to "precede or accompany" the FWP with a statutory prospectus when that is required.

i. Common types of (possible) free writing prospectuses include:

- Those transmitting required information
    - terms sheets
    - recent developments
- Those involved in marketing the securities
    - summary sales documents or marketing points
    - electronic road shows (discussed below)
- Those being used to manage publicity (possibly inadvertent) that would otherwise be problematic
    - errant emails
    - media articles (could be used in marketing also)

4. Media free writing prospectuses.

a. Articles in the news media that appear during offerings may be (or may be considered by the SEC to be) offers but if so, they are free writing prospectuses. They also receive special treatment even under the rules pertaining to FWP's more broadly.

(1) As is the case for all free writing prospectuses (other than prefiling ones which may be used by WKSIs only), the registration statement must be on file.

(2) Media free writing prospectus must be filed within 4 days of the issuer or underwriter becoming aware of the publication (rather than on date of first use, which might be unknown and out of the control of the issuer or any underwriters).

(3) The legend does not have to be included until the media FWP is filed with the SEC.

(4) There is no requirement that the statutory prospectus precede or accompany the media free writing prospectus (true even for non-reporting and unseasoned issuers).

(5) In the case of an IPO, <u>there is no requirement that the registration statement include a price range</u> before a media free writing prospectus is available for the offering (in contrast to when other types of free writing prospectuses may be used in an IPO).

b. The filing obligation may be met by filing the actual media article, a copy of the article with corrections and clarifications noted, or a copy of all written information provided to the media (if that is the case).

(1) Should issuers try to answer questions only in written format so that they can more easily meet their filing obligation (regardless of what else appears in the news story)?

(2) If opting to file a "corrected copy", can an issuer correct a media story in parts that are not about the issuer? Or not derived from information given by the issuer? Should an issuer even try to do that?

c. In order to qualify for the more relaxed rules, the media must be independent of, including not being paid by, the issuer or the underwriters. Special rules are available for issuers that are themselves in the media industry. See Rule 433(f).

d. It is important to remember that media free writing prospectuses are only a subset of media publications. Not all media reporting or stories, even those about the issuer or about the offering, are free writing prospectuses. The SEC made clear in its rulemaking release for the offering reforms it adopted in June of 2005 that a media publication based solely on information filed with the SEC or on other information the dissemination of which did not represent an offer by the issuer or other offering participant, where there is no involvement or participation by an offering participant, is neither an illegal prospectus nor a free writing prospectus.

5. Road shows (live and electronic).

Road shows, or investor presentations conducted by issuers and underwriters to market a securities offering, may fall into one of two general categories under the SEC's new rules. They may be either "live" or "electronic."

a. Live road shows.

(1) Traditional "live" road show was one in which representatives of the issuer and any underwriters meet in person with prospective investors.

(2) Live road shows are oral and are permissible communications during the waiting period.

- Live road shows are <u>not</u> free writing prospectuses

(3) Key is that the road show be "live, in real time and to a live audience"

(4) As part of its offering reforms in June 2005, the SEC clarified that

- as long as visual aids such as slides or whiteboards are not made separately available to investors, they are also "oral" and may be used at a road show without turning it into a free writing prospectus
- handouts are permissible as long as they are collected at the end of the road show (attendees may not take the handouts with them)
- transmission to overflow rooms is okay as long as it is "live" (not recorded)
    - may be transmitted to other cities and more than one place at a time
    - may be transmitted by telephone or internet
    - may <u>not</u> be broadcast on radio or television (which are included within the definition of "written") if they are to retain their oral characterization

b. Electronic road shows.

A road show that does not meet the requirements of live, in real-time and to a live audience and that is graphically transmitted is an "electronic" road show and is a "graphic communication" and thus a free writing prospectus.

- May be produced in a studio and edited.
- Do not need to be recorded before a live audience or to include Q&As (as is customary with a live road show).
- Investors may download the electronic road show and replay it multiple times

(1) An electronic road show is a free writing prospectus and thus:

- Unseasoned and non-reporting issuers must include an active hyperlink to the statutory prospectus contained in the filed registration statement in order to meet the requirement that the statutory prospectus precede or accompany any free writing prospectuses used by those categories of issuers.
- Although electronic road shows are free writing prospectuses, they do not need to be filed with the SEC with one exception for equity IPOs (discussed below).
- Any slides or "handouts" used during the electronic road show may not be made separately available or they will be considered free writing prospectuses in their own right and will have to be filed with the SEC.

(2) If the offering is an equity IPO by a non-reporting issuer, then an electronic road show must be filed unless a bona fide version is made broadly available to an unrestricted audience.

- A "retail" electronic road show
- Does not have to be the same electronic road show provided to institutional investors but must cover the "same general areas of information"

- Does not have to include the same management presenters or cover all the same subjects.
- Version available to a restricted audience (institutional or select investors) might include projections, for example, but the broadly available (retail) electronic road show would not need to have projections.
- "Retail" road show must be available by time any other version is first used.

6. Research reports by investment banks (underwriters).

Although research reports require evaluation under the various rules pertaining to communications during the offering period, it is important to keep in mind that these reports are <u>not</u> issuer communications but originate with and belong solely to the investment bank that disseminates them (and which may or may not be an underwriter in the offering in question).

a. A research report may be

(1) a "prospectus" in violation of § 5(b)(1) or § 5(b)(2),

(2) an offer during the prefiling period in violation of § 5(c) and/or

(3) a solicitation of an offer to buy or an inducement to purchase in violation of Regulation M.

Rules 137, 138 and 139 provide under limited circumstances that publication of information, opinions and recommendations with respect to securities to be offered and sold will not be deemed to constitute an offer to sell such securities or a prospectus for purposes of §§ 2(a)(10) and 5(c). The restrictions of Rule 101 of Regulation M are not applicable to research reports that comply with Rules 138 and 139.

b. Rule 137 permits publication of information, opinions or recommendations with respect to a security by a broker or dealer acting in the regular course of its business who does not propose to be a participant in the distribution (including in an IPO) and who does not receive any consideration in connection with the publication of such information from the registrant or other persons interested in the distribution.

c. Rule 138 permits publication of information, opinions or recommendations by a broker or dealer in the regular course of its business with respect to non-convertible debt or non-convertible, non-participating preferred stock of a reporting issuer that is current with its 1934 Act periodic reports and which proposes to file or has filed a registration statement covering equity securities or securities convertible into equity (or vice versa), even though such broker or dealer is or will be a participant in the distribution of such securities. Rule 138 is also available for research concerning a non-reporting foreign private issuer that either has had its equity securities traded on a designated offshore market for at least 12 months or has a $700 million worldwide public float. It is a condition to the use of Rule 138 that the broker or dealer have previously published or distributed in the regular course of its business research reports on the types of securities that are the subject of the report for which the safe harbor is invoked.

d. Rule 139 permits a broker or dealer participating in a distribution of securities by a seasoned issuer or by certain non-reporting foreign private issuers to publish research concerning the issuer or any class of its securities, if that research is in a publication distributed in the normal course of its business. Rule 139 also provides a safe harbor for industry reports covering certain other reporting issuers, if the broker or dealer complies with restrictions on the nature of the publication and the opinion or recommendation expressed in that publication.

e. Rule 139 Issuer-Specific Reports.

(1) The broker or dealer must publish or distribute research reports in the regular course of its business and the research report in question must not represent the initiation (or re-initiation) of research about the particular issuer or its securities. The publication of just one prior report will satisfy this requirement.

(2) The issuer must qualify under one of the following two tests:

- The issuer meets the registrant requirements for use of Form S-3 or Form F-3 and the minimum float (i.e., $75 million aggregate market value of voting and non-voting common equity held by non-affiliates) or minimum public debt float provisions for use of the respective form and is current with its 1934 Act periodic reports; or

- The issuer is a foreign private issuer that meets all of the registrant requirements of Form F-3, other than the reporting history provision of that form, meets the minimum float or minimum public debt float provisions of that form, and had either (i) securities which have been traded for a period of at least 12 months on a designated offshore securities market, or (ii) a worldwide public equity float of $700 million or more. The SEC has made clear that Rule 139 is available for such issuers' initial public offerings in the United States. See SEC Release No. 33-7132, February 1, 1995.

f. Rule 139 Industry Reports.

(1) Rule 139 also permits issuer research in "industry reports"—that is, reports that include "similar information with respect to a substantial number of issuers in the issuer's industry or sub-industry, or contains a comprehensive list of securities currently recommended by the broker or dealer."

(2) In order to qualify for this safe harbor, the issuer must be either a reporting issuer or a foreign private issuer meeting the tests in paragraph (e)(ii) above regarding issuer-specific reports.

(3) The analysis regarding the issuer or its securities can be given no "materially greater space or prominence in the publication than that given to other securities or issuers."

(4) If sales or earnings projections are included for the issuer, they must have been previously published on a regular basis and similar projections covering the

same periods must also be included with respect to a substantial number of companies in the issuer's industry.

g. Research reports meeting the conditions of Rule 138 or Rule 139 will not constitute "offers" or "general solicitations or general advertising" in connection with Rule 144A offerings, nor will they be "directed selling efforts" or be inconsistent with the "offshore transaction" requirements in Regulation S offerings. (Note that these Rules 138 and 139 were not amended to account for the lifting of prohibitions on general solicitation in Rule 144A offerings.)

h. Under the JOBS Act, a broker or dealer is permitted to publish or distribute a research report about an EGC that is the subject of a proposed public of common equity, even if the broker or dealer participates in the offering. The JOBS Act also prohibits the SEC or any national securities association (currently this refers to the Financial Institution Regulatory Authority or "FINRA") from restricting research analysts from publishing or distributing any research report with respect to the securities of an emerging growth company for a period of time following the date of the first sale of common equity securities under an IPO registration statement or prior to the expiration of any "lock-up" period agreed to with the underwriters in an IPO. Any such report will not be a prospectus and therefore will not provide a basis for liability under section 12(a)(2) of the Securities Act. It could, however, provide a basis for Rule 10b-5 fraud liability under the Exchange Act or SEC enforcement action under section 17 of the Securities Act.

i. FINRA, created through the consolidation of the NASD and the regulatory arm of the NYSE in the summer of 2007, has detailed rules with which all brokers and dealers (as members of the SROs) must comply. These rules are largely intended to mitigate conflicts of interest that research analysts may face in the context of a subject company that is also an investment banking client. In addition to specific disclosure requirements and limitations on analyst compensation and involvement in offerings, the rules also impose "quiet periods" (except for EGCs, as stated above) during which firms involved in the offering may not publish research on the issuer or discuss the issuer during public appearances, such as on financial news programs. These "quiet periods" extend for

40 days following an initial public offering and 10 days after a follow-on offering and apply to managers and co-managers of the offering. Broker-dealers who participate as underwriters or dealers in an initial public offering are subject to a 25-day quiet period. Research by a manager or co-manager of an offering is also restricted in the 15 days prior to and after the expiration or waiver of any lock-up agreements that follow the completion of the offering. See FINRA Manual, NASD Rule 2711(f).

E. Statutory Prospectus Circulation.

1. Circulation of preliminary prospectus.

a. Under Rule 460, circulation of the preliminary prospectus may be a factor in granting acceleration.

b. Information as to distribution of a preliminary prospectus is usually requested by the SEC staff. Rule 418(a)(7) specifies that the registrant should be prepared to provide this information "promptly" when requested and issuers should expect to do so prior to the SEC staff declaring the registration statement effective.

c. Rule 15c2-8 under the 1934 Act requires, among other things, that in the case of a non-reporting company (i.e. an IPO) a preliminary prospectus be delivered "to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of such confirmation".

2. Recirculation of an amended preliminary prospectus.

a. Liability under §12(a)(2) attaches based on the information that has been conveyed to the investor by the time of sale. Recirculating a preliminary prospectus would be one means of conveying (corrected) information but it is not the only possible method, and given the availability of using a free writing prospectus in most cases, recirculation is not a likely method.

b. Acceleration under Rule 460—the SEC may require recirculation as a condition of granting acceleration of effectiveness.

c. Rule 15c2-8 does not require recirculation but does require that the broker or dealer take reasonable steps to assure that a copy of the amended preliminary prospectus, promptly after the filing thereof, be provided to each person soliciting customers' orders, and that any person furnishing a written request for a prospectus receive the latest preliminary prospectus on file.

F. Remedies for violations of the communications rules ("gun jumping" violations).

1. A failure to comply with any of the conditions of the rules pertaining to communications during the offering period could cause the communication to be a violation of § 5. Traditionally, several different reactions and possible remedies have been considered or imposed by the SEC staff and others, including:

- Delay effectiveness
- Rescission — buyer gets 1 year put
    - Including adding a so-called rescission risk factor to prospectus to alert investors to their "put"
- Add offending material to prospectus so issuer and underwriters take strict liability for its content
- Withdrawal from offering of any underwriter responsible for violations
- Do not sell to person receiving the improper offer

2. If "gun jumping" results in a widespread illegal offer, is delay enough in light of Diskin?

VII. The Post-Effective Period.

Sales are permitted only once the registration statement is "in effect".

A. "Access equals delivery".

1. Under § 5(b)(2) it is unlawful to use the mails or interstate commerce to carry a security for the purpose of sale or delivery after sale unless "accompanied or preceded by a prospectus that meets the requirements of" § 10(a).

2. The SEC has provided in Rule 172, however, that a final prospectus will be deemed to have been delivered to investors as long as it has been filed (or will be filed) with the SEC by the required filing date. Per the rule, securities as well as related confirmations and notices of allocations may

be sent to investors after effectiveness of the registration statement without needing to be preceded or accompanied by the final prospectus as long as the prospectus has been (or will be) filed by the applicable due date.

3. The SEC has not extended the "access equals delivery" model beyond the three areas covered by Rule 172 (delivery of securities, confirms and notices of allocations) and it only applies to final prospectuses.

B. Free writing after effectiveness.

1. The § 5(b)(1) prohibition against using a "prospectus" that does not meet the requirements of § 10 continues to apply during the post-effective period.

2. §2(a)(10) (exception (a)) provides that a communication sent or given after the effective date is deemed not to be a "prospectus" if a prospectus meeting the requirements of §10(a) is "sent or given" to the person to whom the communication is made prior to or at the same time as the communication. Sales materials and other written communications can thus be freely used in the post-effective period if accompanied or preceded by a statutory prospectus. If they are not preceded or accompanied by the final statutory prospectus, those writings will be free writing prospectuses and will have to fully comply with those rules.

3. As noted above "access equals delivery" is not available outside the limited circumstances covered by Rule 172.

Note that in the context of a shelf registration, it does not appear that a base prospectus is a sufficient §10(a) prospectus. See Rule 430A(c) and its cross-reference to §10 and exception (a) of §2(a)(10).

C. Prospectus Delivery Following an Initial Public Offering.

Delivery of a prospectus by a dealer (including an underwriter no longer acting as an underwriter with respect to the security involved in such transaction) during the 25 days after the effective date is required if the issuer was not previously a 1934 Act reporting company (90 days if the security is not listed on an exchange. With very limited exceptions (e.g., offerings by blank check companies), "access equals delivery" is available to dealers to meet these delivery obligations. (See §4(3) of the 1933 Act and Rule 174.)

1. Under what circumstances must the prospectus be updated?

2. Research reports not accompanied or preceded by a prospectus must comply with Rule 137, 138 or 139.

VIII. **Civil Liabilities.**

A. Section 11 Liability.

1. Covers misstatements or omissions in the registration statement at the time it became effective.

   a. Information contained in a prospectus supplement (such as in a shelf takedown for an S-3 offering) is part of the registration statement for Section 11 purposes. Information in a prospectus supplement used in a shelf takedown will be deemed part of the registration statement as of the earlier of the date it is first used or the date of the first contract of sale of securities in the related offering.

   b. Rule 430B establishes that the date a prospectus supplement is deemed part of the registration statement will also be a new effective date for the registration statement (including an automatic shelf registration statement) for § 11 purposes with regard to the issuer and any current underwriter. It will not be a new effective date with regard to any other possible defendants.

   c. The date of an annual report on Form 10-K or 20-F is a new effective date for purposes of a registration statement on Form S-3 or F-3 (including an automatic shelf registration). This new effective date applies to all persons with potential liability under § 11.

2. Any person acquiring a security registered under the registration statement (this includes both initial purchasers and anyone who purchased the security later in the open market), who did not have knowledge of the misstatement or omission at the time of acquisition, can sue:

   a. Every person who signed the registration statement (including the issuer).

   b. Every director (at the time of filing of the registration statement) of the issuer (whether or not the director signed the registration statement).

c. Every person who, with his consent, is named in the registration statement as being or about to become a director.

d. Experts (e.g., accountants, engineers, appraisers) who consent to such status (but only with respect to those sections of the registration statement expertized by that defendant).

e. Underwriters.

3. Very broad liability provision:

a. No knowledge or intent to deceive or mislead is required.

b. No reliance on (or even awareness of) the misstatement is required.

4. If the security is acquired after an earnings statement for a 12-month period beginning after the effective date of the registration statement has been made generally available to security holders, then reliance by the plaintiff on the misleading statement is required.

a. Rule 158 provides that periodic 1934 Act reports satisfy the "generally available" standard.

b. Underwriting agreements typically require the issuer to satisfy this provision.

5. Limitations on liability:

a. The amount of recoverable damages is limited to the difference between the price paid (but not greater than the public offering price) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought, provided, that, defendants that are liable for damages for material misstatements or omissions in offering documents are permitted to reduce the rescission damages by proving that the market depreciation was due to factors other than the misstatements or omissions. §11(e).

b. "Knowledge" Defense. The issuer has an affirmative defense under Section 11(a) if it can prove that the plaintiff knew of the material misstatement or omission. The limited case law on this defense generally indicates that the issuer must prove actual knowledge of the error on the part of the purchaser, rather than "generalized" public knowledge. (See, e.g., *Federal Housing Finance Agency v. UBS Americas Inc. 2013 WL3284118, SDNY 2013).*

c. An underwriter's liability is limited to the total public offering price of the securities underwritten by such underwriter. §11(e). Accordingly, underwriting contracts are generally written so that the underwriters' obligations to purchase securities are several versus joint obligations.

d. Except as noted below, any person found liable can recover contribution from any person who, if sued, would have been liable. §11(f).

e. The Private Securities Litigation Reform Act of 1995 (the "Reform Act") requires the jury or court to determine the relative responsibility of each party named as a defendant and any other person claimed by any of the parties to have caused or contributed to the loss incurred by the plaintiff, including persons that have settled. Although a proportionate share of the damages is initially allocated to each defendant in accordance with the jury or court's determination of relative responsibility, defendants that "knowingly commit a violation of the securities laws" remain jointly and severally liable subject to right of contribution, whereas the liability of outside directors in actions under §11 that did not "knowingly commit a violation of the securities laws" is limited to their proportionate share, subject to certain exceptions.

> "[K]nowingly commits a violation of the securities laws" means (i) in the case of an action based upon a misstatement or omission, that the person had actual knowledge that the statement was false (including as a result of the omission) and that other persons are likely to reasonably rely on the misstatement or omission or (ii) with respect to any other action under the securities laws, the person had actual knowledge of the facts and circumstances that made the conduct a violation of the securities laws.

f. The above described limitation on the liability of non-knowing outside directors in actions under §11 is subject to two exceptions. First, if such claims are not collectible against knowing defendants, non-knowing defendants are jointly and severally liable for the uncollectible claims of plaintiffs who establish that (i) they are entitled to damages exceeding 10% of their net worth and (ii) their net worth is less than $200,000. Second, if the damages awarded to any plaintiff, other than the one described above, is uncollectible and such damages are not recoverable against knowing defendants, each of the non-knowing defendants must make an additional payment up to 50% of their own liability to make up the short fall in the plaintiff's recovery. For example, a non-knowing defendant liable for $10,000 of a $100,000 judgment would owe an additional $5,000 if the remaining $90,000 were uncollectible from other defendants. To the extent a non-knowing defendant makes a required additional payment, such defendant may recover such additional amounts from any defendants that have paid less than their proportionate share.

g. Any defendant who settles is released from any future claims arising out of the action from either the plaintiff or other defendants, and the court must reduce the final judgment by the greater of (i) an amount corresponding to the settling defendant's percentage of responsibility or (ii) the amount the settling defendant paid.

6. Due Diligence Defenses--§11(b)(3).

a. Available to all of the above persons who can be sued, except the issuer.

b. A defense, not an affirmative obligation.

(1) <u>Nonexpertized Material.</u> If the alleged misleading statement or omission was not made upon the authority of an expert, the defendant will not be liable if the burden of proof is sustained that the defendant "had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . .".

(2) Expertized Material. As regards any expertized part of the registration statement, a nonexpert defendant will not be liable if the burden of proof is sustained that the defendant "had no reasonable ground to believe, and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert . . .". This standard is far easier to meet than the standard for non-expertized material, because a defendant bears no affirmative obligation to establish that it conducted an investigation.

(3) Material Expertized by Defendant. If the alleged misleading part of the registration statement was made upon defendant's authority as an expert, the defendant will not be liable if the burden of proof is sustained that the defendant "(i) had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert . . .".

- Note that auditors only expertize information that they have audited—interim reviews do not expertize financial disclosures; nor do comfort letter procedures. Issue most obviously comes up with pro forma financials. Query also for auditors' attestation reports on internal controls pursuant to SOX 404 and Auditing Standard No. 5.

(4) Standard in § 11(c). "In determining . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."

(5) Rule 176 contains the SEC's view of certain relevant circumstances in determining what constitutes a reasonable

investigation (e.g., whether, in the case of an incorporated document, the defendant had any responsibility for such document at the time it was originally filed).

(6) Case Law. In Escott v. Barchris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), the court held that the issuer's registration statement contained various material misstatements and omissions in violation of § 11 and found the directors and underwriters liable since they had not satisfied the burden of proof to sustain a due diligence defense. The court noted that the amount of diligence required to establish such a defense depended on the relationship of the defendant to the issuer and their access to information (i.e., an inside director has a greater burden than an outside director). With regard to the underwriters' due diligence defense, the court stated:

"To effectuate [§ 11's] purpose, the phrase 'reasonable investigation' must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of 'data presented' to them by the company . . . . [T]he underwriters must make some reasonable attempt to verify the data submitted to them."

See Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y 1971) (where the court, in holding that the underwriters had established a due diligence defense to a § 11 claim, noted that reasonableness (for purposes of § 11(c)) varied with the degree of involvement of the defendant, their expertise and their access to pertinent information and data).

In In re Software Toolworks, Inc. Securities Litigation, 789 F. Supp. 1489 (N.D.Cal. 1992), the court held that the underwriters had sustained a due diligence defense, and granted their motion for summary judgment, since they had reasonably investigated the issuer and its business by taking the following steps: using experienced due diligence teams, meeting with management, customers and suppliers, reviewing the company's documents and industry information, physically inspecting the issuer's facilities and closely scrutinizing the financial statements with the auditors. With regard to the financial results for the most recent quarter, the court held that they were allowed to rely on the representations of the issuer because these statements were not yet independently verifiable. The court stated that "[i]t is not unreasonable . . .to rely on management's representations with regard to information that is solely in the possession of the issuer and cannot be reasonably verified by third parties". See Weinberger v. Jackson, [1990-1991 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,693 (N.D.Cal. Oct. 11, 1990) (where the court granted summary judgment in favor of the underwriters on their due diligence defense for taking measures comparable to those taken by the underwriters in Software Toolworks).

The determination of the lower court in Software Toolworks was affirmed in part by the 9th Circuit. The court of appeals remanded for trial, however, on the issue of whether the underwriters had met their burden with respect to the most recent quarter's results. The court noted that the plaintiffs had put forth evidence demonstrating that the underwriters knew that the results for this quarter were anomalous and did not accurately reflect the financial status of the issuer's business. Therefore, they argued that the underwriters should have reasonably inferred that the issuer had fabricated these results to protect the offering. In the opinion of the court, under such circumstances, reliance on the representations of management would not sustain a due diligence defense. In re Software Toolworks Inc. Securities Litigation, 38 F.3d 1078 (9th Cir. 1994).

In Picard Chemical Inc. Profit Sharing Plan v. Perrigo Company, 1998 U.S. Dist. LEXIS 11921 (W.D. Mich. June 25, 1998), the Court granted summary judgment to the underwriters on their claim that they had conducted a reasonable investigation and established a due diligence defense under § 11 and § 12(a)(2). The underwriters' investigation included: a substantial base of knowledge about Perrigo's financial and operating condition acquired from work on prior offerings and other financing projects; a day-long "all hands" due diligence meeting at which management and the outside accountants were questioned; a bring-down due diligence call; review of the internal growth plan; contacting major customers;

inspection of facilities; obtaining a comfort letter; and receiving a legal opinion as well as written representations as to the absence of misstatements and opinions in the prospectus.

Interestingly, after the investment bankers testified in their depositions in Picard that they could not recall specific discussions and events that occurred during the due diligence investigation, plaintiffs asserted that this undercut the evidence supporting the due diligence defense and created an issue for the jury. The Court stated that it was not unusual that the investment bankers could not recall the details of lengthy meetings three or four years later and was satisfied with their testimony that all the questions on their due diligence outline had been covered. The Court thus concluded that the investment bankers' inability to recall every detail of their investigation did not preclude summary judgment.

The Southern District of New York took a comprehensive look at due diligence in In re WorldCom, Inc. Securities Litigation (12/15/2004), which arose in relation to two underwritten debt offerings by WorldCom—one for $5 billion in 2000 and another for $12 billion in 2001. Following the collapse of WorldCom stemming from its massive financial frauds, investors sued various parties to those offerings under § 11, including the underwriters. In refusing the underwriters summary judgment, the judge made several critical points about the contours of the due diligence defense. With regard to audited financial statements, although they are "expertized" by the auditors and the due diligence obligation of underwriters is therefore lesser with regard to those disclosures, "red flags" cannot be ignored and the underwriters should have gone further with their diligence efforts in light of the warnings that WorldCom's financials were (or should have been) suspicious. With regard to interim or unaudited financials, the case reminds readers that comfort letters do not expertize the financials to which they speak (nor do interim review reports) and a successful due diligence defense may require additional steps.

(7) Should the managing underwriter sustain a due diligence defense, all underwriters in the syndicate would escape liability. <u>In re Gap Stores Securities Litigation</u>, 79 F.R.D. 283 (N.D.Cal. 1978).

B. <u>Section 12 Liability.</u>

1. § 12(a)(1) imposes liability on any person who offers or sells a security in violation of § 5.

2. § 12(a)(2) imposes liability on any person who offers or sells a security by means of a <u>prospectus or oral communication</u> which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.

3. § 12(b) permits defendants that are liable for damages under § 12(a)(2) for material misstatements or omissions in offering documents to reduce the rescission damages specified under § 12 by proving that the market depreciation was due to factors other than the misstatements or omissions.

4. § 12 differs from § 11 in several respects:

a. Liability under § 12(a)(2) relates to an offer or sale <u>by means of</u> a prospectus or oral statement (not the mere status of the defendant as under § 11), although no reliance is required. Also, unlike Section 11, the purchaser must establish that he or she did not know of "the untruth or omission".

b. The Supreme Court has ruled the term "prospectus" for purposes of § 12(a)(2) has the same meaning as it does under § 10. <u>Gustafson v. Alloyd Co., Inc.</u>, 115 S. Ct. 1061 (1995). Since the § 10 prospectus requirements are only triggered if an offering is required to be registered pursuant to § 5, it appears that transactions that are exempt from § 5 pursuant to § 4 of the Act are not subject to the liability provisions of § 12(a)(2). <u>See</u> <u>id.</u> at 1067-68. Therefore, private placements pursuant to § 4(a)(2) and Rule 144A offerings would not be subject to § 12(a)(2). In addition, § 12(a)(2) does not apply to resales of securities in secondary market transactions.

c. As a result of <u>Gustafson</u>, Section 12(a)(2) liability is limited to registered public offerings. While it is available to all purchasers from the underwriters in the initial distribution, there is a split of authority on whether it extends to persons who purchase in the aftermarket from dealers who have a prospectus delivery requirement during the 25 days (or 90 days) following an IPO (see §4(3) and Rule 174). (See e.g. Feiner v. SS&C Technologies, 47 F. Supp. 2d 250 (D. Conn 1999) [Yes.]; In re Levi Strauss Securities Litigation, 527 F. Supp. 2d 965 (N.D. Cal 200) [No)].

d. Unlike Section 11, Section 12(a)(2) liability is not capped at the offering price. However, the practical significance of this difference is limited to IPOs where the price trades up during the 25-day prospectus delivery period, assuming that liability extends to purchasers from dealers with a prospectus delivery requirement.

e. § 12(a)(2) applies to exempt securities under § 3 (except securities exempt under § 3(a)(2)--government and bank securities). Gustafson, however, seems to suggest that all private offerings are exempt from § 12(a)(2). Therefore, it is not clear whether § 12(a)(2) would apply to a § 3 exempt offering which would otherwise qualify as a private offering under § 4.

f. Liability under § 12 may be imposed not only on the direct seller of the securities, but also on persons who solicit the purchase of the securities, where the person soliciting the purchase is motivated at least in part by a desire to serve his own financial interests or those of the securities owner. Pinter v. Dahl, 108 S. Ct. 2063 (1988).

(1) Rule 159A was adopted by the SEC in 2005 and provides that the issuer in a primary offering of securities is considered to offer or sell the securities to the investors in the initial distribution of the securities and is therefore a "seller" for purposes of § 12(a)(2) only. Judicial decisions have split in the past on when an issuer may be a seller for purposes of § 12(a)(2), especially in firm commitment offerings where the issuer sells the securities to the underwriters who then in turn sell them to investors.

(2) Rule 159A will not create liability under Section 12(a)(2) for the issuer with regard to communications made solely by other offering participants unless the offering participant is acting as an agent or representative of the issuer or the

issuer or its agent has previously authorized or approved the communication.

g. The § 12 remedy is rescission (or damages if the securities are no longer owned).

5. The SEC has provided by interpretation (in the 2005 adopting release for securities offering reform) and Rule 159 that liability under § 12(a)(2) attaches at the time of sale of the securities. For purposes of that liability analysis, information conveyed to the investor only after the time of sale (including a contract of sale) will not be taken into account.

a. The determination of what information had been conveyed to an investor at the time of sale is a case of facts and circumstances.

b. The "disclosure package" for § 12(a)(2) purposes may include items beyond the registration statement, including free writing prospectuses and oral communications.

c. Disclosure that is added or amended only in a final prospectus would not protect the issuer and underwriters under § 12(a)(2) if the sale is made before the investor receives the final prospectus.

d. What is the cure if a material misstatement or omission existed at the time of sale (since it cannot be cured by a subsequently provided disclosure)? can the contract be modified? terminated?

(1) In its final release for the June 2005 reforms, the SEC suggested a four part test for successfully terminating a contract of sale so as to avoid § 12(a)(2) liability.

6. § 12(a)(2) provides a due diligence defense—the defendant must show that "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission".

a. Some judicial decisions have suggested that this "reasonable care" standard is the same as the § 11 "reasonable investigation" standard. See Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980), cert. denied, 450 U.S. 1005 (1981).

b. The SEC stated in the release adopting the June 2005 reforms that "We believe, however, as we have stated previously, that the standard of care under Section 12(a)(2) is less demanding than that prescribed by Section 11 or, put another way, that Section 11 requires a more diligent investigation than Section 12(a)(2)."

c. SEC also stated in the final release that "we believe that any practices or factors that would be considered favorably under Section 11, including pursuant to Rule 176, also would be considered as favorably under the reasonable care standard of Section 12(a)(2)."

d. How does the timing of liability under § 12(a)(2) affect considerations for the timing of due diligence?

7. The Reform Act added a safe harbor for certain forward-looking statements that are identified and <u>accompanied</u> by <u>meaningful</u> cautionary statements <u>identifying important factors</u> that could cause actual results to differ materially from those in the forward-looking statement by certain issuers and certain other persons acting on the basis of the issuer's statements. There are a number of exceptions to the availability of the safe harbor, including, among others, prospectuses for initial public offerings and financial statements prepared in accordance with GAAP.

C. <u>Section 13—Statute of Limitations.</u>

1. An action under § 11 or § 12(a)(2) must be brought within one year of discovery of the misleading statement or omission or after such discovery should have been made by the exercise of reasonable diligence (or, in the case of § 12(a)(1), one year of the violation of § 5).

2. No action under § 11 or § 12(a)(1) may be brought more than three years after the bona fide public offering of the security or, in the case of § 12(a)(2), three years after sale.

3. An action under Rule 10b-5 may be brought not later than the earlier of two years after the discovery of the facts constituting the violation or five years after such violation. See Section 804 of the Sarbanes-Oxley Act of 2002.

D. <u>Civil Liability Problems.</u>

1. The harsh remedy of rescission.

a. If the purchaser knows that there has been a technical violation of § 5, does the purchaser get a one year free ride, being able to exercise the rescission remedy if the security declines in price? In

Pinter v. Dahl, at 2073 and n. 13, the Supreme Court confirmed that, absent other factors, a sophisticated investor who is a knowing purchaser of unregistered securities may still recover under § 12(a)(1), since this result properly furthers § 12(a)(1)'s deterrent effect.

b. Once there has been an illegal offer or sale, as in Diskin, is there any way to avoid the one year right of rescission? The doctrines of mitigation of damages and laches apparently are not applicable to claims under §§ 11 and 12. The doctrine of estoppel might be applicable. Straley v. Universal Uranium & Milling Corp., 289 F.2d 370 (9th Cir. 1961). The in pari delicto defense is available to a § 12(a)(1) claim, but only where the plaintiff's role in an offering of unregistered securities is more as a promoter than as an investor. Pinter v. Dahl.

2. Liability for a preliminary prospectus.

a. Is there liability under Rule 10b-5 or § 12(a)(2) to persons trading in the market? If the issuer already has outstanding securities, is there liability even if the offering is abandoned?

b. Is there liability to a purchaser in the aftermarket who received the preliminary prospectus but was not required to be delivered a final prospectus?

NOTES