LEX HELIUS: THE LAW OF SOLAR ENERGY
—Securities Regulation—

John J. Halle
Stoel Rives LLP
900 SW Fifth Avenue, Suite 2600
Portland, OR 97204-1268
503-294-9233
jjhalle@stoel.com

Christian M. Lucky
Stoel Rives LLP
600 University Street, Suite 3600
Seattle, WA 98101-4109
206-386-7548
cmlucky@stoel.com

Businesses seeking to make use of U.S. capital markets to raise money must concern themselves with U.S. securities laws. The United States and each state or other political subdivision of the United States have laws regulating the purchase, sale, and trading of securities. While the laws are generally similar in most respects, there are some important differences, so it is necessary to check both the federal law and the law of each state in which the fundraising or trading activity will occur.[1]

Federal securities laws are subject to regulation and enforcement by the Securities and Exchange Commission (the "SEC"). The SEC also empowers and oversees the activities of various self-regulatory organizations, such as the National Association of Securities Dealers, Inc., and the various exchanges and other systems on which securities are traded, such as the New York Stock Exchange and the National Association of Securities Dealers Automated Quotation System (NASDAQ). These organizations enact their own regulations within the areas of their authority, but their regulations are subject to review and approval by the SEC. State securities laws are subject to regulation and enforcement by a securities commission that, most often, functions under the authority of the Secretary of State.

Neither federal nor state securities laws are explicitly restricted as to the geographical scope of their application. In practice, as described in more detail below, federal securities laws are applied principally to regulate transactions in the United States or its territories or transactions to which U.S. citizens or residents are a party. Even when no U.S. citizen or resident is a party, U.S. securities laws may be applied when substantial activity in connection with the transaction occurs in the United States, or in circumstances in which the nature of the transaction tends to undermine confidence in U.S. securities markets. As a practical matter, and in the absence of malicious intent, transactions to which no citizen or resident of the United States is a party and as to which no substantial activity occurred in the United States are not subject to U.S. securities laws.

State securities laws clearly apply to protect the citizens and residents of a state who are contacted within the state in connection with a transaction. Thus, for example, state laws regulating the sale of securities by the businesses that issued them ("issuers") clearly apply to sales made to purchasers resident in the state. Some state regulatory commissions have sought to regulate such sales made from the state to residents of another state, but to date they have rarely succeeded in applying their state law to such transactions.

I. What Is a Security? Both federal and state laws define a security very broadly to include a wide variety of instruments, including stock and other forms of equity and certain debt instruments. In addition to the specific list of instruments that constitute securities, an "investment contract" is a security. An investment contract has been defined by courts to be a contract or instrument involving the investment of money or other value in a common enterprise with the expectation of profit resulting from the efforts of others.[2]

As an initial matter, it is important to determine whether a contemplated transaction involves a security, because the securities laws apply only if it does. The answer often depends on a number of fact-specific issues, but here are a few general guidelines:

- Almost any instrument evidencing ownership of a business, including stock, limited partnership interests, limited liability company interests, or other instruments having

[1] Except where we specifically mention that we are describing other law, this chapter generally describes the applicable provisions of the federal securities laws and regulations. In very general terms, the equivalent state laws are likely to be similar, but there may be differences or separate filing and fee requirements that must be observed.

[2] There is some slight variation in the definition, but all variations are generally to the effect described above.

equivalent function, is a security. Joint venture agreements, general partnership interests, and similar instruments representing ownership of a business that the owners will collaborate in running may not be securities.

- Securitized debt instruments, including bonds, debentures, and other instruments evidencing debt held similarly by a group of investors, are securities. Conventional, commercial loan arrangements, whether with traditional lenders or pursuant to private arrangement, are not securities, including syndicated loans with a group of traditional lenders.[3] The line between commercial and securitized debt has generated considerable judicial analysis and requires careful review in the case of novel or unusual interests.

- Derivative instruments, such as options, warrants, and other instruments evidencing the right to exchange the interest for a security or to purchase a security, are deemed to constitute the security into which they are convertible or for which they are exercisable, and may also be securities in their own right. Thus, for example, the sale of a warrant exercisable to buy stock is the sale of a security, as is the sale of the stock on exercise of the warrant. The existence of the warrant may also be a continuing offer to sell the stock.

- Agreements or instruments of any kind are securities if, as a matter of fact, they meet the definitional test of an investment contract described above.

An agreement or instrument may constitute or contain a security regardless of its form. For example, a complex agreement relating to a project may contain numerous provisions to which securities laws do not apply while also containing a security that must adhere to securities laws. Similarly, an instrument may constitute stock if it creates an equity interest in a business, even if the word "stock" is not used.

II. What Do the Securities Laws Regulate? As noted, the securities laws regulate transactions in securities but do not regulate all such transactions. In general, securities laws regulate (1) purchases or sales of securities, (2) offers to purchase or sell securities, and (3) the activity of markets that trade in securities and those who use them. Securities laws generally do not regulate bona fide gifts of securities, nor do they attempt to control the nature of the instrument that constitutes a security or the rights of holders of such securities under such instruments. Such rights are generally controlled under state corporate laws or are determined by private agreement.

Purchases and Sales of Securities. Numerous laws and regulations govern the activity of persons who purchase or sell securities. The general purpose of these laws is to ensure that a transaction is fair to both sides by requiring a buyer or seller with knowledge of material facts relevant to the value of the securities to make that information known to the counterparty in the transaction.[4] As described in more detail below, both federal and

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[3] Some lenders in connection with conventional loan arrangements require warrants or other derivative interests in addition to the normal interest provisions of the loan documents. In such cases, the loan documents themselves may not be securities but the warrants are securities.

[4] Federal securities laws are limited to regulating the process whereby information is disclosed in connection with securities transactions. State laws, as interpreted by state regulatory bodies, are not limited in this way, and most state laws have defined transactions that they deem to be "unfair" and that are prohibited without regard to the extent and accuracy of disclosure. In practice, the difference is largely theoretical because the SEC will usually attempt to use its regulatory authority to make it difficult to engage in transactions that the SEC believes to be substantially unfair, while state regulators will ordinarily grant exceptions to unfairness prohibitions in exchange for restrictions on sales to persons most likely to be victimized by any unfairness.

state securities laws regulate both the sale of securities by issuers (generally upon original issuance) and the resale of those securities by others.

Offers to Sell or Purchase Securities. Not only are purchases and sales of securities regulated, but offers to purchase or sell securities are independently regulated. Thus, for example, it is possible to violate a securities law by offering to sell a security even though no sale ever occurs. In practice, offers are rarely the subject of either public or private enforcement proceedings. In the case of public proceedings, the absence of harm resulting from the offer generally limits enforcement efforts to obtaining cease and desist orders against persons regularly making unlawful offers. The same lack of harm effectively precludes private enforcement action.

The fact that offers are rarely the subject of independent enforcement proceedings does not mean, however, that offers can be made with impunity. As discussed in more detail below, some rules relating to whether and how a security may be sold apply differently depending on whether, how, and to whom offers have been made. Accordingly, ill-considered offers to purchase or sell securities can cause a related sale of securities to be unlawful, even if it would have been permitted had the offers not been made.

Regulation of Trading and Trading Markets. If securities are held by a relatively large number of people, or if they are traded on an exchange or other trading facility, numerous regulations apply to the issuers of the securities, the markets on which the securities are traded, and those persons trading on such markets. Most of the rules applicable to the latter two categories are of only minor significance to energy businesses, but the first category can impose substantial regulatory cost and impose other restrictions and burdens on companies whose securities are traded in the United States. In general, these rules do not apply to companies whose securities are illiquid and closely held, or to companies whose trading markets are in countries other than the United States.

III. Purchases and Sales of Securities: Regulatory Overview.

A. General Provisions. U.S. securities laws make it unlawful for a person, in connection with the purchase or sale of a security,

> (a) to employ any device, scheme, or artifice to defraud,
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> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

This requirement sets a standard for honesty and fair dealing in connection with securities transactions that is considerably more stringent than the standard applicable in other commercial contexts, in which actual fraud is unlawful, but in general the parties to an agreement are charged with protecting their own interests.[5]

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[5] The application of different standards for securities transactions and normal commercial transactions has raised numerous issues concerning which standard is applicable to statements that are made in a commercial context but are seen and possibly relied on by parties in a securities transaction. As a very general proposition, a statement made in a regular commercial context that does not have the purpose or probable effect of conditioning the related securities market is not held to the securities standard. The matter is complex, however, and companies engaged in offering securities should discuss with counsel the appropriate policy with regard to general commercial disclosures.

Under this provision, a purchaser or seller of a security has a legal claim upon a showing that the counterparty made a false statement of a material fact (a material fact being a fact that a reasonable person would consider to be important in connection with the related investment decision). These claims are generally known as "section 10b-5 claims," referring to the regulation under which they exist. Section 10b-5 does not prohibit material omissions unless the information omitted was necessary to make a statement that was made not misleading. Accordingly, there is no *general* duty of complete disclosure in connection with securities transactions. As described below, however, there are numerous rules under which specific disclosure is required.

In particular, case law has, since the 1970s, held that, if a party to a securities sale is in possession of material, nonpublic information with respect to the business whose securities are the subject of the transaction, that party must disclose the information to the other party (or determine that the other party also has that information) in such a way that the other party can take that information into account in making its decision with respect to the transaction. Nonpublic information is information that has not been made available to the general public by press release, regulatory filing, or other method. The requirement is obviously most applicable to businesses buying or selling their own securities or to members of management of the business engaged in such transactions. However, the scope of the requirement is not limited to those persons, and anyone engaged in a securities transaction can be liable for breach of the requirement if he or she goes through with the transaction without making the required disclosure. A breach of this requirement is actionable by the counterparty to the transaction, who may sue to recover the lost value of the investment, if any.

A person may have section 10b-5 liability if that person (known as a "tippor") improperly provided information to a third party who then improperly traded based on that information. Thus, an officer, director, or employee of a business may have section 10b-5 liability, even if he or she did not actually trade based on the information or profit from any such trade, if he or she improperly provided material nonpublic information to someone who did trade. If the officer, director, or employee provided the information in his or her capacity as an agent of the business, the business itself may be liable, which is why it is important for businesses whose securities are traded on any regular basis to take appropriate steps to prevent such disclosures.

There are a number of limitations to the scope of section 10b-5 liability. For example, a tippor can be liable only if the provision of the information was in some way in violation of a duty of the tippor *not* to provide the information. Inadvertent or fortuitous disclosures or disclosures for a proper business purpose cannot be the basis for tippor liability. Similarly, a person who declined to participate in a securities transaction cannot sue under section 10b-5 based on a claim that material information in the possession of the potential counterparty would have resulted in a decision to go through with the transaction. In general, however, trading while in possession of material nonpublic information can be the basis for a claim by the counterparty if the investment decision turns out to have been a poor one.

It is critical to keep in mind that, unlike the rules relating to registration and exemption discussed below, section 10b-5 applies to all sales of securities and all persons engaged in such sales. It applies to both sellers and buyers, and both to securities that are required to be registered as a condition of sale and to those that are exempt from such requirements. In particular, businesses involved in raising money through securities sales may tend to focus on the registration and exemption requirements and might forget that the section 10b-5 rules apply as well. Such a failure can have serious consequences, even if all of the registration and exemption rules are carefully observed.

B. Registration and Exemption Rules. Federal and most state securities laws impose duties on persons who propose to offer or sell securities. Unlike the section 10b-5 rules described above, these rules apply only to sellers of securities and do not impose any duty on buyers.

The core concept of these rules is that a security that is to be sold must be registered unless either the security or the contemplated transaction is exempt. Registration consists of filing a registration statement with the SEC or relevant state authority that meets the requirements for such documents. In theory, absent objection from the relevant authority within a prescribed period of time, the securities can be sold as long as a disclosure document, usually known as a prospectus, is delivered to the buyer in time to permit the buyer to use the information contained therein to make an informed investment decision. In practice, the SEC has made clear that, except in situations generally involving large, established companies, it expects to review and comment on the registration statement, after which there will follow a dialogue with the SEC staff, resulting in one or more amendments being filed and reviewed. Once the SEC staff is satisfied with the registration statement, it "declares" the registration statement effective and sales can take place. While the issuer and the SEC are in discussions regarding the content of the final registration statement, offers can be made by means of a preliminary form of prospectus.

Billions of dollars' worth of securities trade every day in the United States, and it should be obvious that the cumbersome process of registration does not apply to the overwhelming majority of such sales. Most of these sales occur under a registration exemption that exempts sales by persons who are not the issuer of the security, who are not affiliated with the issuer, and who are not underwriters of the securities or dealers in securities. Separate exemptions cover most sales by dealers in securities and by underwriters after a period of time has elapsed from the underwriting, thus allowing regular market transactions to proceed in the ordinary course without precondition.

Other exemptions apply to certain kinds of securities, regardless of the type of transaction involved. Of particular interest to energy companies, sales of securities that are issued or guaranteed by a government entity in the United States, such as municipal bonds and other forms of governmental instruments that are often issued to support a particular project, are exempt from registration without regard to the kind of transaction in which they are sold. As noted above, however, the exemption is from the registration requirements only. The requirements of section 10b-5 will apply to the sale, and other securities laws may either apply to the sale itself or be triggered by the fact that the sale took place.

Given the breadth of these exemptions, the registration rules are an issue mostly for four groups: (1) businesses seeking to raise capital by issuing their own securities (issuers); (2) directors, senior managers, general partners, and persons with equivalent management responsibility, and substantial equity holders in connection with reselling securities of the business that they own or manage; (3) owners of "restricted securities" in connection with the resale of those securities; and (4) underwriters of securities. Each of these categories is discussed below.

IV. Sales by Issuers.

A. Public Offerings. Issuers raising capital by selling their securities are generally faced with a choice of registering the securities to be offered and sold or complying with the requirements of an exemption. Any securities can be sold without meaningful restriction if the issuer files a registration statement and delivers a prospectus to each investor. Securities sold pursuant to registration are unrestricted, except those purchased by affiliates or underwriters, so they are freely tradable in the hands of the general public.

One of the results of a registered securities offering is that the issuer will become a "public company." As such, it will be subject to the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") and will have to file with the SEC annual and quarterly reports, and other reports upon the occurrence of specific events. This obligation will continue for at least a year and thereafter as long as there are more than a specified number of record holders of the securities (in most cases, 300). If the publicly owned securities are equity, numerous other provisions of the Exchange Act are also likely to apply, including provisions relating to the holding of stockholders meetings; trading of the securities by executive officers, directors, and holders of more than 10 percent of the securities; reports required to be filed by holders of more than 5 percent of the securities; and the conduct of tender offers for the securities. Finally, although it is not required by law, the likely result of a registered securities offering is that the securities will be listed on an exchange or other trading mechanism, causing the issuer to be subject to the rules of that facility.

For a company that is not already public, a decision to do a registered securities offering represents a choice of strategic direction in addition to the selection of a capital raising method. An initial public offering generally takes from six months to a year to consummate. The expense is quite large, and a considerable amount of the expense is not avoidable if the offering does not work. The volatility of capital markets creates risk that an offering that seems sensible at the time of the decision to proceed may appear less attractive at the time it is consummated. Following the offering, there is significant additional recurring expense. There is also a need to publicly report information that would normally be considered proprietary in a private company. Finally, the need to establish and maintain constructive investor relationships is time-consuming and can lead to management decisions that may not optimize the potential of the business.

The advantages of being a public company include access to public capital markets, which, after an initial period of time, can be accessed quite quickly and efficiently; increased flexibility in structuring acquisitions; and increased liquidity for stockholders. In general, a decision to go public is one involving economies of scale. In a larger business, the advantages of public status, combined with the ability to amortize the cost over a larger capital base, can make the alternative attractive. Smaller businesses are generally well advised to remain private if they are able to do so.

B. Private Placements. Issuers that are and intend to remain private generally rely on one or more of several exemptions, the general requirement for which is that the securities are not sold, either directly or indirectly, to the general public.[6] These exemptions, available only to issuers and generically known as "private offering exemptions," allow issuers to offer and sell securities without registration as long as (1) they are offered and sold only to a limited group of investors, and (2) the issuer takes steps to prevent immediate resale of the securities by restricting their resale. The securities so issued and so restricted are referred to as "restricted securities."

Offer Restrictions. To qualify for the exemption for both the offer and the sale, the offer must be made without "public advertizing or solicitation." Opinions vary as to the exact meaning of "public advertizing or solicitation," but the general practice is that offers or solicitations must be made individually to specific potential investors that the issuer has determined to be in a category to which such offers can be made within the limits of the exemption. Any kind of offer or solicitation made by means of any mass media, such as newspaper advertisements, mass emails, or other forms of general distribution in which the individual recipients are not

[6] The use of private placement exemptions is not limited to private businesses. Public companies regularly engage in private placements as part of their capitalization program.

known and identified as proper recipients, constitutes public solicitation in violation of the restriction. Using open-access Web sites constitutes public solicitation if they contain an offer of securities, but Web sites that are restricted to a group of potential investors whose suitability has been determined in advance are permitted.

It is important to note that the use of public advertising or solicitation in connection with a private placement not only invalidates the exemption for those who were publicly solicited but also for the offering as a whole, thus probably leaving the issuer without an available exemption for the offering.[7] In this situation, it is likely that the issuer will be unable to proceed with any kind of offering for a six-month period (known as a "cooling off period").

Investor Identity Restrictions. Federal securities regulations permit private placements to be made to an unlimited number of accredited investors. In general, financial institutions, institutional investors of significant size, and relatively wealthy individuals are accredited investors.[8] If the total amount to be raised in the offering exceeds $5 million, each investor must also be financially sophisticated enough (or have retained an advisor with such sophistication) to understand the merits and risks of the investment.

The regulations also permit private placements to be made to up to 35 nonaccredited investors. This provision has some limited utility in specific instances but is rarely used. The most important reason is that the informational requirements are substantially greater if the offering is made to any nonaccredited investor. Additional reasons include the fact that the effort required to solicit nonaccredited investors is disproportionate to the amount that they can prudently invest and the fact that selling securities to nonaccredited investors increases the risk of legal action if things do not go well for the investment.

Most private placements are made to a small group of institutional investors and/or very wealthy individuals. In the case of newer and smaller businesses, the former are known as "venture capital investors" and the latter are known as "angels."[9] In either case, the investment is likely to be in the form of preferred, convertible stock. More mature companies are funded by a group of institutions generally referred to as "mezzanine investors." These investments are more likely to be debt offerings, possibly with an equity piece as an inducement. Fully mature companies and projects have access to a wide variety of private funding alternatives, and it is not uncommon for a project to be funded at various levels by different institutional investors.

C. Transitions Between Private and Public Funding Strategies. A number of historical anomalies in the securities laws have resulted in problems for an issuer that wishes to change strategies in the middle of a funding effort to go from a public to a private, or from a private to a public, offering. Briefly stated, the problem for an issuer that has tried to do a public offering and was either unsuccessful or now perceives a greater benefit from a private placement is that the public offering will be considered to be public advertising or solicitation for the private placement, thus making the private placement exemption unavailable. In the view of the SEC, this problem occurs from the moment that the issuer files a registration statement relating to the public offering, even if no active solicitation of investors occurred.

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[7] In a further draconian twist, the SEC takes the position that a failed private placement that is immediately converted into a public offering violates a public offering rule that prohibits oral or written offers before the registration statement is filed.

[8] An individual is an accredited investor if (1) his or her net worth exceeds $1 million, (2) his or her income exceeded $200,000 in each of the last two years, or (3) his or her joint income with spouse exceeded $300,000 in each of the last two years.

[9] It is also not uncommon for relatively small amounts of seed capital to be raised from friends and family at the very initial stages of a business. These investments also generally qualify under a private placement exemption, if properly conducted.

Similarly, an issuer that has been trying to do a private placement but decides to do a public offering runs into problems because any offers made to prospective investors in the private placement will be considered offers of the publicly offered securities prior to filing a registration statement, in violation of rules prohibiting such offers.

In general, the SEC addresses both issues by regulations that prescribe a lapse period in which the issuer may not offer or sell securities, the observance of which separates the two offerings. It may also be possible to avoid the connection between the two offerings by offering a radically different form of security or otherwise making material changes in the opportunity offered (see Section IV.D below). Issuers should be aware, however, that a decision to switch from one format to the other may impose a significant delay in their financing arrangements.

D. A Brief Introduction to Integration. As noted above, offers and sales of securities may be exempt from registration if the nature and manner of the offering meet certain requirements. To determine whether the requirements have been met, it is necessary to define the "offering" that is required to meet the applicable requirement. Offers of securities deemed to constitute a single offering for this purpose are said to be "integrated."

There may be no area of securities law that gets as metaphysical as integration analysis. Obviously, a single entity offering stock to a number of investors at a given time is engaged in a single offering. However, a question arises if an issuer is simultaneously offering stock to investors as a capital raising project and to employees on exercise of options that are a part of the issuer's compensation program. Similarly, if a company is doing a public equity offering at the same time that it is restructuring its securitized debt arrangements with institutional lenders, an integration question is raised. In a somewhat different way, if a number of related entities are simultaneously raising capital for a common project, an integration analysis is required.

The SEC has adopted regulations that specifically cause offerings made in certain conditions not to be integrated. For example, offerings separated by a specified lapse of time in which the issuer does not make similar offers or sales are nonintegrated by regulation. Where no such specific regulation applies, however, an analysis of the underlying issues is unavoidable and the outcome is often uncertain.

E. Structures Available to Issuers with Publicly Traded Securities. Issuers that have established public trading markets in their securities have the benefit of relatively easy access to public capital markets for future offerings. However, for all but the largest public companies, a private placement may often be faster and cheaper than a public offering. The downside, however, is that the restrictions on resale that result from a private placement reduces the value of the security to the investor and may limit the kind of investors that can invest in it.

To address these issues, various investment banks offer private sales of securities that are quickly registered for resale by the investor, thereby making them liquid in the hands of the investor. These transactions, known as "PIPE" have, at least theoretically, the advantage of allowing an issuer to arrange a quick financing at a price more closely resembling the price the issuer could expect in a public offering.

As discussed above, the SEC has crafted rules imposing restrictions on resale to prevent an issuer from using private placements as a mere conduit to the public. If, however, the resale happens in a registered public offering, some of the SEC's concerns are alleviated because the public investors get the protection of registration as they would if the offering had been public in the first place. Accordingly, subject to certain timing restrictions, the SEC permits registration of the securities immediately following the private placement and the resale of the securities once the registration statement becomes effective.

While the theory remains valid, a number of issues have arisen in practice. For example, investors in PIPE transactions still require a discount to market because of the short-term restriction on resale, and the discount may be unpopular with the issuer's existing investors.[10] More troubling, to both the SEC and the existing investors, it is widely believed that some PIPE investors are earning a very significant short-term profit without being at risk by arranging short sales or comparable arrangements in advance of the PIPE offering that they cover with the securities purchased in the PIPE offering. The short sales themselves drive down the price of the security in advance of pricing, thereby increasing the effective discount while the investment risk is eliminated by the fact that the investor zeros out its position in the security at purchase.

These concerns have caused PIPE transactions to come under some suspicion with both stockholders and regulators. The structure remains valid and viable but should be considered only in light of the potential market and regulatory concerns.

V. Sales by Holders of Restricted Securities and Affiliates. Affiliates of an issuer are defined as people or entities that control, are controlled by, or are under common control with the issuer. In general, affiliates include senior management and large stockholders of the issuer as well as parent, subsidiary, or other related entities.

As noted above, normal sales by persons other than the issuer of a security and holders of restricted securities are exempt from registration without any meaningful precondition. Sales by affiliates of the issuer are also subject to restriction and can be resold only upon satisfaction of certain conditions.[11]

Resales of Restricted Securities. Certificates representing restricted securities normally contain a legend indicating that the securities may not be resold except pursuant to registration or an applicable exemption. In a sense, the legend states the obvious, since all sales of securities are subject to that restriction. The legend reinforces this requirement and also usually indicates that the issuer will not recognize or assist with any sale that does not meet this requirement to its satisfaction.

As described above, restricted securities can be resold pursuant to registration as soon as the registration statement is effective. If no effective registration statement exists for restricted securities, an exemption will be required. By far the most commonly used exemption for resales of restricted securities exists under Rule 144, which generally permits such resales (1) after a period of time in which the reseller has held the securities, if certain conditions are met, or (2) without condition after a longer period, as long as the reseller is not an affiliate. The conditions, if applicable, relate to the manner in which the securities are sold, the number of securities sold in relation to either the number of publicly traded securities or the trading volume, the need to file a report with respect to the sale with the SEC, and the need for publicly available information about the issuer. For most sellers, meeting the conditions is not onerous except that doing so takes time and also takes the sale out of the trading routine under which unrestricted securities are normally sold.

Once the restricted securities can be resold without condition, it is customary for the holder of the certificates to apply to the issuer to have new certificates issued without the legend, which no longer applies and the existence of which can delay and complicate a trade, even when an ordinary trade is permissible.

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[10] Similar mechanics also commonly affect the market for securities following the announcement of a public offering, so the effective discount may be unavoidable and the decision to do a public offering or a PIPE may be a balancing test.

[11] These restrictions apply only to sales to which U.S. securities laws are generally applicable. Sales that take place entirely outside the United States may not be subject to limitation under U.S. securities laws.

Resales by Affiliates. Affiliates reselling restricted securities are subject to all of the restrictions applicable to those securities in the same way that the restrictions apply to nonaffiliates. In addition, affiliates must continue to meet all of the conditions applicable to resales under Rule 144, without time limit.[12] Affiliates selling unrestricted securities (for example, securities that they purchased in the open market or in a public offering) may do so at any time, subject to the applicable conditions.

Institutional Trading in Restricted Securities. The limitations on resales of restricted securities do not apply to transactions entirely among qualified institutional buyers ("QIBs"). QIBs are generally very large financial institutions, such as banks and insurance companies, that the SEC has determined not to be in need of the protection afforded to less sophisticated investors under the securities laws. QIBs may freely trade restricted securities among themselves, and there are markets set up that facilitate such trading. The markets are, of course, restricted to QIBs.

Private Resales of Restricted Securities. As written, the private placement exemptions apply to sales of securities by their issuers, and there exists no express rule under which an investor can resell restricted securities by limiting the offer and sale of the securities in the same manner that the issuer would limit such offers and sales if it were making the offer under a private placement exemption. Nevertheless, it is generally accepted that the resale of a restricted security is exempt if it is made under circumstances in which the sale would have been exempt as a private placement if made by the issuer. The analysis supporting this theory is excessively convoluted, but the principle is well established.

Insider Trading Considerations. As noted above, compliance with registration or exemption requirements does not relieve any participant in a securities sale from the obligation to make adequate and timely disclosure of material nonpublic information. This consideration is a particular issue for resales by affiliates, which may regularly be in possession of material inside information and, even if they are not, may be assumed to be in possession of such information. To avoid either the reality or the appearance of a problem in this area, affiliates are well advised to consider carefully the timing of any sales of securities. In general, it is best to make such sales in the period closely following the release by the issuer of a periodic report on its condition. A number of issuers address this issue by creating policies (either mandatory or advisory) that discourage or prohibit trading except during periods in which such trading is least likely to pose a problem. The fact that any particular trade occurs in compliance with these policies does not ensure that there is no insider trading problem, and any and all such trades should be evaluated with the issue in mind.

The burdens that these considerations impose on affiliates can be alleviated, at least for the purpose of permitting affiliates to engage in a regular program under which they dispose of securities, by adopting a plan under which the securities are automatically sold at certain times and under certain conditions. An affiliate that adopts such a plan is deemed to have material nonpublic information only if it had the information at the time the plan was adopted. The affiliate's knowledge on the date of any particular sale is not relevant. Of course the plan must provide (subject to some general ability to make amendments to the plan from time to time) for the automatic execution of the sales.

VI. Securities Regulations Applicable to Non-U.S. Companies Raising Capital in the United States. U.S. securities laws and regulations impose substantial regulatory compliance obligations on U.S. issuers. This

[12] This restriction also applies to persons who, at the time of the resale, had recently been affiliates.

section explains under what circumstances non-U.S. issuers that raise capital in the United States will be subject to U.S. securities regulations, and provides an overview of the laws and regulations applicable to non-U.S. issuers.

In most circumstances, a non-U.S. issuer that offers and sells securities in the United States will be subject to the same offering requirements under the Securities Act of 1933 (the "Securities Act") as is a domestic U.S. issuer. As described above, federal and state securities laws have two principal components relating to securities offerings: (1) registration requirements and (2) full disclosure provisions. Non-U.S. issuers cannot legally offer or sell securities to U.S. residents without first filing a registration statement with the SEC or complying with a statutory exemption from federal and state registration, if an exemption is available.[13] Absent an available exemption at the federal and state levels, if a non-U.S. issuer fails to file a registration statement when legally required, the SEC and applicable state-level securities administrators may bring enforcement actions against the foreign issuer, and the foreign issuer may be subject to civil lawsuits by subscribers who purchased securities in the offering.

Foreign issuers that offer or sell securities to U.S. residents also are subject to the second requirement, the antifraud provisions of federal law and state laws (collectively, the "Antifraud Provisions"). The Antifraud Provisions essentially require full and accurate disclosure of all material information about a securities offering. Specifically, the Antifraud Provisions make it unlawful for any person in connection with the sale of any security to make any untrue statement of a material fact or to omit a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.[14] Thus, in a typical offering, even if the offering is exempt from registration under federal and state securities laws, the foreign issuer prepares and distributes to prospective purchasers an offering memorandum disclosing all material facts about the issuer and the offering in order to comply with the Antifraud Provisions. A current and detailed disclosure document (comparable to an offering memorandum or prospectus) would include a description of the business conducted by the issuer and the securities being offered, audited financial statements of the issuer, and risk factors relating to the issuer and the securities being offered. If a foreign issuer offers and sells only to accredited investors and avails itself of the safe harbor exemption provided by Rule 506 under Regulation D, the prospectus requirements may be less fulsome than otherwise would be the case.

Foreign issuers that sell securities to U.S. residents and are not able to avail themselves of an exemption from registration are required to file a registration statement with the SEC in connection with an offering. The nature of the registration statement and the extent of the detail required therein is described below and will depend on the extent of the contacts of the foreign issuer with the United States.

In addition to the registration requirements of the Securities Act and state-level registration requirements that apply to the offer and sale of securities, Exchange Act section 12(g) requires an issuer to file an Exchange Act registration statement regarding a class of equity securities within 120 days of the last day of its fiscal year if the number of its record holders is 500 or greater and its total assets exceed $10 million. A foreign issuer that has not conducted a registered public offering in the United States nevertheless may accrue 500 holders in the United States either by having made successive offerings into the United States that are exempt from registration or by U.S. residents having made open-market purchases of the securities of the foreign issuer on exchanges located

[13] Securities Act § 5.

[14] Exchange Act § 10(b) and Rule 10b-5 thereunder; Securities Act § 11.

outside of the United States. As we describe below, the U.S. securities laws provide some foreign issuers with exemptions from the Exchange Act registration requirements.

A. Foreign Private Issuers. Foreign issuers with no shareholders in the United States and no contacts with the United States are not subject to U.S. securities laws and regulations. Conversely, foreign issuers may have enough shares held by U.S. residents and sufficient business contacts with the United States to be deemed by the SEC to be U.S. domestic issuers.[15] These foreign issuers are subject to the same regulations as domestic U.S. issuers. Between these two extremes, the SEC provides regulatory accommodations to non-U.S. companies with shareholders in the United States that it deems to be "foreign private issuers" because the number of shares held by U.S. holders is beneath a regulatory threshold and the foreign issuer's contacts with the United States also fall below a regulatory threshold.

The SEC has in several areas recognized that requirements that it imposes on domestic issuers would be unduly burdensome if imposed on foreign issuers with minimal contacts to the United States, either because of practical impediments to compliance or because of significant conflicts between the regulation and cultural or business practices in the country of origin. In these areas, where the SEC has determined that it can do so while maintaining the substantive requirements for shareholder and market information, it has adopted exemptive rules or alternative compliance requirements available only to foreign companies. To avoid the use of these provisions by substantially domestic companies that happen to have foreign incorporation, the SEC has adopted a definition of a "foreign private issuer."

Importantly, an issuer's status as a foreign private issuer may change with developments in its corporate operations. In such circumstances, the benefits of being a foreign private issuer are promptly suspended. Losing foreign private issuer status unexpectedly will pose very serious regulatory challenges for a foreign issuer. Companies should be well aware of the criteria to qualify as a foreign private issuer and should avoid losing that status unintentionally through mergers, acquisitions, securities issuances, project finance, or other operations.

1. The Foreign Private Issuer Test. Exchange Act Rule 3b-4(c) defines a foreign private issuer as

> any foreign issuer other than a foreign government except an issuer meeting the following conditions as of the last business day of its most recently completed second fiscal quarter: (1) More than 50 percent of the outstanding voting securities are directly or indirectly held of record either by residents of the United States; and (2) any of the following: (i) The majority of the executive officers or directors are United States citizens or residents, (ii) more than 50 percent of the assets of the issuer are located in the United States, or (iii) the business of the issuer is administered principally in the United States.

One part of the definition is based on the company's level of U.S. shareholdings and the other on its business contacts with the United States. A non-U.S. company may have to analyze both parts of the definition in order to determine whether it is a foreign private issuer. When calculating record ownership, an issuer must "look through" the record ownership of brokers, dealers, banks, or other nominees that hold securities for the account of their customers, and determine the residency of those customers. To apply this test, the company must "look

[15] *See* Release No. 33-6433 (Oct. 28, 1982).

through" record ownership in a maximum of three jurisdictions: the United States, the company's home country (*i.e.,* the country in which it is incorporated or organized), and the jurisdiction where its primary trading market is located, if that is different from its home country. The response to these inquiries may produce additional layers of nominees, and the inquiry should continue with those nominees.

2. **SEC Regulatory Accommodations Given to Foreign Private Issuers.** As more fully described above, the Exchange Act imposes substantial reporting and other burdens on companies having a class of securities registered under the Exchange Act. Some of the regulatory burdens imposed on companies with securities registered under the Exchange Act would be difficult to apply to foreign companies, either because the regulations would conflict with similar regulations of the company's jurisdiction of incorporation or because their enforcement would involve the United States in the inappropriate regulation of activity outside the United States.

a. **Rule 12g3-2 Exemption of Foreign Issuer Equity Securities.** To reduce the registration burden upon foreign private issuers with limited U.S. nexus, the SEC adopted Rule 12g3-2 establishing two exemptions from the section 12(g) registration requirement.

The first exemption, under Rule 12g3-2(a), exempts a foreign private issuer whose equity securities are held of record by less than 300 U.S. residents, although it has 500 or more record holders on a worldwide basis. A foreign private issuer that relies on this exemption must reassess the number of its U.S. security holders at the end of each fiscal year in order to determine whether the exemption remains valid.

The second exemption, under Rule 12g3-2(b), focuses on investor access to material information provided to the SEC by the foreign private issuer and is available regardless of the number of its U.S. security holders.

All foreign private issuers that meet these requirements immediately are exempt from Exchange Act registration without having to apply to or notify the SEC concerning the exemption. To remain eligible for this exemption (in addition to maintaining its foreign listing, continuing to meet its trading volume requirement, and not incurring Exchange Act reporting obligations), a foreign private issuer must continue to electronically publish material non-U.S. disclosure documents in English for subsequent fiscal years promptly after the information has been made public.

b. **Exemption from Exchange Act Sections 14 and 16 for Foreign Private Issuers.** The Exchange Act provides that securities registered by a foreign private issuer are exempt from sections 14(a), 14(b), 14(c), 14(f), and 16 of the Exchange Act. The section 14 provisions listed above impose filing and informational requirements on public companies in connection with the solicitation of proxies, the holding of annual or other meetings of the shareholders, or certain changes in the composition of the board of directors. Section 16 (1) requires officers, directors, and holders of more than 10 percent of a class of equity securities registered under the Exchange Act to file regular reports with respect to their ownership of such securities; (2) imposes penalties on such persons if they engage in certain trading practices including both sales and purchases of such securities within a six-month period; and (3) prohibits short sales of such securities by such persons.

c. **Special Disclosure Rules for Foreign Private Issuers.** A traditional impediment to foreign companies' access to U.S. public capital markets had been the very specific requirements for disclosure imposed by the SEC on domestic public companies. Many foreign companies have found these requirements to be burdensome or prohibitive. One problem was that financial information was often required to be presented in a format that the foreign company did not ordinarily generate and could not generate without substantial effort and expense. Another was that detailed disclosure of certain information about officers,

directors, and shareholders, in particular information relating to compensation, violated standards of individual privacy commonly accepted in many foreign countries.

To address these concerns, the SEC has adopted alternative disclosure forms under both the Securities Act and the Exchange Act that are available only to foreign private issuers and that allow for reduced or modified disclosure. For registrations under the Securities Act, the SEC has provided Forms F-1 and F-3 as alternatives to Forms S-1and S-3, respectively. For both registration applications and annual reports under the Exchange Act, the SEC has provided Form 20-F as an alternative to Form 10 and Form 10-K.

The principal differences between the special forms and their domestic counterparts involve financial statements and compensation. The SEC allows foreign private issuers to use financial statements prepared in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board, without reconciliation to U.S. generally accepted accounting principles ("U.S. GAAP").[16]

Unless the company makes more detailed information available to its shareholders or the public (in which case such information must also be presented), officer and director compensation information may be presented in substantially less detail than is required of domestic companies.

Quarterly and other nonannual reporting under the Exchange Act is even less burdensome for foreign private issuers. Quarterly reports on Form 10-Q and episodic reports on Form 8-K are not required. In lieu thereof, a foreign private issuer is required to file, under Form 6-K,11 information that it (1) makes or is required to make public pursuant to the law of the jurisdiction of its domicile, (2) files or is required to file with an exchange on which its securities are traded and that is made public by the exchange, or (3) distributes or is required to distribute to its shareholders.

d. Other Accommodations. In addition to the foregoing accommodations, the following is a list of other significant regulatory accommodations the SEC grants to foreign private issuers.

- No "short-swing" trading liability is imposed on insiders who purchase and sell securities within a six-month period.
- Foreign private issuers are not subject to the SEC's prohibition on selective disclosure of material information (Regulation FD).
- Fewer restrictions exist on offers and sales of securities outside the United States for companies relying on the SEC's Regulation S "safe harbor" from the U.S. registration requirements.

Other provisions of the Exchange Act are applicable to foreign private issuers as well as domestic companies. In particular, section 13, which regulates tender offers by an issuer for its own stock and requires reports of persons who acquire more than 5 percent of a class of registered securities, and Sections 14(d) and (e), which regulate tender offers for registered securities by persons other than the issuer, apply to both domestic companies and foreign private issuers.

[16] Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Securities Act Release No. 33-8879, Exchange Act Release No. 34-57026 (Dec. 21, 2007).

3. **Losing Foreign Private Issuer Status.** When a foreign issuer ceases to qualify as a foreign private issuer, the consequences are immediate. Among other things, the issuer's communications are subject immediately to the selective disclosure prohibitions of Regulation FD. Insiders must file reports of beneficial ownership within 10 days after the issuer's determination that it no longer is a foreign private issuer. The issuer's first quarterly report on Form 10-Q will be due 45 days after the end of its current fiscal quarter. The issuer must report its financial statements in U.S. dollars and apply U.S. GAAP in preparing those statements. Companies planning to offer securities in their home market, or anywhere else outside the United States, without U.S. registration will have to comply with the more restrictive requirements of Regulation S that apply to U.S. companies (described below).

The SEC has indicated that a company should assess its foreign private issuer status on the last day of each of its fiscal quarters and upon completion of the following events:

- Any purchase or sale by the issuer of its equity securities (other than in connection with an employee benefit plan or compensation arrangement, a conversion of outstanding convertible securities, or an exercise of outstanding options, warrants, or rights);
- Any purchase or sale of assets by the issuer other than in the ordinary course of business; and
- Any purchase of equity securities of the issuer in a public tender or exchange offer by a person unaffiliated with the issuer.

An issuer must determine its eligibility to use an SEC form restricted to use by foreign private issuers at the time it files the form. If its status changes after filing, the company does not have to withdraw its previous filing and refile on a different form. If the company files a Form F-3 registration statement for a "shelf" offering and later ceases to be a foreign private issuer, it may continue to make "take downs" from the shelf that only require filing a prospectus supplement.

a. **Being Prepared.** If an issuer believes that it will cease to be a foreign private issuer, it should have a plan to comply with enhanced reporting requirements. Preparation may include:

- Notifying insiders that their sales and purchases of securities may subject them to "short-swing" trading liability and the obligation to report beneficial ownership under section 16 of the Exchange Act;
- Preparing to file condensed, consolidated financial statements for quarterly reports using U.S. GAAP (including applicable subsidiaries);
- Converting to a U.S. dollar reporting; and
- Developing policies governing corporate communications with shareholders and market professionals.

B. **Canadian Issuers: Multijurisdictional Disclosure System.** The U.S. securities laws offer certain accommodations to Canadian issuers under the U.S. Multijurisdictional Disclosure System (the "MJDS"). The MJDS accommodations are in addition to the foreign private issuer accommodations, and all Canadian issuers that qualify as foreign private issuers remain eligible to use the foreign private issuer disclosure system. Canadian

issuers that use the MJDS remain subject to U.S. civil liability and the Antifraud Provisions, and financial statements for certain MJDS offerings must be reconciled to U.S. GAAP.

MJDS permits qualified issuers chartered in Canada to offer debt and equity securities, file continuous disclosure information, and register exchange offers and business combinations in the United States by filing with the SEC and distributing to U.S. investors disclosure documents prepared and reviewed under Canadian law. "Substantial" Canadian issuers, whose performance can be followed through publicly available information, are able to access the U.S. capital markets and comply with their U.S. registration and reporting obligations by filing Canadian-prepared disclosure documents with the SEC under cover of an MJDS form. The MJDS also permits qualified Canadian issuers to use Canadian disclosure documents to meet the SEC's tender offer requirements. The MJDS introduced Forms F-7, F-8, F-9, F-10, and F-80 to assist Canadian issuers when registering under the Securities Act; Form 40-F to facilitate registration and reporting for Canadian issuers under the Exchange Act; and Schedules 13E-4F, 14D-1F, and 14D-9F to simplify tender offer filings for Canadian issuers under the Exchange Act.

VII. Regulation S: Raising Capital Offshore. Regulation S promulgated under the Securities Act provides that any offer or sale of securities that occurs within the United States is subject to the registration requirements of section 5 of the Securities Act, and that any offer or sale of securities that occurs outside the United States is not. Regulation S offers two safe harbors when determining whether an offer and sale is made outside of the United States. The first safe harbor applies to offers and sales by the issuer, securities professionals involved in the distribution process by contract, their respective affiliates, and persons acting on behalf of any of them. The second safe harbor applies to resales by persons other than the issuer, securities professionals involved in the distribution process by contract, their respective affiliates (except certain officers and directors), and persons acting on behalf of any of them. Regulation S applies to issuers differently based on the issuer's nexus to the United States.

Both safe harbors have two general conditions. First, the offer or sale of securities must be made in an "offshore transaction." For a domestic U.S. issuer that is not publicly traded, this requires that (1) no "offer" may be made to any person physically located in the United States, and (2) each purchaser of securities must be outside the United States at the time of the decision to purchase the security. The second general condition is that no "directed selling efforts" be made in the United States that would condition the U.S. market and encourage people to attempt to participate in the offering offshore. Securities sold offshore by U.S. issuers, affiliates, and distribution participants pursuant to Regulation S are treated as "restricted securities" within the meaning of Rule 144 (see above) and continue to remain "restricted securities" notwithstanding that they are resold outside the United States pursuant to Regulation S.

If an issuer attempts compliance with any rule in Regulation S, that does not constitute an exclusive election. A person who offers or sells securities in reliance on Regulation S may also rely on any other applicable exemption from registration. The failure to meet the terms of either safe harbor does not create a presumption that the transaction is subject to section 5. Therefore, some issuers may seek to avail themselves of both Regulation S and the exemption granted by section 4(2) of the Securities Act.