

Defining Foreign Private Issuers: Are You a Wizard or a Muggle?

Companies defined as “foreign private issuers” enjoy a number of important advantages under special SEC rules and accommodations.

Key Points:

- A company must pass one of two tests to qualify as an FPI.
- Companies have some flexibility when assessing many of the elements related to FPI status; however, they should use a consistent approach.

Introduction

The world of Harry Potter is divided into wizards and muggles, those who can work magic, and those who (sadly) cannot. In the world of US federal securities laws, the division between domestic US companies and foreign private issuers, or FPIs, is just as important. While FPIs don't have magical powers — at least that we know of — FPIs do enjoy some very important advantages under special rules and accommodations established by the US Securities and Exchange Commission (SEC).

How do you know if you are a foreign private issuer?

A company must pass one of the following tests to qualify as an FPI, based on SEC rules that provide the definition of “foreign private issuer.”¹

- **Test # 1:** The company is incorporated outside the United States **and** more than half of its voting securities are owned of record by non-US residents. Companies that meet these requirements automatically qualify as FPIs.
- **Test # 2:** The company is incorporated outside the United States, **but** fails Test # 1 — it can still qualify as an FPI if all three of the following factors are false:
 - The majority of the company's executive officers or directors are US citizens or residents.
 - More than 50% of its assets are located in the United States.
 - The company's business is administered principally in the United States

While these tests may seem straightforward at first glance, a variety of questions can arise on closer analysis, such as: “What is ownership of record?”, “How do you figure out where assets are located?” and “What does it mean to administer a business principally in the United States?”

This publication reflects recent (December 2016) SEC Staff interpretations relating to FPIs.² We aim to answer the most frequent real-life questions that come up in running the FPI tests, even when definitive guidance from the SEC is absent. A flowchart illustrating the core elements of the FPI definition appears at the end of this publication.

Companies have some flexibility when assessing many of the elements relating to FPI status. However, we strongly advise issuers to apply the various FPI tests consistently rather than switch approaches on a particular test to achieve a desired result.

Questions about voting securities

The first part of the FPI test relates to voting securities.

1. *What is a voting security anyway?*

In other contexts under the federal securities laws, a voting security means any security that entitles the owner to vote for the election of directors of a company. Voting securities generally do not include preferred securities that are entitled to vote for a limited number of directors if the securities are in default, unless they are, in fact, in default and entitled to vote. For purposes of running the FPI test, the same approach should be used — that is, **include** all securities that are entitled to vote for directors and **exclude** those that aren't.

2. *If a company has multiple classes of voting securities (such as a small number of Class A shares with super voting rights that are held by founders and a large number of Class B shares with low voting rights that are held by the public), do the ones with super voting rights get super weight in the analysis?*

The SEC Staff has confirmed that an issuer may choose between the *absolute number* of voting securities held outside and inside the United States, or the *voting power* held outside and inside the United States.³ If non-US residents hold super voting shares (for example, founders shares), the company should run the FPI test based on voting power. On the other hand, if US residents hold super voting shares (for example, US private equity funds) and non-residents hold many low voting shares, the company should run the FPI test based on the absolute number of voting securities.

3. *How does a company deal with shares that are held in "street name" through brokers or held through nominees like DTC?*

In theory, companies must look through the record ownership of all brokers, dealers, banks and other nominees that hold securities on behalf of their customers and determine the residency of those customers. However, the SEC has provided helpful and practical advice to limit the scope of the search for US resident shareholders, as explained next in question 4.

4. *The company's shares are held around the world. Is a global search for the company's US resident shareholders necessary?*

No, the look-through analysis only has to be done in three jurisdictions: 1) the United States, 2) the company's jurisdiction of incorporation and, 3) if different, the jurisdiction of the company's primary trading market. For instance, a Dutch NV whose primary trading market is the London Stock Exchange would not need to look through intermediaries in Japan as part of a search for US resident shareholders, but would only need look at intermediaries in the Netherlands, the United Kingdom and the United States.

5. *How deep does this look through go?*

Having not provided definitive guidance, the SEC might respond with Irving Berlin's lyrics: "How deep is the ocean? How high is the sky?" However, the SEC has helpfully conceded that when information is not

available because a nominee does not provide it (for whatever reason) or imposes unreasonable charges, a company can assume that customer accounts are held in the nominee's principal place of business.⁴ This assumption should address situations when the look-through investigation hits a wall, unless a company is aware that a particular non-US nominee holds shares on behalf of a specific US resident investor.

6. Are shares underlying outstanding convertible and exchangeable securities and exercisable warrants counted as part of the calculation?

No, they are not counted in running the share-ownership test. The FPI test turns on record ownership of shares (subject to the look-through analysis discussed above) and not on concepts of beneficial ownership of shares (under which companies frequently need to take into account shares that underlie convertible and exchangeable securities and warrants).

7. When looking at individuals, who is a US resident?

Green Card holders are presumed to be US residents.⁵ With respect to non-Green Card holders, there is no clear standard in this area of the SEC's rules. Both the US tax code and US immigration laws have well-developed "residency" concepts, but the SEC Staff has refrained from applying those concepts to the FPI test. As a result, companies should establish a reasonable basis for determining the residency status of non-Green Card holders (tax residency, mailing address, physical presence, location of a significant portion of their financial and legal relationships, etc.) and apply that basis consistently.⁶ In a useful analogy under a rule in which residency in a particular US state must be assessed, the SEC has stated that the facts and circumstances of the situation will be used in judging an issuer's reasonable belief as to residency. In this context, the SEC has stated that an issuer may look at the home address of an individual, as evidenced by relevant documents, or by reliable public or private databases such as credit bureaus.⁷

8. When looking at entities, what is a US resident?

The SEC has not given guidance under the FPI definition, and has adopted varying approaches under other residency-based rules:

- Under Regulation S relating to sales of securities outside the United States, SEC rules clearly indicate that, for the purpose of determining whether a corporation or other entity is a US person, a company should look to the jurisdiction of incorporation or formation without focusing, for example, on the corporation's principal place of business.
- However, under Rules 147 and 147A under the Securities Act relating to sales of securities in a specific US state, SEC rules are equally explicit that companies should look to an entity's principal place of business, and not its jurisdiction of incorporation, for the purpose of determining whether the entity is resident in that state.

In light of this inconsistency, FPIs would appear free to adopt either of the above approaches, or another reasonable approach, in assessing residency of shareholders that are entities, as long as that approach is documented and applied consistently to all similarly situated shareholders.

9. How should companies deal with American Depositary Receipts?

For this purpose, the ADR depository bank (or more likely its custodian) is treated like any other nominee. That is, companies must look through the record ownership of the ADR depository bank and determine the residency of holders of ADRs. The depository bank should be able to provide assistance in this process.

Questions about directors and officers

One prong of the FPI test focuses on directors and executive officers.

10. How do companies apply this test?

There are, in effect, four tests, which must each be run separately:

- Board of Directors — (a) Are a majority of the directors US citizens? (b) Are a majority of the directors US residents?
- Executive officers — (c) Are a majority of executive officers US citizens? (d) Are a majority of executive officers US residents?

11. What if the company has a two-tier board structure?

With this structure, which is typical of German and Dutch corporations, a company should determine which board performs the functions of a US-style board and run the tests using the members of that board.⁸ (This would typically be the supervisory board rather than the management board in the case of German and Dutch corporations.) If those responsibilities are split between the two boards, then the company should run the tests on a fully combined basis.

12. If some of the company's directors have super voting rights or veto rights, do they get super weight in this test?

There is no basis for this type of treatment. All individuals count as one.

13. Which corporate employees are deemed to be executive officers?

The title “executive officer” is common in US business circles and a specific term of art under the SEC’s rules referring to members of senior management with major management responsibilities or policy-making functions.⁹ But the title is not so typical outside the United States, as evidenced by the fact that the SEC’s main disclosure form for FPIs largely avoids the term and refers instead to members of the company’s administrative, supervisory or management bodies. For purposes of the FPI test, companies should select those senior individuals whose responsibilities come closest to the US concept of “executive officer” and apply that standard consistently.

14. Can a company stack its board with non-US residents and citizens in order to qualify as an FPI?

The rule includes no prohibition that prevents an issuer from structuring its board as it deems appropriate. Nonetheless, both the SEC and private parties have brought litigation relating to whether a company qualifies as an FPI and courts may not look favorably on such a practice.

15. If a company has an even number of directors or executive officers and they are evenly split as to their US citizenship or residency, at exactly 50%, what should it do?

The FPI test turns on having a **majority** who are US citizens or residents, which means more than 50%. If a company is at 50%, it does not have a majority of directors or executive officers who are US citizens or residents, and therefore does not fail this part of the FPI test. The company could consider adding one director or executive officer who is not a US citizen and resident in case of unanticipated resignations or other changes in personnel.

16. How should companies deal with individuals who are dual US citizens?

The FPI definition does not ask whether an individual is a citizen of another country, but rather a citizen of the United States. So for this purpose, an individual who holds dual citizenship in the United States and another foreign country is treated as a US citizen.

Questions about where assets are

Another part of the FPI test looks at the location of a company's assets.

17. How should a company measure assets to determine whether a majority are located in the United States?

Companies can rely on the geographic segment information under US GAAP, IFRS (US GAAP's international counterpart), or home country GAAP for this test.¹⁰ A company does not need to go beyond US GAAP, IFRS or home country GAAP if accounting segment information indicates that a majority of its assets are outside the United States.

18. Are there other ways to measure assets?

Yes. Applying the basic accounting principles under US GAAP, IFRS or home country GAAP may not be entirely satisfactory because those accounting standards may not take into account all of an issuer's assets. Moreover, tangible assets physically located in one country may be easy to identify as being located in that country, but intangible assets, such as intellectual property and goodwill, are not so easy to locate. Companies should develop and document a reasonable methodology for valuing and assessing the location of their assets, and implement a control environment with respect to that methodology, to support determinations if questions arise under this test.

Questions about where a business is principally administered

The last part of the FPI test turns on this unique phrase.

19. Is this simply a question of where the company's HQ office is located?

A better question is whether a geographically dispersed corporation with various decision-makers located in several (and perhaps varying) locations can be said to have an HQ office. No single factor nor group of factors will be determinative. An issuer should assess on a consolidated basis the location from which its officers direct, control and coordinate its aggregate activities.¹¹

20. Does it matter if the company's annual meeting is held in the United States?

No, barring very unusual circumstances.¹²

21. What about holding board meetings in the US?

Same answer. The test is based on where the officers primarily direct, control and coordinate the issuer's overall business.¹³

22. What if the company's CEO has a company-provided apartment in New York City?

If the apartment is particularly nice, and especially if it has dramatic views, the CEO should regularly permit the company's general counsel and outside counsel to use the apartment on weekends to conduct diligence that corporate US activities do not run afoul of the FPI test.

Other questions

23. How often does a company need to test its FPI status?

Generally speaking, and thankfully, the SEC's rules only require an FPI status check once a year, on the last day of a company's second fiscal quarter (*i.e.*, June 30 for companies with a December 31 fiscal year end). If a company is planning to file a registration statement with the SEC to sell or list securities, the company needs to test within 30 days of initial filing.

24. Should a company monitor its FPI status more than that?

Absolutely, unless a company is very sure of its FPI status (for instance, if it has large and known shareholders outside the United States or definitively passes all of the other tests). To avoid being surprised, many FPIs monitor their shareholder base on at least a quarterly basis and keep regular tabs on the other FPI determinants. Companies may want to include the FPI assessment as part of their ongoing disclosure controls and procedures.

25. What if the company's status changes?

Presumably, if this happens, a company will discover it sometime during the third fiscal quarter (or maybe even during the fourth fiscal quarter). As a result, the company will have a short transition window because it must comply with all of the rules applicable to US companies with effect from the first day of the next fiscal year (*i.e.*, January 1 for companies with a December 31 fiscal year end). For FPIs that are registered with the SEC some of the more significant changes would include: (1) filing quarterly reports, current reports on Form 8-K generally within four days after specific events, and stock ownership reports by all directors, executive officers and 10% shareholders; and (2) preparing US GAAP and US dollar financial statements, and US-style proxy statements and processes, including acceptance of shareholder proposals. Numerous other accommodations that would not be available upon a change in status should be addressed, including significant accommodations for FPIs that are not registered with the SEC.

26. Is the SEC likely to challenge a company's analysis?

The SEC Staff regularly asks registrants, especially in IPO situations, to provide information the company used to determine that it is an FPI and therefore entitled to use the FPI forms and accommodations. The Staff is more likely to ask when filed documents contain disclosure, or other information is publicly available (such as through internet search engines or social media sites) that raises questions from the Staff's point of view. Such situations could occur when, for example, there appears to be a large percentage of shares held by US investors or significant operations in the United States, or several directors or officers appear to be US citizens or residents.

27. If challenged, what should a company do?

Companies should be prepared to respond to the SEC Staff with factual information to demonstrate that: (1) the company has implemented controls and procedures designed to assess the various elements of the FPI definition, (2) these controls and procedures are reasonable to gather the relevant information, and (3) the information obtained allowed the company to form a reasonable conclusion as to its FPI status. A company's response should be as specific and fact-filled as possible in order to allow the Staff to come to its own conclusion that the process and determination as to FPI status are reasonable.

28. Can a company request any guidance from the SEC Staff at the planning and structuring stages of a proposed transaction?

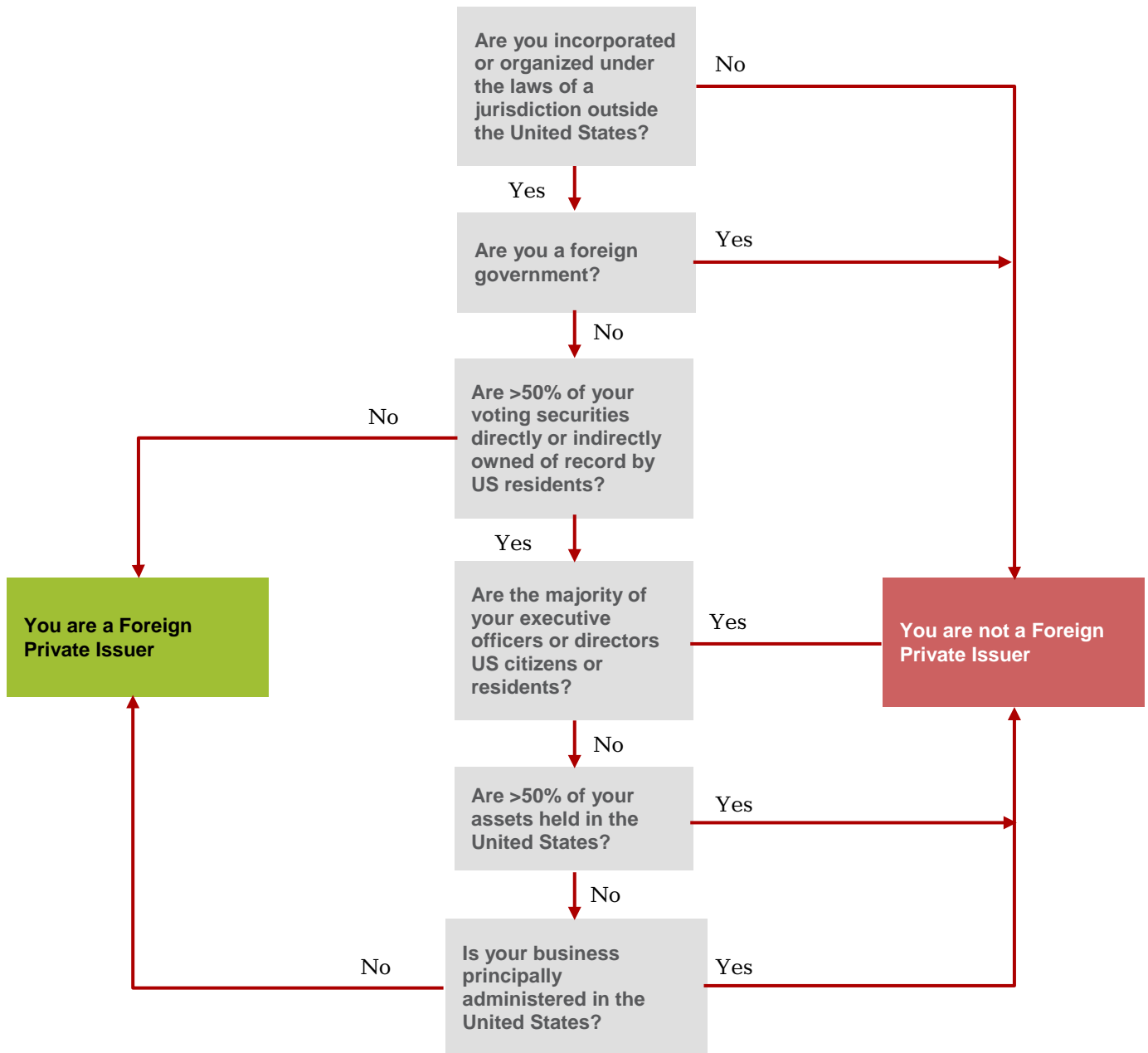
Companies should not expect any definitive guidance on a case-by-case basis. In December 2016, the SEC Staff published interpretations on various aspects of the FPI test, but historically the Staff has been reluctant to provide detailed guidance or "no-action letters" relating to FPI status. As a result, careful

consultation with a law firm that is well acquainted with both the law and the lore underlying the FPI definition is essential.

29. *Can a US corporation ever be an FPI?*

No, never.

Are You a Foreign Private Issuer?



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Endnotes

¹ Securities Act Rule 405; Exchange Act Rule 3b-4.

² Securities Act Rules Compliance and Disclosure Interpretations (C&DIs) [Securities Act CDIs], Questions 203.17-203.23 (December 8, 2016). See also Exchange Act Rules CDIs, Questions 276.01, 277.02-277.06 (December 8, 2016).

³ Securities Act CDIs, Question 203.17.

⁴ Instruction B to Foreign Private Issuer definition under Securities Act Rule 405 and Exchange Act Rule 3b-4. See also *International Disclosure Standards*, SEC Release No. 33-7745 (September 28, 1999) at Item II.E: "If after reasonable inquiry, however, the issuer is unable to obtain information about the nominee's customer accounts, including cases where the nominee's charge for supplying this information would be unreasonable, the issuer may rely on a presumption that the customer accounts are held in the nominee's principal place of business." Available at <https://www.sec.gov/rules/final/34-41936.htm>.

⁵ Securities Act CDIs, Question 203.17.

⁶ *Id.*

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- ⁷ *Exemptions to Facilitate Intrastate and Regional Securities Offerings*, SEC Release No. 33-10238 (October 26, 2016).
- ⁸ Securities Act CDIs, Question 203.20.
- ⁹ Securities Act Rule 405; Exchange Act Rule 3b-7.
- ¹⁰ Securities Act CDIs, Question 203.21.
- ¹¹ Securities Act CDIs, Question 203.22.
- ¹² Securities Act CDIs, Question 203.23.
- ¹³ *Id.*