

# Global IPO Guide

## LATHAM & WATKINS LLP

### 2019 EDITION

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**Initial public offering of: a sizeable number of ordinary shares**  
**Offer price per share: stated in local currency**

This is our global initial public offering guide. It will help you navigate the US portion of a global IPO – in other words, an IPO in which you sell locally listed ordinary shares to investors outside the United States under Regulation S, and to investors inside the United States in private transactions without registration with the US Securities and Exchange Commission. The US investors in global IPOs are usually large US institutional investors known as qualified institutional buyers, or QIBs, purchasing under Rule 144A or another exemption from the registration requirements of the Securities Act.

Prior to the offering, there will have been no US market for your ordinary shares, but we will help you understand what will be required of you from the US perspective. We want your global IPO to go off as quickly and as smoothly as possible, without any unpleasant surprises.

The underwriters are crucial players in conducting any successful offering. You and your counsel will be spending lots of quality time with them, their counsel, and your auditors.

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*Undertaking an IPO involves risks. See “Summary” beginning on page 1 to read about common pitfalls and how good advance planning and legal advice can help you avoid them.*

Depending on your jurisdiction, closing of your offering should occur anywhere from 90 days to one year after you say “go.”

No regulatory body in any jurisdiction has approved or disapproved of this guide, or passed upon the accuracy or adequacy of this guide, but we hope it will make the global offering process less mysterious and the goal of reaching a larger investor base more attainable.

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# THE LATHAM GLOBAL IPO GUIDE

## SUMMARY

*This Summary does not contain all of the information that you will need to successfully complete your global IPO. You really should read this entire guide as well as the other Latham & Watkins publications referred to in this guide if you want to get the full picture. Actually, you should just hire Latham & Watkins to act as your international counsel and then you will not need to read any of this stuff. However, if you want an advance copy of the playbook and are not yet ready to choose your counsel, you can read this Summary and get a pretty good sense of what to expect in the global IPO process. Because this guide covers many different jurisdictions, the specific requirements and timing can vary considerably.*

### **Our Mission**

We are among a select group of leading IPO law firms in the United States – having been the market leader in every year since 2010. In 2018, we helped US and foreign companies raise almost \$14.0 billion. Our mission in this guide is to arm you with a thorough overview of the US aspects of the global IPO process, including practical tips gleaned from our unparalleled experience in the trenches. This guide is different from any other guide you might come across, because we do more than just recite the rules – we share the secret sauce. We believe that our leadership position in the IPO market positions us to give you the practical advice you need to navigate the global IPO process successfully.

### **The Preliminary Checklist**

Even before the organizational meeting that kicks off the global IPO process, you will want to start grappling with a number of key issues. These include the following:

- *Which banks will be joint global coordinators and who will be your other underwriters?* You probably already have a relationship with potential underwriters, and you may be thinking of adding others to the syndicate. The joint global coordinators, or JGCs – the underwriters whose names are listed above the other banks on the prospectus cover – will take the lead for the IPO. The other underwriters listed on the prospectus cover page will also play an active role in the process.
- *Is the right audit team in place and are the auditors ready to go?* Your underwriters will require accountants' comfort letters covering the financial statements. Non-US companies with smaller local auditors sometimes find their existing auditors are not experienced in these matters or are not enthusiastic about the prospect of their audit being part of an offering document that goes to US investors. Some companies decide to switch to a larger international accounting firm or add one to the team in order to gain from the experience the larger firm has amassed. Obviously, these decisions have timing and cost implications.
- *Do you have the right international law firm in your corner?* A global IPO is a complex undertaking requiring the coordination and reconciliation of legal requirements across several jurisdictions. A strong, experienced international legal team can ensure that local and international counsel are working together, avoiding unpleasant surprises, and reducing the burden of the IPO drill on management. This is important because the management team will still be obligated to run the business during the time-consuming IPO process. As with your auditors, you will want to make sure you and your underwriters choose a law firm that is the right fit.

- *Are the financials ready for prime time?* Although your global IPO will not be registered with the SEC, your underwriters will want to use the SEC's financial statement requirements for US public IPOs as the starting point for defining the package of financial information that will go to investors. Topics such as financial statements for recent significant acquisitions, financial statements for certain significant subsidiaries, segment treatment, and the like can be time-consuming to address.
- *Do you have a communications plan in place?* US law imposes strict limitations on communications around a planned global IPO. These rules can cause significant friction, especially for companies that are used to being transparent and have active PR programs. On the other hand, violations of the SEC's communications restrictions – often called “gun jumping” – can cause an offering to be delayed for weeks or even months. You will need to ensure you have a plan in place to prevent unauthorized public statements during the public offering process.
- *Will there be cornerstone or anchor investors?* Investors who agree to buy in a concurrent offering (cornerstone investors) or those who agree in advance to buy a portion of the IPO (anchor investors) are a common feature of global IPOs in Asia. You will need to build in time to negotiate and document these arrangements.
- *Is quarterly data available?* Some underwriters will want to see selected quarterly data for the most recent eight quarters in your offering document. You will want to anticipate the need for quarterly data before the rules or the banks require it so that you can have it prepared and scrubbed by your accountants well before you need it.
- *Will there be any industry data?* You may need to commission industry reports, which can take time to compile and diligence.
- *Will forecasts be prepared for disclosure to investors?* Some jurisdictions require forecasts to be given to investors, which may require auditor sign-off.
- *Are you ready for life as a public company?* Will changes need to be made to ownership structures, shareholder agreements, employment arrangements, and the like? Will it be necessary to hire a treasurer, a general counsel, an investor relations officer, or other individuals with public company experience? Are you ready to start turning out financial statements on the timeline required of public companies? Will revisions be needed to bring executive compensation arrangements in line with public company practices and those of key public competitors? Do you have appropriate internal controls in place?

## The Global IPO Timeline

It is important to understand the “how to” aspects of going public so that you know what to expect over the next few months and can stay one step ahead of the issues. While the precise timeline will of course vary from jurisdiction to jurisdiction, here is an indicative list of the key milestones in a global IPO:

Day 1	7 – 14 Days	30 – 60 Days	30 – 60 Days	60 – 90 Days	61+ Days	Day T+1	Day T+2	Day T+3 – 12
Org Meeting	File Red Herring with Local Regulator	Update Offer Document	Respond to Comments from Local Regulator	Submit Offer Document to Local Regulator	Commence Road Show	Pricing Occurs	Trading Begins	Close IPO

There is simply no substitute for good preparation. First impressions are important, and you want (need) to know what is coming so you are ready when it arrives.

**The First Month.** Some of the most important decisions you will make during this process will be made right at the outset, even before the organizational meeting. These include selection of:

- Your JGCs
- Your local and international counsel
- Your auditors
- Any other third-party experts or consultants your jurisdiction might require, including industry consultants

The quality of the team you assemble will have a major impact on the rest of the process and, perhaps, the success of your global IPO. Take the time to get this part right. You will want to build a team of bankers, lawyers, and auditors who have experience with global IPOs and, ideally, with your industry. IPO issuers may even interview law firms to propose as counsel for their underwriters. (If there is going to be just one international counsel, they will represent the underwriters.) Experienced bankers, lawyers, and auditors will be more efficient with your time and get you to market when conditions are optimal. They are informed about, and will focus on, what matters to investors.

The organizational meeting is the official kickoff of the IPO process. It is attended by all of the professionals we mentioned above and most of the company's executive officers. However, you will not want to use the org meeting to start getting organized – you should begin that process well before the org meeting. Ideally, a month or so before the org meeting, you will have selected international counsel, identified the three or four most useful precedent global IPO filings by comparable companies (the “comps”), and started working to flesh out a rough draft of the offering document so that you are ahead of the curve by the time the org meeting arrives. It is never too soon to start discussing the content of the road show with your underwriters since the information in the road show should also be consistent with the offering document. If you start ahead of the curve, you can stay in control of the process from beginning to end. If you start behind, you will be on your heels for the duration.

The org meeting also marks the beginning of the legal, business, and accounting due diligence process. The underwriters will engage in a thorough due diligence exercise designed to provide a reasonable basis to believe that the offering document and the other offering materials such as the road show presentation are free of material misstatements and omissions. Underwriters take due diligence very seriously, for both liability and reputational reasons. The due diligence process starts with a detailed management presentation about the business (usually at the org meeting) and continues through all of the drafting sessions and right up to the closing.

In addition to meeting with management, the underwriters will frequently conduct site visits to the company's principal facilities and interview key customers and business partners. Counsel for underwriters will also conduct a comprehensive review of the company's business and operating plans, corporate records, material contracts, litigation, and intellectual property. The review will proceed more smoothly if the relevant documents are assembled in advance and made available in a physical or virtual data room. Finally, the underwriters will ask you to prepare a binder of evidence to support the accuracy of certain factual assertions in the offering document (such as market share, size of market opportunity, and recent industry awards). Compiling these materials can be a time-consuming process and will slow you down if left until the end.

**The Second Month.** Most of the second month will be spent working to finalize the disclosure in your offering document and helping the underwriters with their due diligence drill. The offering document contains financial and non-financial disclosure.

Here is a brief summary of the typical contents of an offering document in a global IPO:

- *The Box.* A summary of the information that is contained in the offering document will appear at the beginning of the offering document on pages that are marked with a box border (like this page), which is why the summary section is referred to as the summary box, or the “box.” In IPO drafting sessions, the working group will spend considerable time drafting the box since it is at the beginning of the offering document and sets out the issuer’s story and value proposition in a few easy-to-read pages. Typically, the summary box will include the following headings: Company, Industry, Competitive Strengths, Business Strategies, Risk Factors, Offering Summary, and Summary Financial Data.
- *MD&A/OFR.* The offering document will contain a “management’s discussion and analysis” section (sometimes called an “operating and financial review”), which discusses the issuer’s financial results and condition. The purpose of the MD&A is to provide investors with the information necessary to interpret the issuer’s operating results and financial condition through the eyes of management. It is the place where management explains the issuer’s financial statements to investors. A well-written MD&A will identify the key drivers of the issuer’s results of operations and focus on trends and uncertainties in the marketplace. It will explain the issuer’s business as management sees it, separately discussing each operating segment’s performance as well as the business as a whole. It will also identify and discuss the key performance indicators, or KPIs, that management uses to evaluate the performance and financial health of the business. Many MD&A sections include a general discussion of the issuer’s future plans and prospects under a subheading such as “Outlook.” Drafting the MD&A requires close coordination among the issuer’s financial team, its accountants, and counsel and can be a time-consuming exercise.
- *Business.* The Business section of the offering document contains a detailed description of the issuer’s business. It will include the text about the business from the summary box (including competitive strengths and business strategies) as well as a raft of more granular information about the issuer’s principal products and services, the location of its primary facilities, the number of its employees, and the like. If the issuer’s business is regulated, there will be a summary of key regulation. If the issuer is involved in material litigation or is subject to other material contingent liabilities, those will be described. The Business section is intended to be the full story about the issuer’s operations.
- *Risk Factors.* The Risk Factor section gives you a chance to warn investors about risks and challenges that may result in bad news in the future. It is the place to manage investor expectations. We think of these cautionary disclosures as insurance. The buy side is rarely put off by risk factor disclosure (they are usually aware of the risks) but the risk factors often provide important legal protection should risks come to roost after the closing. Don’t fret. It is typical for the risk factors to go on for several pages and to sound quite negative. Mitigating language is not included in the risk factor disclosures.

**The Third Month.** Here are the projects that will be taking your time during the third month:

- *Management’s Model/Analyst Day.* The research analysts at your syndicate banks will want frequent chances to meet and speak with you to discuss your company, its businesses and its strategy, and – where permitted – to review management’s projections for the next several years (typically quarter-by-quarter for the next two years and then year-by-year for another year or so thereafter). A group meeting with the syndicate analysts will take place, usually referred to as “analyst day.” Unlike the investment bankers who have been helping you prepare your offering document, the research analysts do not work for you. They are independent and focus on serving the buy-side audience who reads their research. Your meetings with research analysts are very important because these analysts are going to help educate the market about your company once the transaction has launched. You will want to be well prepared for analyst day and any follow-up meetings with analysts after this first meeting. Management should look to deliver a clear and



concise articulation of the company's story on analyst day and be ready to answer detailed questions about the management model. While the investment bankers can help you prepare for the analyst meetings, regulatory restrictions limit the information that they can share, and the interactions they can have, with research analysts. The bottom line is that you want to provide the syndicate analysts with the information they need to formulate a well-informed perspective on your business.

- *The Underwriting Documents.* In a global IPO, the underwriting documents are a suite of related agreements needed to close the transaction. There may be a domestic and an international underwriting agreement complemented with option and share lending agreements. The underwriting agreements have a brief moment in the limelight between the end of the road show when they are signed and the IPO closing. An underwriting agreement is probably unlike any other agreement you have seen in any other transaction, and at first glance may strike you as somewhat one-sided. Don't let that put you off – most of the pages of an underwriting agreement exist to assist the underwriters in carrying out their due diligence drill (you can think of the reps and warranties as a series of questions designed to uncover potential disclosure issues). As a result, there are only a few real business points in the whole agreement, and negotiating it should not be a particularly adversarial or time-consuming process.
- *The Lock Up.* The issuer's existing shareholders, directors, officers, and option holders will typically be asked, and in some jurisdictions required, to agree not to sell any of their shares during a period following the offering, which may vary according to local regulation but is otherwise 180 days. There is room to negotiate exceptions to the lock up – for estate planning and charitable giving, for example – and these exceptions will need to be finalized before the start of the road show. The underwriters will require that the signed lock-up agreements be delivered prior to the launch of the road show.
- *Preparing the Road Show Slides.* Ideally, you have been thinking about the content of the road show since you started drafting the offering document because the content of the road show must be consistent with, and should largely be drawn from, the contents of the offering document. However, distilling your story into a 30-minute pitch can be challenging. The road show slides will receive considerable attention, as they should since the road show is at the very center of the marketing process.
- *Finalizing Valuation.* Obviously, this is where the action is. You will not typically fill in the targeted price range until the day you start your road show or when the IPO bid period commences, but you will be discussing valuation with your bankers right up until that moment. Once a valuation is determined, you and the bankers may consider a stock split to try to get the proposed price within a desirable range. They will be watching the trading prices of the comps (if there are any publicly traded comps) and discussing the appropriate new-issue discount with each other and with you.
- *Finishing Everything Else.* You will not have much free time once the road show starts so you will want to make sure you have all of the loose ends tied down before you hit the road. Anything on the to-do list for the second month that didn't actually get done in the second month will need to be completed before you can start the road show.

**The Road Show, Pricing, and Closing.** Road shows are both fun and grueling. You may be expected to cover both the East and West Coasts of the United States (and possibly a few places in between). You should expect the CEO and CFO to give two full weeks to this part of the process.

The road show begins with a “teach-in” to the sales forces of each of the lead underwriters and continues through a series of group meetings (typically lunches) with buy-side institutional investors and one-on-one meetings with the largest institutional investors. Retail investors usually see a video recording of an early road show meeting, which is made available on the internet to anyone interested. On the road show, the underwriters are building an order book of indications of interest from investors, which helps them gauge the level of demand for your stock.

The bookbuilding process will result in a pricing recommendation (how many shares can be sold and at what price) by the underwriters. Once the deal has priced, you will sign the underwriting agreement, and the underwriters will commit to buy all of the shares being offered at a discount to the “price to public” in the offering. (In some markets the IPO is structured as a direct sale to the investors, for local tax and regulatory reasons.) The underwriters will then immediately resell the shares at the price to public appearing on the front page of the offering document to the investors who have been allocated shares (referred to as confirming orders). The difference between the discounted price the underwriters pay for your stock and the public offering price – the “gross spread” – is the underwriters’ payment for their services. Your stock will open for trading the next morning.

Three to twelve business days later, the offering will close and you will receive the net proceeds from your global IPO. Finally, you will be able to go back to running the business and working hard to meet the growth expectations you signaled the market to expect.

**A Note About Research Analysts.** Subject to any restrictions imposed by local law on sharing projections, the research analyst at each of your JGCs will create his or her own financial model based in part on what he or she learns on analyst day and in subsequent one-on-one diligence sessions with you. The analysts will have myriad questions about the company, its business, its strategy, and the management model, and each analyst will produce his or her own proprietary model, which can be expected to differ in some ways from the management model. You will not typically share projections with potential global IPO investors during the road show and some jurisdictions will not allow projections to be included in the analyst’s research report, but, where permitted, the analysts may verbally discuss their proprietary models with potential IPO investors once the offering has launched. The analysts’ models may include growth rates and margin assumptions specific to your business as well as other metrics based on your industry. It is important to ensure that the analysts are not basing their projections of future growth or profitability on outdated, inaccurate, or incomplete information, as the information that you provide will be the basis for many of the assumptions that they make and share with buy-side clients during this investor education process.

### **Corporate Information**

Our principal executive offices do not exist. We have a one-firm approach with no headquarters. Instead, we have over 2,600 attorneys practicing in 60 international practice groups and industry teams spread out over offices in 14 countries. We have over 450 attorneys in our capital markets practice group. We started our firm the same year that the US Congress created the SEC (in 1934) and have been the leading IPO firm since 2010. Given how long we have been at this, we believe we have seen it all and doubt you have a problem we have not tackled before.

Our website address is [www.lw.com](http://www.lw.com). Information contained on, or that can be accessed through, our website is enthusiastically incorporated by reference into this Global IPO Guide, and all of it is yours for the taking. We look forward to working with you on your global IPO.

## THE GLOBAL IPO BUSINESS

There are a few primary US federal statutes and concepts that we will be talking a lot about in this guide. Here is a brief summary to get things started.

### Securities Act of 1933 and Securities Exchange Act of 1934

The two Depression-era federal statutes at the center of our discussion are the US Securities Act of 1933 and the US Securities Exchange Act of 1934. The Securities Act generally governs the initial offer and sale of securities in the United States. The Exchange Act generally regulates the post-issuance trading of securities, the activities of public companies, including reporting obligations and M&A transactions, and the activities of other market participants (such as underwriters).

The SEC, the regulatory body in charge of the Securities Act and the Exchange Act, has issued a comprehensive body of rules and regulations under those Acts that have the force of law. The SEC and its Staff have also provided interpretive guidance on a wide range of questions under the securities laws.

### Foreign Private Issuers

If you are contemplating a global IPO, you are very likely to be a foreign private issuer, or FPI. That is a term of art in US securities regulation, and means an entity (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside of the US unless:<sup>1</sup>

- more than 50% of its outstanding voting securities are directly or indirectly owned of record by US residents; and
- any of the following applies:
  - the majority of its executive officers or directors are US citizens or residents;
  - more than 50% of its assets are located in the United States; or
  - its business is administered principally in the United States.

It is always prudent to confirm your status as an FPI at the very outset since the regulatory regime for companies that do not meet the FPI test is quite different in a number of crucial respects.

#### PRACTICE POINT

An issuer that has more than 50% US ownership can still be a foreign private issuer. In order to fail to qualify as a foreign private issuer, a company needs to be both majority owned by US residents and meet any one of the three additional tests noted above.

### Global IPO Structure – Regulation S, Rule 144A, and Traditional Private Placement Transactions

Global IPOs that are not registered in the United States with the SEC are typically structured to take advantage of a combination of exemptions. The portion of the transaction sold to investors outside the United States will be designed to comply with the safe harbor for offshore transactions provided by Securities Act Regulation S. At the same time, the portion sold to US investors will be structured to comply with the safe harbor of Securities Act Rule 144A for resales to QIBs, the private placement exemptions of Section 4(a)(2) of the Securities Act, or Securities Act Regulation D.

We discuss these exemptions below.

## Regulation S

### **Background**

Regulation S provides a safe harbor from Securities Act registration requirements for certain offerings outside the United States and offshore resales of securities. If the conditions of Regulation S are met, the transaction is deemed to take place outside the United States and hence does not trigger the registration requirements of Section 5 of the Securities Act.<sup>2</sup>

The basic requirements (we refer to them below as the Regulation S Basic Conditions) are that:

- the offer or sale must be made in an “offshore transaction;” and
- there must be no “directed selling efforts” in the United States.

An “offshore transaction” is defined as an offer that is not made to a person in the United States, and either:<sup>3</sup>

- at the time the buy order is originated, the buyer is outside the United States, or the seller (and any person acting on the seller’s behalf ) reasonably believes that the buyer is outside of the United States;
- for purposes of the issuer safe harbor, the transaction is executed in, on, or through the physical trading floor of an established foreign securities exchange located outside of the United States (this would be a rare occurrence today); or
- for purposes of the resale safe harbor, the transaction is executed in, on, or through the facilities of a designated offshore securities market, and neither the seller (nor any person acting on the seller’s behalf) knows that the transaction has been prearranged with a buyer in the United States.

The term “directed selling efforts” is broadly defined to include any activities that have, or can reasonably be expected to have, the effect of conditioning the market in the United States for the securities being offered in reliance on Regulation S.<sup>4</sup> Prohibited efforts include mailing offering materials into the United States, conducting promotional seminars in the United States, granting interviews about the offering in the United States (including by telephone), or placing advertisements with radio or television stations broadcasting in the United States.<sup>5</sup> Importantly, selling activities in the United States in connection with concurrent US offerings do not constitute directed selling efforts.<sup>6</sup> More generally, offshore transactions in compliance with Regulation S are not integrated with registered or exempt US domestic offerings.<sup>7</sup>

### **Rule 903**

Rule 903 of Regulation S provides a safe harbor for sales by issuers, “distributors” (essentially, entities that act as underwriters for the issuer), and most affiliates of the issuer (other than certain officers and directors). Bear in mind that the term “affiliate” is defined very broadly, and it is not always simple to determine precisely who is and who is not an affiliate.

Under Rule 903, there are three levels or “categories” of requirements, with Category 1 being the least burdensome and Category 3 being the most restrictive. Global IPOs by FPIs will typically fall into Category 1.

Category 1 has no requirements other than to comply with the Regulation S Basic Conditions. It is available for:

- securities offered by foreign issuers<sup>8</sup> who reasonably believe at the commencement of the offering that there is no “substantial US market interest”<sup>9</sup> in the securities offered;
- securities offered and sold in an “overseas directed offering;”<sup>10</sup>
- securities backed by the full faith and credit of a foreign government; or

- securities offered and sold pursuant to certain employee benefit plans established and administered under the laws of a foreign country.

### Rule 144A Transactions

Although market participants often refer to Rule 144A offerings, as a technical matter most Rule 144A transactions involve two steps: Sales to initial purchasers under an exemption such as Regulation S or Regulation D (discussed below), followed by resales to QIBs under Rule 144A. As a result, Rule 144A transactions follow various limitations not found directly in Rule 144A itself as well as the explicit requirements of Rule 144A.

#### PRACTICE POINT

Securities purchased under Rule 144A are deemed restricted securities and can only be resold pursuant to Rule 144A or another exemption (including the Regulation S resale safe harbor).<sup>11</sup>

The requirements for a valid Rule 144A transaction include:

- **Sales to QIBs:** the securities must be offered and sold only to QIBs or to a person who the seller (and any person acting on its behalf ) “reasonably believes” is a QIB; and
- **Notice to buyers:** the seller (and any person acting on its behalf ) must take “reasonable steps” to ensure that the buyer is aware that the seller may be relying on Rule 144A (generally by so noting either in the offering document or, in the case of an undocumented offering, in the trade confirmation).

### Section 4(a)(2) – Traditional Private Placements

Section 4(a)(2) of the Securities Act exempts “transactions by an issuer not involving any public offering.” The term “public offering” is not defined in the Securities Act, and the scope of the Section 4(a)(2) exemption has largely evolved through case law, SEC pronouncements, and market practice.

The core issue is whether the persons to whom securities are offered need the protection of the Securities Act – that is, whether they are sufficiently sophisticated so as to be able to fend for themselves.<sup>12</sup> In determining whether a transaction is a public offering, relevant factors include the number of offerees and their relationship to each other and the issuer, the number of securities being offered, the size of the offering, and the manner in which the offering is conducted.<sup>13</sup> All of the surrounding circumstances must be considered in this analysis.<sup>14</sup>

#### PRACTICE POINT

Section 4(a)(2) is only available for offers and sales by an issuer; resales of securities acquired from an issuer require a separate exemption (such as Rule 144A). Global IPOs in certain jurisdictions are structured for tax and regulatory reasons as Section 4(a)(2) sales directly to investors.

Private placements under Section 4(a)(2) typically consist of, among other things:

- a nonpublic offering (that is, an offering without any form of general solicitation or advertising);
- to a limited number of offerees;
- who are buying for investment and not with a view to distribution; and
- who are sophisticated investors and have been provided with or have access to information about the issuer.<sup>15</sup>

In addition, the securities issued in a private placement generally include restrictions on resales by the purchasers (such as through the use of stop-transfer orders, restrictive legends, and the like).<sup>16</sup>

### Regulation D Private Placements

As you can see, it is not possible to map the borders of Section 4(a)(2) with precision. Securities Act Regulation D helps give some certainty in this area, and it also establishes various safe harbors from Securities Act registration.

Foreign private issuers are most likely to look to Rule 506 of Regulation D, which is not limited to offering amount. If the conditions of Rule 506 are met, the transaction is deemed not to be a public offering within the meaning of Section 4(a)(2).

Under Rule 506:

- **Accredited Investors and others:** There is no limit to the number of accredited investors, or AIs, who may participate in the transaction, and up to 35 non-AIs may purchase securities. In addition, each non-AI must demonstrate to the issuer's reasonable belief that it, "either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."<sup>17</sup> Issuers and their placement agents typically satisfy this requirement by having potential investors complete "investor questionnaires" demonstrating their accredited status or their sophistication.
- **Information requirements:**<sup>18</sup> There is no specific information requirement for AIs, although antifraud considerations of course come into play. By contrast, non-AIs must receive extensive information about the issuer. If the issuer is not an Exchange Act reporting company, that information includes non-financial and financial information substantially equivalent to what it would have been required to provide in a registration statement under the Securities Act. The issuer must also make available to each purchaser the opportunity to ask questions about the offering or the issuer.

### PRACTICE POINT

Regulation D also includes a limitation on the use of Rule 506 by "bad actors" – that is, entities that have run afoul of various US laws. The bad actor requirements have led certain deal teams to prefer to rely on Section 4(a)(2) rather than Regulation D.

- **General solicitation/general advertising only permitted under certain circumstances:** "General solicitation" or "general advertising" may only be used to offer or sell the securities under circumstances spelled out in Rule 506(c).
- **Limitation on resale:**<sup>19</sup> Securities acquired in a Regulation D transaction are "restricted securities" that cannot freely be resold absent registration or an exemption from registration. The issuer must take reasonable care to make sure that purchasers would not be deemed to be statutory underwriters (that is, engaged in a distribution of the securities), which is typically satisfied by requiring purchaser representations about investment intent, restrictive legends on certificates, and restrictions on transfer.
- **Form D:**<sup>20</sup> The issuer must file a notice with the SEC on Form D no later than 15 days after the first sale of securities. Form D must be filed electronically on the SEC's EDGAR system.<sup>21</sup>

Accredited investors include:<sup>22</sup>

- certain US financial institutions such as banks, savings and loan associations, broker-dealers, and the like;
- corporations or partnerships not formed for the specific purpose of acquiring the securities being offered with assets over \$5 million;

- directors, executive officers, and persons holding similar positions with or in the issuer;
- natural persons with a net worth (alone or with that person's spouse) exceeding \$1 million, excluding the value of the primary residence of the investor;
- natural persons with individual income in excess of \$200,000 per year or, with that person's spouse, in excess of \$300,000 per year; and
- any entity in which all the equity owners are themselves AIs.

### **Restrictions on Communications During the Global IPO Process**

As discussed above, directed selling efforts or general solicitation in the United States can destroy the availability of the exemptions from registration on which global IPOs typically rely. In addition, publicity about a global IPO can amount to an illegal offer of securities. Accordingly, communications about a planned or pending global IPO are subject to certain limitations.

In particular, a foreign private issuer may:

- continue to advertise products and services and to issue press releases regarding factual business and financial developments in accordance with past practice;<sup>23</sup>
- distribute a preliminary and final offering document to certain investors; and
- conduct certain press activities outside the United States under Securities Act Rule 135e.

### **Offshore Press Activity – Securities Act Rule 135e**

Rule 135e provides a safe harbor from the definition of offer for FPIs, and offshore press activity meeting Rule 135e does not constitute general solicitation or directed selling efforts.<sup>24</sup>

Rule 135e allows an FPI to provide journalists with access to: (1) its press conferences held outside the United States; (2) meetings with issuer (or selling security holder) representatives conducted outside the United States; and (3) written press-related materials released outside the United States at or in which the issuer discusses its intention to undertake an offering. To take advantage of Rule 135e, the offering must not be conducted solely in the United States – that is, the issuer must have a bona fide intent to make an offering offshore concurrently with the US offering. The issuer must also provide access to both US and non-US journalists, and ensure that any written press releases are distributed to journalists (including US journalists) outside the United States and contain a specified legend.

#### **PRACTICE POINT**

Note that even if Rule 135e is otherwise available, an issuer may not rely on it to provide internet access to its offshore press conferences or written press-related materials issued offshore, unless it implements procedures to ensure that only persons physically located outside the US will have access to the press conferences or materials.<sup>25</sup>

### **Research Reports**

Research reports potentially raise concerns about directed selling efforts and general solicitation. For this reason (and because of liability concerns), many underwriters refuse to allow research to be distributed in the United States in connection with global IPOs.



## ENDNOTES

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- <sup>1</sup> Securities Act Rule 405; Exchange Act Rule 3b-4.
- <sup>2</sup> Securities Act Rule 901.
- <sup>3</sup> Securities Act Rule 902(h).
- <sup>4</sup> Securities Act Rule 902(c)(1).
- <sup>5</sup> Securities Act Rule 902(c).
- <sup>6</sup> *Final Rule: Offshore Offers and Sales*, Release No. 6863, text at FN 64 (April 24, 1990).
- <sup>7</sup> *Id.*, text at FN 145.
- <sup>8</sup> Securities Act Rule 902(e). A “foreign issuer” is any foreign government or foreign private issuer.
- <sup>9</sup> Securities Act Rule 902(j) defines “Substantial US Market Interest.”
- <sup>10</sup> Securities Act Rule 903(b)(ii) defines what is considered an “overseas directed offering.”
- <sup>11</sup> Securities Act Rule 144A, Preliminary Note 6.
- <sup>12</sup> See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (“the applicability of the [private placement exemption] should turn on whether the particular class of persons affected needs the protection” of the Securities Act; an offering to those “who are shown to be able to fend for themselves” is a private placement).
- <sup>13</sup> See Release No. 33-285, 1935 SEC LEXIS 485 (January 24, 1935).
- <sup>14</sup> See Release No. 33-4552, 1962 SEC LEXIS 166 (November 6, 1962) (all the surrounding circumstances must be considered “including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering”).
- <sup>15</sup> Certain courts have held that this information must be comparable to the information investors would have received in a public offering. See, e.g., *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 903 (5th Cir. 1977).
- <sup>16</sup> Securities sold under Section 4(a)(2) are restricted securities that may not be freely resold to the public. Securities Act Rule 144(a)(3).
- <sup>17</sup> Securities Act Rule 506(b)(2)(ii); Securities Act Rule 501(h) defines “purchaser representative.”
- <sup>18</sup> Securities Act Rule 502(b).
- <sup>19</sup> Securities Act Rule 502(c).
- <sup>20</sup> Securities Act Rule 503.
- <sup>21</sup> Regulation S-T, Rule 101(a)(1)(xiii).
- <sup>22</sup> Securities Act Rule 501(a).
- <sup>23</sup> See *Guidelines for the Release of Information by Issuers Whose Securities are in Registration*, Release No. 33-5180 (August 16, 1971).
- <sup>24</sup> Securities Act Rules 502(c), 902(c)(3)(vii).
- <sup>25</sup> *SEC Guidance: Use of Electronic Media*, Release No. 33-7856, FN 68 (April 28, 2000).



## GLOBAL IPO FINANCIAL STATEMENTS

### What Financial Statements Must Be Included?

The starting point for figuring out what financial statements will be contained in the offering document for a global IPO is determining the financial statement requirements for an IPO registered with the SEC. We accordingly discuss below what would be needed in a public IPO in the United States by an FPI. (References below to a “registration statement” refer to the IPO disclosure document filed with the SEC on a prescribed form; “Regulation S-K” refers to the SEC’s rules for textual disclosure; and “Regulation S-X” refers to the SEC’s rules for financial statements.)

Foreign private issuers nonetheless tend to take a flexible approach to financial statements in global IPOs depending on a variety of factors, including local market practice, deal size, underwriter practice, investor expectations, and other marketing issues. As a result, you and the underwriters may choose to deviate from the requirements listed below in specific circumstances. In addition, local law might also require you to provide additional financial information, cover additional periods, or have interim periods audited.

### The Basic Requirements for US Public Offerings

#### Annual Audited Financial Statements

- Consolidated annual audited financial statements of the issuer consisting of:<sup>1</sup>
  - balance sheet;
  - statements of comprehensive income (or a statement of net income if there was no other comprehensive income);
  - statement of changes in equity;
  - statement of cash flows;
  - related notes and schedules required by the system of accounting under which the financial statements were prepared; and
  - if not included in the primary financial statements, a note analyzing the changes in each caption of shareholders’ equity presented in the balance sheet.
- Audited financial statements must cover each of the latest three fiscal years,<sup>2</sup> with certain exceptions:
  - if the issuer has been in existence less than the required three years, financial information covering the issuer’s predecessor entities (if any) may need to be provided;<sup>3</sup>
  - if a jurisdiction outside the United States does not require a balance sheet for the earliest year of the three-year period, that balance sheet may be omitted;<sup>4</sup> and
  - in an EGC IPO registration statement, as discussed below.
- Under certain circumstances, audited financial statements may cover nine to 12 months rather than a full fiscal year for one of the required years.<sup>5</sup>
- Audited financial statements must be accompanied by an audit report covering each of the audited periods.<sup>6</sup>

## Interim Unaudited Financial Statements

- If a registration statement becomes effective more than nine months after the end of the last audited fiscal year, the issuer must provide consolidated interim financial statements.<sup>7</sup>
- Those financial statements:
  - may be unaudited;<sup>8</sup>
  - must cover at least the first six months of the fiscal year;
  - should include a balance sheet, statement of comprehensive income, statement of cash flows, statement of changes in equity, and selected note disclosures;
  - may be in condensed form, as long as they contain the major line items from the latest audited financial statements and include the major components of assets, liabilities, and equity (in the case of the balance sheet), income and expenses (in the case of the statement of comprehensive income), and the major subtotals of cash flows (in the case of the statement of cash flows); and
  - should include comparative interim statements for the same period in the prior fiscal year, except that the requirement for comparative balance sheet information may be met by presenting the year-end balance sheet.<sup>9</sup>

## EGC Offerings

- In order to qualify as an emerging growth company, or EGC, a company must have annual revenue for its most recently completed fiscal year of less than \$1.07 billion.<sup>10</sup> After the initial determination of EGC status, a company will remain an EGC until the earliest of:
  - the last day of any fiscal year in which the company earns \$1.07 billion or more in revenue;
  - the date when the company qualifies as a “large accelerated filer,” with at least \$700 million in public equity float;<sup>11</sup>
  - the last day of the fiscal year ending after the fifth anniversary of the IPO pricing date; or
  - the date of issuance, in any three-year period, of more than \$1.0 billion in non-convertible debt securities.
- An EGC may conduct its initial public equity offering using two years, rather than three years, of audited financial statements and as few as two years, rather than five years, of selected financial data.<sup>12</sup> The required MD&A would cover only the years for which audited financial statements are provided.

## Selected Financial Information

- A registration statement must include selected historical financial information, comprised of statement of comprehensive income and balance sheet data for each of the last five fiscal years (or such shorter period as the issuer has been in operation), with the following exceptions:<sup>13</sup>
  - selected financial data for either or both of the two earliest years may be omitted if the issuer represents to the SEC in the review process that such information cannot be provided, or cannot be provided on a restated basis, without unreasonable effort or expense;<sup>14</sup> and
  - EGCs may present less than five years of selected financial information, as discussed above.
- If interim unaudited financial statements are included, the selected financial data should be updated for that interim period, and comparative data from the same period in the prior fiscal year should be provided.<sup>15</sup>
- Selected financial data should be presented in the same currency as the financial statements.<sup>16</sup>

## Acquired Company Financial Information and Pro Forma Financial Information

- Depending on the size of the acquisition and its significance to the issuer (which is measured in various ways – not all of them intuitive), audited annual financial statements for the most recent one, two, or three fiscal years, plus appropriate unaudited interim financial statements under S-X Rule 3-05 as described in more detail below. An EGC need only provide two years of acquired company financials, even for acquisitions at the highest level of materiality.
- Under S-X Article 11, when acquired company financial statements are included in a registration statement (and in certain other instances), pro forma financial information under Regulation S-X must also be included, covering the most recently completed fiscal year and the interim period in the current fiscal year.

## Statement of Capitalization and Indebtedness

- A registration statement must include a statement of capitalization and indebtedness.<sup>17</sup> Although the rules require the capitalization table to be as of a date no earlier than 60 days prior to the date of the registration statement,<sup>18</sup> the SEC Staff will not object if a foreign private issuer presents the statement as of the same date as the most recent balance sheet required in the registration statement.<sup>19</sup> If, however, there have been or will be significant subsequent changes in capitalization (for example, securities issuances including the proposed IPO), those changes should be reflected in “as adjusted” columns or footnotes to the table.<sup>20</sup>

## When Does Financial Information Go “Stale”?

Understanding the timing requirements for the provision of financial statements is almost as critical as understanding the scope of the financial information required. The determination of when financial statements go “stale” (*i.e.*, are too old and must be updated) is sure to come up at the all-hands meeting, and planning to have the necessary financial information prepared on time is an essential part of the offering process.

The following tables summarize financial statement staleness requirements, measured by the number of days between the effective date of the registration statement (or, by analogy, the pricing date of a Rule 144A offering if the transaction is intended to mirror SEC requirements) and the date of the financial statements in the filing.<sup>21</sup> For any of the time frames noted below, if the last day before the financial statements go stale is a Saturday, Sunday, or US federal holiday, Securities Act Rule 417 allows the filing to be made on the next business day, thereby effectively postponing the staleness date.

## Staleness of Annual Audited Financial Statements

- In a public IPO by a foreign private issuer, the audited financial statements must be as of a date not older than 12 months prior to the time the document is filed.<sup>22</sup> In other words, an IPO issuer with a **December 31** fiscal year end cannot file a registration statement after **January 1** without including audited financial statements for the year just ended (or audited financial statements as of an interim date less than 12 months prior to the filing). However, if the issuer is already public in another jurisdiction, the 12-month rule does not apply.<sup>23</sup> In addition, an issuer may comply with the 15-month rule in an IPO where it is able to represent that it is not required to comply with this requirement in any other jurisdiction outside the United States and that complying with the requirement is impracticable or would involve undue hardship.<sup>24</sup>

## Staleness of Interim Unaudited Financial Statements

- If a registration statement becomes effective more than nine months after the end of the last audited fiscal year (e.g., **September 30**, in the case of an issuer with a **December 31** fiscal year end) the issuer must provide unaudited interim financial statements covering at least the first six months of the year.
- In addition, if an issuer publishes interim financial statements that are more current than those required, it must include the more current information in its registration statement.<sup>25</sup> For example, if an issuer with a fiscal year ending December 31 publishes first quarter information and does a securities offering in July, it must include the first quarter information in its registration statement.

## MD&A

Registration statements for foreign private issuers must contain or incorporate by reference an “Operating and Financial Review and Prospects,” which contains essentially the same information as the MD&A (so we will refer to this as MD&A).<sup>26</sup>

The SEC has steadily expanded the line-item disclosure requirements for the MD&A, adding specific requirements for off-balance sheet arrangements, long-term contractual obligations,<sup>27</sup> certain derivatives contracts, and related-party transactions<sup>28</sup> as well as critical accounting policies.<sup>29</sup> For an explanation of the SEC’s view of required liquidity and capital resources disclosure, see the guidance release from September 2010,<sup>30</sup> and for a sweeping explanation of the purpose of MD&A disclosure, see the guidance release from December 2003.<sup>31</sup>

## Recent and Probable Acquisitions

### Overview

In addition to financial statements of the issuer, registration statements generally require inclusion of audited financial statements for a significant acquisition of a “business” that has taken place 75 days or more before the offering, or, in the case of the most material acquisitions, as soon as the acquisition becomes “probable.”<sup>32</sup> These requirements can be found in S-X Rule 3-05. In addition, where a material acquisition has occurred or is probable, pro forma financial information complying with S-X Article 11 for the most recent fiscal year and the most recent interim period will generally also be required in the registration statement.

### What Is a “Business”?

The SEC defines the term “business” to include an operating entity or business unit, but excludes machinery and other assets that do not generate a distinct profit or loss stream.<sup>33</sup> It is important to note that the definition of a business under US GAAP (and potentially other GAAPs) differs from the SEC’s definition. Accordingly, an acquisition may be a business under US GAAP but not for SEC purposes, and vice versa.

### What Is “Probable”?

Evaluating whether a given transaction is probable involves looking at the facts and circumstances. The SEC Staff has taken the general view that an acquisition becomes probable at least upon the signing of a letter of intent,<sup>34</sup> and has also stated that an acquisition is probable “where registrant’s financial statements alone would not provide adequate financial information to make an investment decision.”<sup>35</sup> In practice, unless there were significant conditions relating to a proposed acquisition, an issuer would not want to be in the position of arguing and disclosing that an important acquisition is not probable.

## **Significance Tests**

Whether financial statements for recent and probable acquisitions must be included in the filing also depends upon the "significance" of the acquisition. Significance of an acquired business is evaluated under S-X Rule 3-05 based upon three criteria (which in turn are derived from S-X Rule 1-02(w)):

- the amount of the issuer's investment in the acquired business compared to the issuer's total assets;
- the issuer's share of the total assets of the acquired business compared to the issuer's total assets; and
- the issuer's share of "pre-tax income"<sup>36</sup> from continuing operations of the acquired business compared to the issuer's pre-tax income from continuing operations;

in each case, based on a comparison between the issuer's and the target's most recent annual audited financial statements (which need only be audited for the issuer).

Acquisitions of related businesses are treated as a single acquisition for purposes of the significance tests. Businesses are considered "related" if they are owned by a common seller or under common management, or where the acquisition of one business is conditioned upon the acquisition of each other business or a single common event.<sup>37</sup>

Generally:

- if the acquired business exceeds 20% of any of the three significance criteria, then one year of audited financial statements are required, as well as the interim financial periods that would be required under S-X Rules 3-01 and 3-02;<sup>38</sup>
- if it exceeds 40%, then two years of audited financial statements and the appropriate interim financial periods are required;<sup>39</sup> and
- if it exceeds 50% of any of the three criteria (or if securities are being registered to be offered to the security holders of the acquired business), then three years of audited financial statements and the appropriate interim financial periods are required; however, if the issuer is an EGC, then two years of audited financials for the acquired business may be presented, regardless of whether the issuer presents two or three years of its own financial statements.<sup>40</sup>

## Summary of Financial Statement Requirements

The following table summarizes the general rules for an acquisition that occurred more than 75 days before the offering.

Acquisition Scenario	Reporting Requirement
<ul style="list-style-type: none"> <li>Individual acquisition at or below the 20% significance level.</li> </ul>	<ul style="list-style-type: none"> <li>No requirement to include audited or interim financial statements.</li> </ul>
<ul style="list-style-type: none"> <li>Individual acquisition (or multiple acquisitions of “related businesses,” as described above) in excess of the 20% significance level, but not above the 40% level.</li> </ul>	<ul style="list-style-type: none"> <li>Audited financial statements for the most recent fiscal year of the acquired business must be included. Unaudited interim financial statements may need to be included, depending on the time of year that the offering takes place.</li> </ul>
<ul style="list-style-type: none"> <li>Multiple acquisitions of unrelated businesses below the 20% significance level individually, but aggregating in excess of the 50% level of significance.</li> </ul>	<ul style="list-style-type: none"> <li>Audited financial statements for the most recent fiscal year will be required for a substantial majority of the individually insignificant acquisitions. Unaudited interim financial statements may need to be included, depending on the time of year that the offering takes place.</li> </ul>
<ul style="list-style-type: none"> <li>Individual acquisition (or multiple acquisitions of “related businesses,” as described above) in excess of the 40% significance level, but not above the 50% level.</li> </ul>	<ul style="list-style-type: none"> <li>Audited financial statements for the two most recent fiscal years of the acquired business must be included. Unaudited interim financial statements may need to be included, depending on the time of year that the offering takes place.</li> </ul>
<ul style="list-style-type: none"> <li>Individual acquisition above the 50% significance level.</li> </ul>	<ul style="list-style-type: none"> <li>Audited financial statements for the three most recent fiscal years of the acquired business must be included (or, if the issuer is an EGC, audited financial statements for the two most recent fiscal years of the acquired business must be included). This requirement also applies to acquisitions of this size that have closed within the 75-day period prior to the offering or are “probable” at the time of the offering. However, audited financial statements for the earliest of the three fiscal years required may be omitted if net revenues reported by the acquired business in its most recent fiscal year are less than \$50 million. Unaudited interim financial statements may need to be included, depending on the time of year that the offering takes place.</li> </ul>

Note that:

- The permitted age of financial statements of an acquired or soon-to-be-acquired business is generally determined by looking to the “staleness” rules that apply to its financial statements (rather than the staleness rules applicable to the financial statements of the acquiring company).<sup>41</sup> In other words, you need to determine whether the acquired company is, for example, a large accelerated filer, an accelerated filer, or an initial filer, and then analyze the dates on which its financial statements go stale.<sup>42</sup>
- Below the 50% significance level, no audited financial statements are required in the offering document for probable acquisitions or for completed acquisitions consummated up to 74 days before the date of the offering.<sup>43</sup> The commitment committees of some financing sources may, however, require at least a one-year audit of the acquired company in this situation together with historical pro forma financial information, even if the 74-day grace period has not yet expired.

## **Exceptions to the Financial Statement Requirements for Acquired Businesses**

There are a number of exceptions to the requirement to provide separate financial statements of acquired businesses.

### **Exceptions to the Requirement to Provide Financial Statements of Acquired Businesses**

- Separate financial statements for an acquired business do not need to be presented once the operating results of the acquired business have been included in the issuer's audited consolidated financial statements for at least nine months unless the financial statements have not been previously filed by the issuer or unless the acquired business is of such significance to the issuer that omission of such financial statements "would materially impair an investor's ability to understand the historical financial results of the registrant."<sup>44</sup> Where the acquired business met at least one of the significance tests at the 80% level, the statements of comprehensive income of the acquired business should normally continue to be furnished.<sup>45</sup> This rule means that financial statements for major acquisitions at the highest level of materiality may be required for subsequent securities offerings, even those unrelated to the financing of the original acquisition.
- A single audited period of nine, 10, or 11 months may count as a year for an acquired business in certain circumstances.<sup>46</sup>

## **MD&A for Acquisitions**

Whenever historical financial statements of an acquired business (or probable acquisition) are included in the offering document, the registrant will need to consider whether a separate MD&A section discussing those financial statements is appropriate. Although there is no specific line item requiring that a second MD&A be included, it is not uncommon for registrants to interpret Securities Act Rule 408<sup>47</sup> to require a full discussion and analysis of the financial statements of an acquired business (or probable acquisition), particularly where it exceeds 50% on any of the three significance criteria discussed above.

## **Pro Forma Financial Information**

As noted above, where a material acquisition has occurred, or is probable, that would trigger the need for acquired business financial statements under S-X Rule 3-05, pro forma financial information complying with S-X Article 11 must also be included. Pro forma financial information is intended to illustrate the continuing impact of a transaction by showing how the specific transaction might have affected historical financial statements had it occurred at the beginning of the issuer's most recently completed fiscal year.

In particular, S-X Article 11 requires:<sup>48</sup>

- a pro forma condensed balance sheet<sup>49</sup> as of the end of the most recent period for which a consolidated balance sheet of the issuer is required, unless the transaction is already reflected in that balance sheet;<sup>50</sup> and
- a pro forma condensed statement of comprehensive income<sup>51</sup> for the issuer's most recently completed fiscal year and the most recent interim period, unless the historical statement of comprehensive income reflects the transaction for the entire period.<sup>52</sup>

S-X Article 11 provides extensive specific requirements for the content of pro forma financial information, including those set out in the following table.<sup>53</sup>



## Pro Forma Financial Information – Certain Key Content Requirements

Pro forma adjustments related to the pro forma condensed statement of comprehensive income must include adjustments that give effect to events that are:

- directly attributable to the transaction;
- expected to have a continuing impact on the issuer; and
- factually supportable.<sup>54</sup>

As a result, adjustments for expected future synergies and cost savings that are not expressly mandated by the acquisition documents will generally not be permitted.

Pro forma condensed statements of comprehensive income should be presented using the issuer's fiscal year end.<sup>55</sup> If the most recent fiscal year end of the acquired company differs from that of the issuer by more than 93 days, the acquired company's fiscal year end should be brought up to within 93 days of the issuer's fiscal year end (if practicable).<sup>56</sup>

## Industry Guides

S-K Item 801 sets out five industry "guides" requiring enhanced disclosure of financial and operational metrics for issuers in certain industries:<sup>57</sup>

- **Guide 3 – Statistical Disclosure by Bank Holding Companies:** requires disclosure of analyses of interest earnings, investment and loan portfolios, loan loss experience, deposit types, returns on equity and assets, and short-term deposits.
- **Guide 4 – Prospectuses Relating to Interests in Oil and Gas Programs:** requires enhanced disclosure relating to the offering terms and participation in costs and revenues among investors and others, as well as a 10-year financial summary of any drilling programs by the issuer and its associates, including recovery on investment for investors in those programs.
- **Guide 5 – Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships:** requires a summary of the financial performance of any other real estate investment programs sponsored by the general partner and its affiliates.
- **Guide 6 – Disclosure Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters:** requires disclosure of details of reserves and historical claim data if reserves for unpaid property-casualty claims and claim adjustment expenses of the issuer, its consolidated and unconsolidated subsidiaries and equity investees exceed 50% of the common stockholders' equity of the issuer and its consolidated subsidiaries.
- **Guide 7 – Description of Property by Issuers Engaged or to Be Engaged in Significant Mining Operations:** requires disclosure of information relating to each of the mines, plants, and other significant properties owned or operated (or intended to be owned or operated) by the issuer, including location of the property, brief description of the title, claim, or lease to the property, a history of previous operations, and a description of the present condition and operations on the property.<sup>58</sup>

In addition, as part of its 2008 initiative for modernizing oil and gas reporting, former Guide 2 was removed from Item 801 and largely recodified in S-K Item 1200. S-K Item 1200 requires enhanced disclosure of oil and gas reserves (including from non-traditional sources), the company's progress in converting proved undeveloped reserves into proved developed reserves, technologies used in establishing reserves, the company's internal controls over reserves estimates, and disclosure based on geographic area (as defined). Required disclosure also includes information regarding proved undeveloped reserves; oil and gas production; drilling and other exploratory and development activities; present activities; delivery commitments; and oil and gas properties, wells, operations, and acreage. Finally, disclosure of probable and possible reserves and oil and gas reserves' sensitivity to price is optional under S-K Item 1200.<sup>59</sup>



## PRACTICE POINT

Compiling the information required by these industry guides and S-K Item 1200 may be a significant undertaking, and the issuer's financial and operating management should consult with its professional advisors early in the process if an industry guide applies to the offering.

### **Additional Financial Information That Is Typically Included**

In addition to the formal requirements of Form 20-F and Regulation S-X, it is customary to include additional operational and other metrics in the offering document to help investors understand the issuer's business. This information is usually included at the end of Selected Financial Data section under a caption labeled "Other Financial Data." The three most common examples are described below.

#### *Other Financial Data*

A page of summary financial data is always included in the "summary box" in the offering document. Although there are no specific line item requirements for this key marketing page, it usually contains the same line items as the "Selected Financial Data" page that appears later in the disclosure document, including the additional operational and other metrics included in the "Other Financial Data" section. These additional metrics will vary with the type of issuer and its industry, and will be selected based on the criteria that management and the investment community monitor to evaluate performance or liquidity. Typical examples include comparable store sales data for a retailer, capital expenditures for a manufacturer, and subscriber numbers for a cable television company. The "Other Financial Data" section is also typically where non-GAAP measures, such as Adjusted EBITDA, are presented.

#### *Recent Financial Results*

If a significant amount of time has passed since the most recent financial statements included in the offering document, it may be appropriate to include a summary of recent financial results in the summary box. Examples of "recent results" disclosures are most common after a quarter or half year (depending on how frequently the issuer reports) is completed but before financial statements concerning that quarter/half year have become available. The issuer and the underwriters will want to tell investors as soon as possible about any positive improvement in operating trends, while if the recent results are negative, recent results disclosure may be advisable to avoid any negative surprises for investors when the full quarterly/half yearly numbers become available.

#### *Recent Developments*

To the extent material, the likely consequences of material recent developments may be disclosed in the "summary box" or the MD&A. For example, it is customary to discuss a material recent or pending and probable acquisition in the MD&A section of the offering document, whether or not audited financial statements of the acquired or to-be-acquired business are required to be presented. This practice will often result in a discussion of the impact of pending or recent acquisitions on margins, debt levels, etc., in a section of the MD&A labeled "Overview," "Impact of the Acquisition," or a similar title. The textual disclosure may include a discussion of any special charges or anticipated synergies expected to result from the acquisition or other pending event.

## ENDNOTES

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<sup>1</sup> See Form 20-F, Item 8.A.1.

<sup>2</sup> See Form 20-F, Item 8.A.2.

<sup>3</sup> See Form 20-F, Instruction 1 to Item 8. See also S-X Rule 3-02(a) (noting if the issuer has been in existence less than the prescribed number of years, it is sufficient to provide statements of comprehensive income for the life of the issuer and its predecessors); *Financial Reporting Manual*, Section 6220.5 (a foreign private issuer that has been in existence less than a year must include an audited balance sheet that is not more than nine months old; if the issuer has commenced operations, it must include audited statements of income, stockholders' equity and cash flows for the period from the date of inception to the date of the audited balance sheet). Financial information of a registrant's predecessor is required for all periods prior to the registrant's existence, with no lapse in audited periods or omission of other information required about the registrant. *Financial Reporting Manual*, Section 1170. The term *predecessor* is broadly defined. See Securities Act Rule 405.

<sup>4</sup> See Form 20-F, Instruction 1 to Item 8.A.2.

<sup>5</sup> See S-X Rule 3-06. Under this rule, the SEC will accept financial statements for periods of not less than nine, 21 and 33 consecutive months as substantial compliance with the requirement to provide financial statements for one, two and three years, respectively. In particular, whenever audited financial statements are required for a period of one, two or three years, a single audited period of nine to 12 months may count as a year if:

- the issuer has changed its fiscal year during the period;
- the issuer has made a significant business acquisition for which financial statements are required under S-X Rule 3-05 and the financial statements covering the interim period pertain to the business being acquired; or
- the SEC grants permission to do so under Rule 3-13, provided that financial statements are filed that cover the full fiscal year or years for all other years in the time period.

See *id.* Note, however, that permission is rarely granted by the SEC Staff. See *Financial Reporting Manual*, Note to Section 1140.8 (issuer must show unusual circumstances). On June 29, 2017, the SEC Staff signaled that it might be willing to grant permission if an issuer is able to argue that the information is not necessary for investor protection. See Staff of the Division of Corporation Finance, *Draft Registration Statement Procedures Expanded* (June 29, 2017, updated August 17, 2017):

While an issuer should take all steps to ensure that a draft registration statement is substantially complete when submitted, we will not delay processing if an issuer reasonably believes omitted financial information will not be required at the time the registration statement is publicly filed. In addition, we will consider an issuer's specific facts and circumstances in connection with any request made under Rule 3-13 of Regulation S-X.

<sup>6</sup> See Form 20-F, Item 8.A.1, Item 8.A.3.

<sup>7</sup> See Form 20-F, Item 8.A.5.

<sup>8</sup> See Form 20-F at Items 17(c), 18; see also *Final Rule: First-time Application of International Financial Reporting Standards*, Release No. 8567 (April 12, 2005) [*First-time Application of IFRS Release*] (discussing the applicable exceptions).

<sup>9</sup> See generally Form 20-F, Item 8.A.5.

<sup>10</sup> See JOBS Act Sections 101(a) and (b) (adding new Securities Act Section 2(a)(19) and Exchange Act Section 3(a)(80)).

<sup>11</sup> See Regulation S-K Items 308 (a) and (b). Under Exchange Act Rule 12b-2, a "large accelerated filer" is an issuer that, as of the end of its fiscal year:

- has an aggregate worldwide market value of voting and non-voting common equity held by non-affiliates (market capitalization) of \$700 million or more (measured as of the last business day of the issuer's most recently completed second fiscal quarter);
- has been subject to SEC reporting under the Exchange Act for a period of at least 12 calendar months; and
- has filed at least one annual report under the Exchange Act with the SEC.

In addition, under Exchange Act Rule 12b-2, an "accelerated filer" is an issuer meeting the same conditions, except that it has a market capitalization of \$75 million or more but less than \$700 million (measured as of the last business day of its most recently completed second fiscal quarter).

<sup>12</sup> See JOBS Act Section 102(b)(1) (adding new Securities Act Section 7(a)(2)).

<sup>13</sup> See Form 20-F, Item 3.A.1. The selected financial statements must include at least each of the following line items: "net sales or operating revenues; income (loss) from operations; income (loss) from continuing operations; net income (loss); net income (loss) from operations per share; income (loss) from continuing operations per share; total assets; net assets; capital stock (excluding long-term debt and redeemable preferred stock); number of shares adjusted to reflect changes in capital; dividends declared per share in both the currency of the financial statements and the host country currency, including the formula used for any adjustments to dividends declared; and diluted net income per share." Form 20-F, Item 3.A.2 The selected financial statements may also include any additional items that would enhance an understanding of the issuer's financial condition and results of operations.

<sup>14</sup> See Form 20-F, Item 3.A.1.

- <sup>15</sup> See Form 20-F, Item 3.A.1. The requirement for comparative balance sheet data may be met by presenting the year-end balance sheet information. See *id.*
- <sup>16</sup> See Form 20-F, Item 3.A.1.
- <sup>17</sup> See Form 20-F, Item 3.B.
- <sup>18</sup> See *id.*
- <sup>19</sup> SEC Division of Corporation Finance, *International Reporting and Disclosure Issues*, Section III.B.f (Nov. 1, 2004).
- <sup>20</sup> See *id.*
- <sup>21</sup> See Form 20-F, Instruction 1 to Item 8.A.4. The rules regarding the age or “staleness” of the required financial statements for foreign private issuers vary a great deal from those applicable to US domestic issuers. Generally speaking, the financial statements for US domestic issuers go “stale” at a much faster rate.
- <sup>22</sup> See Form 20-F, Item 8.A.4. (requiring IPO issuers to provide audited financial statements “as of a date not older than 12 months at the time the document is filed” and noting that the audited financial statements in such cases “may cover a period of less than a full year”).
- <sup>23</sup> See *Financial Reporting Manual*, Section 6220.3.
- <sup>24</sup> See Form 20-F, Instruction 2 to Item 8.A.4; see *Financial Reporting Manual*, Section 6220.3.
- <sup>25</sup> See Form 20-F, Item 8.A.5. This requirement applies to any publication of financial information that includes, at a minimum, revenue and income information, even if that information is not published as part of a complete set of financial statements. See Form 20-F, Instruction 3 to Item 8.A.5.
- <sup>26</sup> See Form 20-F, Item 5.
- <sup>27</sup> See *Final Rule: Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, Release No. 33-8182 (January 28, 2003).
- <sup>28</sup> See *Other Orders and Notices: Commission Statement about Management’s Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8056 (January 22, 2002).
- <sup>29</sup> See *Proposed Rule: Disclosure in Management’s Discussion and Analysis about the Application of Critical Accounting Policies*, Release No. 33-8098 (May 10, 2002); see also *Other Orders and Notices: Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, Release No. 33-8040 (December 12, 2001).
- <sup>30</sup> See *Interpretive Release: Commission Guidance on Presentation of Liquidity and Capital Resources Disclosure in Management’s Discussion and Analysis*, Release No. 33-0144 (September 17, 2010).
- <sup>31</sup> See *Interpretive Release: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8350 (December 19, 2003).
- <sup>32</sup> See Form F-1, Item 4(b); see also Form F-3, Item 5(b)(1)(i).
- <sup>33</sup> See S-X Rule 11-01(d). The question whether an acquisition is of a “business” should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity’s operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business. However, a lesser component of an entity may also constitute a business. Among the facts and circumstances to consider in evaluating whether an acquisition of a lesser component of an entity constitutes a business are:
- whether the nature of the revenue-producing activity of the component will remain generally the same as before the transaction; or
  - whether any of the following attributes remain with the component after the transaction: (i) physical facilities, (ii) employee base, (iii) market distribution system, (iv) sales force, (v) customer base, (vi) operating rights, (vii) production techniques, or (viii) trade names.
- See *id.*
- <sup>34</sup> However, a different conclusion may be reached depending upon the customary practice for an industry or a particular issuer. For example, an issuer may be submitting a letter of intent as one of many parties in a bidding process, or a roll-up entity may routinely sign letters of intent to further its due diligence investigations of multiple potential targets, but with the acquisition of only a minority of those companies becoming probable.
- <sup>35</sup> See *Financial Reporting Manual*, Section 2005.4.
- <sup>36</sup> By “pre-tax income,” we mean the income from continuing operations before income taxes. See S-X Rule 1-02(w)(3). If the acquired business had a net loss, then the absolute value of the negative amount is generally used for the test. See *Financial Reporting Manual*, Section 2015.9.
- <sup>37</sup> See S-X Rule 3-05(a)(3) (governing whether businesses are “related”); Rule 11-01(d) (governing whether an acquisition involves a “business”).
- <sup>38</sup> See S-X Rule 3-05(b)(2)(ii).
- <sup>39</sup> See *id.* at Rule 3-05(b)(2)(iii).
- <sup>40</sup> See S-X Rule 3-05(b)(2)(iv) (50% test); S-X Rule 3-05(b)(1) (registration of securities to be offered to security holders of acquired business); *The Center for Audit Quality SEC Regulations Committee Highlights* (March 19, 2013) (an EGC may include only two years of financial statements of the Rule 3-05 acquiree, even in situations where an EGC voluntarily provides a third year of financial statements).

- <sup>41</sup> See S-X Rule 3-05(a)(1) (financial statements of acquired businesses must be prepared and audited in accordance with S-X).
- <sup>42</sup> Although the staleness date for an acquired company's financial statements is determined based on the status of the acquired company (e.g., as an accelerated or non-accelerated filer), an interesting wrinkle may emerge where the acquiring company is on a faster track than the acquired company. In that fact pattern, the separate requirement to include pro forma financial information under Article 11 of Regulation S-X can effectively accelerate the need for the acquired company's financial information. The acquiring company will need to produce financial statements for the acquired business if the acquiring company wants to go to market with "last twelve months" pro forma financials after the date on which its own year-end financials are due but before the due date for the acquired company's financials.
- <sup>43</sup> See S-X Rule 3-05(b)(4)(i). The date of an offering will be deemed to be the date of the final prospectus or prospectus supplement filed pursuant to Rule 424(b). See *id.* By analogy, the pricing date would be the date of an offering in a Rule 144A transaction.
- <sup>44</sup> See S-X Rule 3-05(b)(4)(iii).
- <sup>45</sup> See *id.* In certain situations the SEC Staff will apply a 70% significance test. See *Financial Reporting Manual*, Section 2040.2.
- <sup>46</sup> See S-X Rule 3-06.
- <sup>47</sup> Securities Act Rule 408 states that, "In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."
- <sup>48</sup> See S-X Rule 11-01(a)(1) (noting pro forma financial information required for a "significant" business acquisition); see S-X Rule 11-01(b)(1) (noting a "significant" acquisition means an acquisition above the 20% significance level); see S-X Rule 11-01(c) (no pro forma financial information is needed if separate financial statements of the acquired business not included).
- <sup>49</sup> See S-X Rule 11-02(b)(1).
- <sup>50</sup> See S-X Rule 11-02(c)(1). The pro forma condensed balance sheet should be prepared as if the transaction had occurred on the date of the latest historical balance sheet. See S-X Rule 11-02(b)(6).
- <sup>51</sup> See S-X Rule 11-02(b)(1).
- <sup>52</sup> See S-X Rule 11-02(c)(2)(i). The pro forma condensed statements of comprehensive income should be prepared as if the transaction had taken place at the beginning of the latest fiscal year included in the filing. See S-X Rule 11-02(b)(6).
- <sup>53</sup> See generally S-X Rule 11-02.
- <sup>54</sup> See S-X Rule 11-02(b)(6).
- <sup>55</sup> See S-X Rule 11-02(c)(3).
- <sup>56</sup> See *id.* This updating could be accomplished by adding subsequent interim period results to the most recent fiscal year-end information and deducting the comparable preceding year interim period results. See *id.* Another common approach is to use the acquired company's most recent quarterly information.
- <sup>57</sup> See generally S-K Item 801.
- <sup>58</sup> On October 31, 2018, the SEC adopted amendments to modernize property disclosure requirements for mining registrants, including foreign private issuers. The final rules provide a two-year transition period so that a registrant will not be required to begin to comply with the new rules until its first fiscal year beginning on or after January 1, 2021. However, registrants may voluntarily comply with the new rules earlier.
- The changes align the SEC's rules more closely with global standards, as embodied by the Committee for Reserves International Reporting Standards. When fully effective, the rules will rescind Industry Guide 7 and remove Item 4.D of Form 20-F. Most of the disclosure requirements for registrants with material mining operations, including foreign private issuers, will be consolidated in new subpart 1300 of Regulation S-K. See *Final Rule: Modernization of Property Disclosures for Mining Registrants*, Release No. 33-10570 (Oct. 31, 2018).
- <sup>59</sup> See *Interpretive Release: Modernization of Oil and Gas Reporting*, Release No. 33-8995 (December 31, 2008).

## LIABILITY UNDER THE US FEDERAL SECURITIES LAWS FOR GLOBAL IPOs

Foreign private issuers who access the US capital markets are exposed to liability under the federal securities laws in a variety of ways. This liability can be civil or, in certain circumstances, criminal. Although litigation by private plaintiffs is more common, the SEC frequently initiates civil enforcement actions against issuers and persons associated with them. In cases involving serious securities fraud, the US Department of Justice (DOJ) sometimes brings criminal proceedings, often in parallel with an SEC civil action.

We summarize below the key areas of federal securities law liability relevant to global IPOs.

### Registration – Section 5 of the Securities Act

Section 5 of the Securities Act effectively requires every offer and sale of securities to be either registered with the SEC or made pursuant to an available exemption from registration. The terms “offer” and “sale” in the Securities Act are broadly construed. For example, an offer includes any attempt to dispose of a security for value.<sup>1</sup> As a result, publicity in the United States about an impending offering, website disclosure of the offering, or even an email communication to “friends and family” announcing an offering can constitute an unregistered offer in violation of Section 5.

Violations of Section 5 can give rise to liability in SEC enforcement actions and also in actions brought by investors under Section 12(a)(1) of the Securities Act, as discussed below. They can also lead to the delay (or even abandonment) of a securities offering if the SEC imposes a cooling-off period. As a result of these onerous remedies, it is critical to control publicity and comply carefully with the requirements for any applicable exemptions from Section 5 registration.

Under Section 12(a)(1), an investor who buys securities issued in transactions violating Section 5 can rescind the sale and recover his or her purchase price (plus interest, less any amount received on the securities). If the investor no longer owns the securities, he or she can recover damages equal to the difference between the purchase and the sale price of the securities (again, plus interest, less any amount received on the securities).<sup>2</sup>

Section 12(a)(1) imposes strict liability, and an investor is not required to demonstrate any causal link between his or her damages and the violation of Section 5.<sup>3</sup> However, in order to be liable, a defendant must be a seller – that is, a person who successfully solicits the purchase, motivated at least in part by financial interest – and the plaintiff must actually have bought the securities from that defendant.<sup>4</sup>

### Antifraud

As a general matter, there is no duty under the US federal securities laws to disclose material information unless an applicable rule or regulation specifically requires disclosure.<sup>5</sup> An issuer’s duty to disclose may arise in situations such as purchasing or selling securities.

Once an issuer chooses to disclose information to investors or the public, it must do so completely and accurately.<sup>6</sup> If a statement is believed by the issuer to be true when made, but the issuer subsequently learns that it was not true, the issuer generally has a duty to correct that statement.<sup>7</sup> If, on the other hand, a statement by an issuer was reasonable when made but it becomes misleading in light of subsequent events, the issuer might or might not have a “duty to update” the statement, depending on a number of factors.<sup>8</sup> This is one reason why projections of future results require careful thought.

### What Is “Material”?

The various antifraud provisions of the Securities Act and the Exchange Act impose liability for material misstatements or omissions in the offer or sale, or in connection with the purchase or sale, of securities.

The fundamental test for “materiality” is whether there is a substantial likelihood that a reasonable investor would consider the misstatement or omission important in deciding whether or not to purchase or sell a security.<sup>9</sup> As the US Supreme Court has explained, “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”<sup>10</sup>

The determination of materiality is a mixed question of law and fact,<sup>11</sup> and there is no bright-line quantitative test for materiality.<sup>12</sup> In adopting Regulation FD, for example, the SEC indicated that the following subjects should be carefully reviewed to determine whether they are material:<sup>13</sup>

- earnings information;
- mergers, acquisitions, tender offers, joint ventures, or changes in assets;
- new products or discoveries, or developments regarding customers or suppliers (for example, the acquisition or loss of a contract);
- changes in control or in management;
- change in auditors or auditor notification that the issuer may no longer rely on an auditor’s audit report;
- events regarding the issuer’s securities – for example, defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits, or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and
- bankruptcies or receiverships.

In addition, in *Staff Accounting Bulletin No. 99*, the SEC Staff pointed to several qualitative factors that may need to be considered in assessing materiality and that could render a quantitatively minor misstatement material, including whether the misstatement:

- arises from an item capable of precise measurement from an estimate and, if so, the degree of imprecision inherent in the estimate;
- masks a change in earnings or other trends;
- hides a failure to meet analysts’ consensus expectations;
- changes a loss into income or vice versa;
- concerns a segment or other portion of the issuer’s business that has been identified as playing a significant role in the issuer’s operations or profitability;
- affects the issuer’s compliance with regulatory requirements;
- affects the issuer’s compliance with loan covenants or other contractual requirements;
- has the effect of increasing management’s compensation – for example, by satisfying requirements for the award of bonuses or other forms of incentive compensation; or
- involves concealment of an unlawful transaction.

### **Fraud in Connection With the Purchase or Sale of Securities – Rule 10b-5**

Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 provide a broad (and heavily litigated) basis for both civil and criminal liability in securities transactions. Such claims can be brought by parties to the transaction as well as by the SEC, the DOJ, and investors who were effecting transactions in the subject securities during the period of improper disclosure. Rule 10b-5 prohibits, in connection with the purchase or sale of securities:

- employing “any device, scheme, or artifice to defraud;”



- making “any untrue statement of material fact” or omitting “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
- engaging in any “act, practice, or course of business which operates or would operate as a fraud or deceit.”

### **Elements of a Claim Under Rule 10b-5**

The elements of a claim under Rule 10b-5 by a private plaintiff are:

- a misrepresentation or omission of a material fact;<sup>14</sup>
- made with *scienter* – that is, either intent to deceive, manipulate, or defraud,<sup>15</sup> or recklessness (beyond mere negligence);<sup>16</sup>
- in connection with the purchase or sale of a security;
- upon which the plaintiff relied; and
- which caused the injury.

In government enforcement actions under Rule 10b-5, only the first three elements apply.

The requirement that the alleged fraud must have been “in connection with” the purchase or sale of securities is flexibly construed to effectuate the remedial purposes of the Exchange Act, particularly when the SEC is the plaintiff.<sup>17</sup> A private plaintiff, by contrast, must show that he or she actually purchased or sold stock,<sup>18</sup> and cannot succeed on a claim that he or she would have sold had the truth been known; but Rule 10b-5 does not require privity between the defendant and the plaintiff,<sup>19</sup> and accordingly a plaintiff need not show that he or she actually bought securities from the person who made the misleading statements.

### **Scope of Rule 10b-5**

Rule 10b-5 covers oral and written statements, whether or not relating to a disclosure document.<sup>20</sup> These would potentially include statements made during a press conference or an interview, or in a press release. In addition, while an issuer is generally not liable for the statements of others, there may be exceptions. For example, the issuer could be liable for misstatements in an analyst’s report if a corporate insider participates sufficiently in the preparation of the report or circulates the report to prospective investors.<sup>21</sup>

### **Insider Trading**

Insider trading is also prosecuted under Rule 10b-5, civilly by the SEC and criminally by the DOJ. As interpreted by the SEC and the US federal courts, Rule 10b-5 prohibits a person from buying or selling securities on the basis of material nonpublic information, or providing such information to another person who trades, in violation of a fiduciary duty or similar duty of trust and confidence.<sup>22</sup> Rule 10b-5 imposes an obligation to either disclose material nonpublic information or abstain from trading on:

- corporate insiders, such as directors, officers, and controlling shareholders, who owe a fiduciary duty to the issuer’s shareholders;<sup>23</sup>
- temporary insiders, such as lawyers, accountants, or investment bankers;<sup>24</sup> and
- outsiders who “misappropriate” material nonpublic information for trading purposes in breach of a duty owed to the source of the information.<sup>25</sup>

## PRACTICE POINT

Bear in mind that a person can be liable under Rule 10b-5 even if he or she did not actually trade on the material nonpublic information, but instead passed it directly or indirectly to a third party – a practice known as “tipping” – to get some “personal benefit.”<sup>26</sup> The personal benefit could be pecuniary gain (such as a kickback or a “reputational benefit that will translate into future earnings”) or even the benefit one gets from making “a gift of confidential information to a trading relative or friend.”<sup>27</sup> In addition to the tipper, the “tippee” (the person to whom the information is disclosed) may also be liable under Rule 10b-5 if he or she trades on the basis of the tipped information and had reason to know the information came from a person who violated a duty of trust and confidence.<sup>28</sup>

### **Damages Under Rule 10b-5**

In private actions, violations of Rule 10b-5 can lead to rescission or damages.<sup>29</sup> Damages comprise a purchaser's out-of-pocket loss, essentially limited to the difference between the purchase or sale price the plaintiff paid or received and the mean trading price of the security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market.<sup>30</sup> Punitive damages are, however, not available in private actions under Rule 10b-5.<sup>31</sup>

In civil or administrative actions, the SEC can obtain money penalties, disgorgement, and injunctions or cease-and-desist orders. In criminal prosecutions, the DOJ can obtain penalties that include imprisonment, fines, and disgorgement.

### **Controlling Person Liability**

Liability under the US federal securities laws potentially extends beyond issuers, underwriters, and other direct participants in securities offerings to the persons who control those participants. In particular, Section 15 of the Securities Act and Section 20 of the Exchange Act provide that controlling persons may be jointly and severally liable with the persons they control. As a result, an issuer's significant shareholders, its board of directors, and members of its management may be liable along with the issuer for violations of Rule 10b-5.

The term “control” generally means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.<sup>32</sup> This is not a bright-line test, and instead depends on the facts and circumstances of any particular case. A defendant generally will be found to have controlled an issuer if he or she actually participated in (that is, exercised control over) the operations of the issuer and possessed the power to control the specific transaction or activity from which the issuer's primary liability derives.<sup>33</sup> Some courts have held that the defendant must be a “culpable participant” in the issuer's wrongful conduct in order to trigger liability.<sup>34</sup>

The controlling person has a defense to liability under Section 15 if he or she “had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist,” and a defense under Section 20 if he or she “acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.” This analysis is obviously quite fact specific<sup>35</sup> and may depend on such factors as whether the defendant is an independent director.



## PRACTICE POINT

Potential controlling persons such as controlling shareholders and members of an issuer's board of directors should familiarize themselves generally with the disclosure used in connection with an offering and should pay particular attention to any high-level statements about an issuer's strategy, business, or financial performance. They should also review carefully any statements about themselves (for example, disclosure about a controlling shareholder).

### Enforcement

The SEC prosecutes civil violations of the US federal securities laws.<sup>36</sup> It has wide-ranging powers to investigate any conduct that could constitute a violation of those laws.<sup>37</sup> SEC investigations are conducted by the Division of Enforcement, which reports to the five members appointed by the President of the United States who constitute the Commission itself. If, after investigating, the Division of Enforcement believes it has found a violation, it typically recommends to the Commission that enforcement action be taken. The Commission then decides by majority vote whether to take action or not and what action to take. Charges may be brought administratively within the SEC or in a US federal district court. In either venue, the preponderance-of-the-evidence standard of proof applies, meaning that the finder of fact needs only to find that it is more likely than not that the Division of Enforcement has proved the elements of the offense. The proof need not be "clear and convincing" or "beyond a reasonable doubt" (the latter being the standard of proof in criminal cases).<sup>38</sup> An adverse decision in an SEC administrative or civil trial can be appealed to a US federal appellate court, and some appeals are eventually heard by the US Supreme Court.

While the SEC has civil enforcement authority only, Section 24 of the Securities Act and Section 32(a) of the Exchange Act make it a federal crime for any person to willfully violate any provision of those acts or a rule promulgated under the acts. "Willfully" is not defined uniformly by all US federal courts, but in most courts it means that the defendant knew his conduct was wrongful but did not necessarily know it was unlawful (whereas in the SEC civil context "willfully" simply means that the actor was conscious of taking the action and not sleepwalking or the like). Consequently, the SEC works closely with criminal law enforcement agencies throughout the US to develop and bring criminal cases when the misconduct warrants more severe action and can be proved beyond a reasonable doubt.

Criminal penalties under the federal securities laws can be severe. Under Securities Act Section 24, conviction for each violation can result in a fine of up to \$10,000 and/or imprisonment for up to five years. Under Exchange Act Section 32, for individuals, conviction can result in a fine of up to \$5 million and/or imprisonment for up to 20 years per violation; however, no one can be imprisoned for violating an Exchange Act rule or regulation if he or she proves that he or she had no knowledge of the rule or regulation. Fines against entities can reach \$25 million per violation.

## ENDNOTES

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- <sup>1</sup> Securities Act Section 2(a)(3).
- <sup>2</sup> David M. Brodsky & Daniel J. Kramer, *Federal Securities Litigation*, pp. 4-16 to 4-17 (1st ed. 1997) (*Federal Securities Litigation*).
- <sup>3</sup> *Id.*, pp. 4-2 to 4-3.
- <sup>4</sup> *Id.*, p. 5-20 (citing *Pinter v. Dahl*, 486 U.S. 622, 641-54 (1988)).
- <sup>5</sup> *Federal Securities Litigation*, p. 6-4.
- <sup>6</sup> *Id.*, pp. 6-4 to 6-5.
- <sup>7</sup> See, e.g., *Stansky v. Cummins Engine Co., Inc.*, 51 F.3d 1329 (7th Cir. 1995) (distinguishing duty to correct from duty to update).
- <sup>8</sup> See, e.g., *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410 (3d Cir. 1997).
- <sup>9</sup> See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); see also Securities Act Rule 405 (“material” information is “matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered”). *TSC* involved the interpretation of Section 14(a) of the Exchange Act and Rule 14a-9. The Supreme Court has, however, explicitly extended *TSC*’s definition of materiality to Rule 10b-5, *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988), and the lower US federal courts have generally used the *TSC* standard in all contexts involving the antifraud provisions of the US federal securities laws. See Louis Loss, Joel Seligman & Troy Paredes, *Securities Regulation*, Chapter 6.C.5 (Registration and Post Registration Provisions of the 1934 Act; Proxies, False or Misleading Statements (Rule 14a-9)), (5th ed. 2014) (*Loss, Seligman & Paredes*).
- <sup>10</sup> *TSC Indus., Inc.*, 426 U.S. 438, 449.
- <sup>11</sup> *Id.*, p. 450.
- <sup>12</sup> See Staff Accounting Bulletin 99.
- <sup>13</sup> *Selective Disclosure and Insider Trading*, Release No. 33-7881, n.47 (August 15, 2000) (*Regulation FD Release*).
- <sup>14</sup> In the case of an omission, a plaintiff must show that there was a duty to disclose the material facts; merely being in possession of material nonpublic information does not, of itself, create a duty to disclose. *Federal Securities Litigation*, p. 6-4.
- <sup>15</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).
- <sup>16</sup> *Federal Securities Litigation*, pp. 6-13 to 6-14.
- <sup>17</sup> Cf., e.g., *SEC v. Zandford*, 535 U.S. 813, 822 (2002).
- <sup>18</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975).
- <sup>19</sup> *Loss, Seligman & Paredes*, Chapter 9.B.7 (Fraud; Issuers and Insiders; Scope of Rule 10b-5), n.678.
- <sup>20</sup> See *id.* (explaining that “[t]he Rule may be violated by feeding misinformation into the marketplace, or even withholding information too long,” regardless of whether the defendants themselves bought or sold securities) (citation omitted).
- <sup>21</sup> *Federal Securities Litigation*, pp. 6-30 to 6-31. The SEC has stated that an issuer may be “fully liable” if it disseminates and adopts false third-party reports “even if it had no role whatsoever in the preparation of the report.” *Use of Electronic Media Release*, n.54 (citing *In the Matter of Presstek, Inc.*, Release 34-39472 (December 22, 1997)).
- <sup>22</sup> *Federal Securities Litigation*, p. 6-32.
- <sup>23</sup> *Federal Securities Litigation*, pp. 6-32 to 6-33.
- <sup>24</sup> *Id.*, p. 6-34; see also *Regulation FD Release*, n.28 (referring to a temporary insider as “a person who owes a duty of trust or confidence to the issuer,” such as an attorney, investment banker, or accountant).
- <sup>25</sup> *Id.*, pp. 6-34 to 6-35 (citing *United States v. O’Hagan*, 521 U.S. 642 (1997)). The SEC has added two rules to clarify issues that have arisen in insider trading cases. First, Rule 10b5-1 provides that trading “on the basis of” material nonpublic information includes all trading while in possession of that information, except certain trades previously contracted for in good faith and not as part of a plan or scheme to evade the prohibitions of Rule 10b5-1. Second, Rule 10b5-2 fleshes out the meaning of a “duty of trust or confidence” for purposes of the misappropriation theory.
- <sup>26</sup> *SEC v. Dirks*, 463 U.S. 646 (1983).
- <sup>27</sup> *Id.*; see also *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003) (applying the *Dirks* personal benefit rule to misappropriation case).
- <sup>28</sup> *Federal Securities Litigation*, p. 6-34.
- <sup>29</sup> *Id.*, p. 6-42.
- <sup>30</sup> Exchange Act Section 21D(e)(1); see also Exchange Act Sections 21(d)(3) (providing for money penalties in SEC civil actions) and 32(a) (providing for criminal penalties for willful violations of the Exchange Act); *Federal Securities Litigation*, pp. 6-43 to 6-45 (discussing damages under Exchange Act Section 10(b)).
- <sup>31</sup> *Federal Securities Litigation*, p. 6-42; see also Exchange Act Section 28(a) (limiting recovery for damages in actions under the Exchange Act to actual damages).

<sup>32</sup> Securities Act Rule 405; *see also* Exchange Act Rule 12b-2.

<sup>33</sup> *Federal Securities Litigation*, p. 11-5.

<sup>34</sup> *Id.*, pp. 11-5 to 11-7.

<sup>35</sup> *See generally id.*, pp. 11-7 to 11-10 (discussing the defense).

<sup>36</sup> For a comprehensive discussion of SEC Enforcement practice, *see*, for example, *The Securities Enforcement Manual: Tactics and Strategies* (Richard M. Phillips, ed. 1997); William R. McLucas, J. Lynn Taylor & Susan A. Mathews, *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 Temp. L. Rev. 53 (1997).

<sup>37</sup> *See SEC v. Murphy*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,688 (C.D. Cal. 1983).

<sup>38</sup> *Steadman v. SEC*, 450 U.S. 91 (1981).

## LEGAL MATTERS

A cast of outstanding lawyers too numerous to name have passed upon the contents of this Global IPO Guide on behalf of Latham & Watkins LLP.

### WHERE YOU CAN FIND MORE INFORMATION

We maintain extensive thought leadership resources on our website at <http://www.lw.com/thoughtleadership> and at our capital markets online reference library, [www.wowlw.com](http://www.wowlw.com). We list below some materials that you may find useful for your global IPO.

- [\*The Latham FPI Guide: Accessing the US Capital Markets from Outside the United States\*](#) (2018)
- [\*Guide to Financial Statement Requirements in US Securities Offerings by Non-US Issuers\*](#) (2019)
- [\*Defining Foreign Private Issuers: Are You a Wizard or a Muggle?\*](#) (2018)
- [\*The JOBS Act, Two Years Later: an Updated Look at the IPO Landscape\*](#) (2014)
- [\*The Last Days of Disco Ops\*](#) (2014)
- [\*The Good, the Bad, and the Offer: Law, Lore, and FAQs\*](#) (2014)
- [\*"You Talkin' to Me?" FAQs About the SEC's New General Solicitation, Regulation D, and "Bad Actor" Rules\*](#) (2013)
- [\*The JOBS Act After One Year: A Review of the New IPO Playbook\*](#) (2013)
- [\*Giving Good Guidance: What Every Public Company Should Know\*](#) (2012)
- [\*The JOBS Act, Part Deux: Frequently Asked Questions About Title II of the JOBS Act\*](#) (2012)
- [\*The JOBS Act After Two Weeks: The 50 Most Frequently Asked Questions\*](#) (2012)
- [\*The JOBS Act Establishes IPO On-Ramp\*](#) (2012)
- [\*Recent Developments In Recent Developments — Using "Flash" Numbers in Securities Offerings\*](#) (2011)
- [\*Cheap Stock: An IPO Survival Guide\*](#) (2010)
- [\*Adjusted EBITDA is Out of the Shadows as Staff Updates Non-GAAP Interpretations\*](#) (2010)

## REPORT OF NON-INDEPENDENT EDITORS

The Readers of the Latham & Watkins Global IPO Guide:

We have edited the accompanying Global IPO Guide as of March 31, 2019. The Global IPO Guide reflects the accumulated wisdom of the lawyers at Latham & Watkins LLP. Our responsibility is to express an opinion on the Global IPO Guide based on our role as non-independent editors.

We conducted our edits in accordance with our standards for top-quality thought leadership. Those standards require lively, plain-English explanations to demystify complicated concepts. They strive for the highest possible level of technical accuracy with the least amount of mind-numbing gobbledeygook.

In our opinion, the Global IPO Guide is properly drawn up in accordance with the standards set above and gives a true and fair view, in all material respects, of what you need to know to plan and execute a successful global IPO.

/s/ Cohen, Dudek & Trotter, LLC

Washington, DC and New York, NY  
March 31, 2019

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Latham & Watkins is a global powerhouse in both the debt and equity capital markets. With more than 450 capital markets lawyers located in offices in the world's major financial, business and regulatory centers, we advise on the market's largest and most complex securities offerings. Latham unites the resources of a truly international firm with an on-the-ground understanding of local markets and deep industry and product expertise in order to provide our clients with unparalleled service and commercial advice.

Latham is among a select group of leading IPO law firms in the United States – having been the market leader in every year since 2010. Our lawyers have extensive experience navigating the US securities regulatory landscape, which includes the US securities laws, SEC rules and regulations (including financial reporting requirements), stock exchange rules, and the rules of various self-regulatory organizations. In addition to our expertise advising US issuers and their investment banks, we routinely advise clients on securities offerings by non-US issuers in Europe, Asia, Latin America, and the Middle East. In many of these transactions, the issuer's securities are sold in concurrent offerings in the United States.

We take pride in our efforts to explain and demystify complex legal issues in the capital markets in a lively, plain-English manner. You can find our industry-leading thought leadership pieces on our website, [www.lw.com](http://www.lw.com), and on our Words of Wisdom online reference library, [www.wowlw.com](http://www.wowlw.com). For a glossary of more than 1,200 terms used in capital-raising transactions, visit the iTunes App store to download two of our most popular apps: The Book of Jargon™ — US Corporate and Bank Finance and The Book of Jargon™ — European Capital Markets and Bank Finance.

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